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ESG: A challenge to the Private Equity industry

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By Leigh Webb, Head of Private Equity Sponsor Coverage

One of the most fundamental differences between public and private companies lies in disclosure. In public markets there is no place to hide, with companies operating under the steely glare of investors, regulators, auditors, ratings agencies, analysts and essentially a higher standard of reporting requirements. Conversely, in the world of PE, companies can operate to a large extent under the radar. Private companies have traditionally remained private and not reported non-financial performance. However, this is changing fast. They are taking investor money from funds which are now placing great emphasis on ESG matters.

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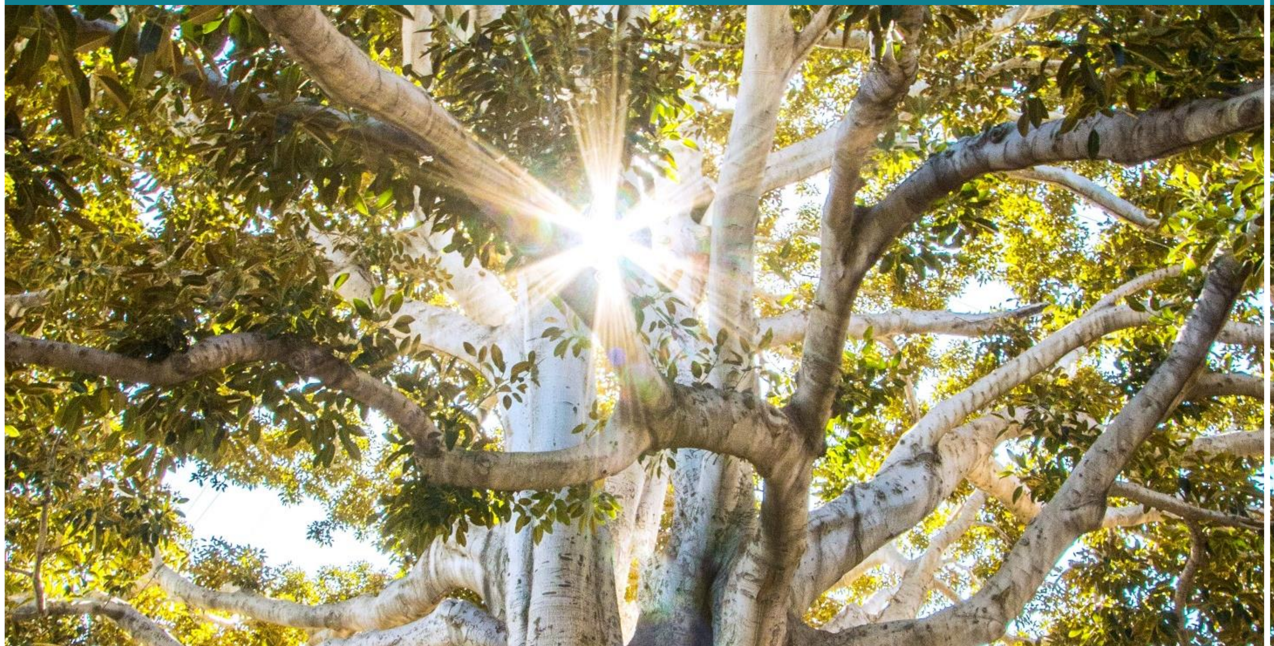

ESG: a challenge to the private equity industry

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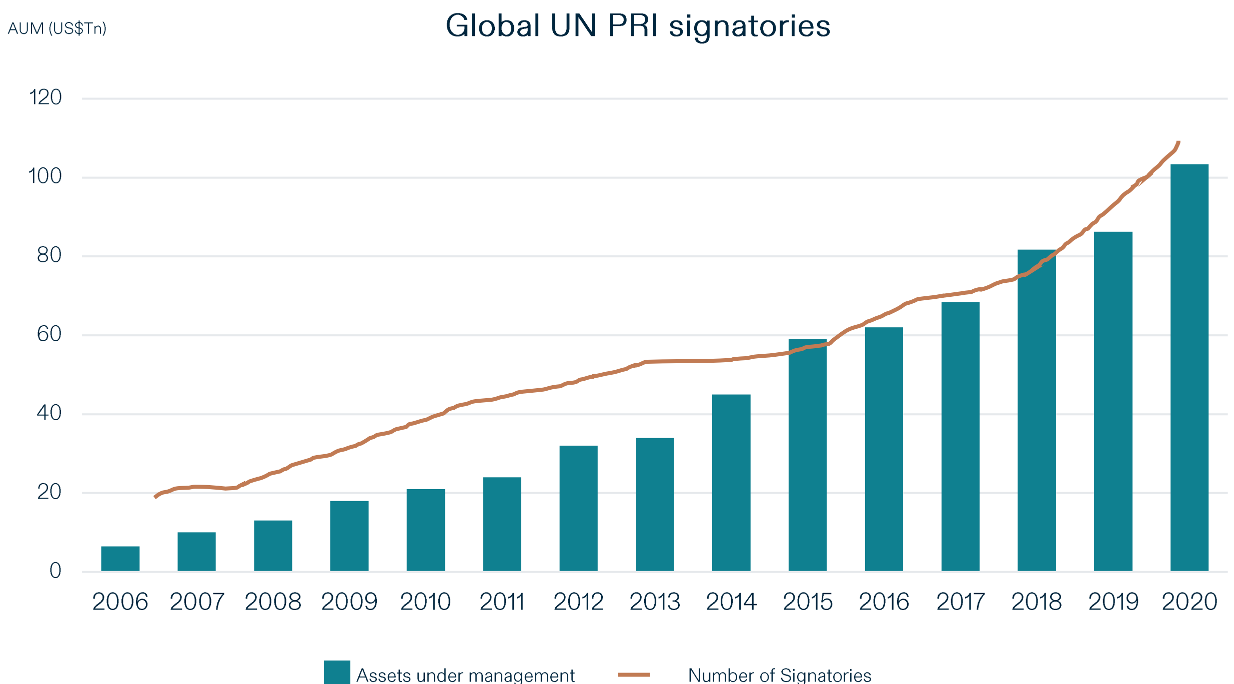
Regardless of whether those funds are ESG evangelists or ESG sceptics, they are themselves now obliged to report on how they incorporate ESG into their investment decision-making process, driven by either United Nations Principles of Responsible Investment (UN PRI), Sustainable Accounting Standards Board (SASB), Task Force on Climate-related Financial Disclosures (TCFD) or most recently Sustainable Finance Disclosure Regulation (SFDR). All global funds now expect greater transparency from their portfolio companies, including those owned by private equity.

Long-only investors like Blackrock, M&G and Schroders are at the vanguard. Currently PE firms are in their slipstream and in danger of being left behind.

PE managers must look beyond short-term returns; they have to look at the long-term sustainability of the companies they invest in. Whilst there is not necessarily an expectation on PE-owned companies to have perfect ESG credentials, there needs to be an enthusiastic acceptance of the need to embrace and engage all aspects of it and demonstrate a roadmap with clearly defined milestones and KPIs.

Some progressive PE companies are leading the way. TPG for example has adopted ESG principles both internally and within its portfolios with much fanfare and has launched several impact funds. The firm also recently announced the appointment of former US Treasury Secretary Hank Paulson as executive chairman of TPG Rise Climate, a fund specifically focused on climate-related investments.



Palatine Impact Fund is another honourable exception.

"Palatine has developed a market leading ESG framework and processes over the course of the last 10 years which is built into the DNA of our business and the way the we add value to our investments. We work with our investments to identify ESG opportunities and then drive, resource, monitor and report on them as rigorously as any other key part of the business plan. Our ESG framework has consistently shown that prioritising ESG initiatives is not only the right thing to do but it also increases profits and value. These businesses become more sustainable, resilient and successful.

Our Impact fund is a natural extension from the ESG focus at Palatine. Addressing environmental and societal challenges is increasingly a priority for individuals, organisations and businesses so impactful businesses are thriving. Business founders and management want to find investors who share their priorities and there is a big pull from investors wanting their money to be used for positive purposes but they also want their investments to grow. Our Impact fund is differentiated because it focusses on returns and purpose. We look for businesses that have a quantifiable positive impact and are great, scalable businesses where we can work with them to help grow both their positive impact and their scale"

Tristan Craddock, Palatine Impact

Why is responsible investing important?

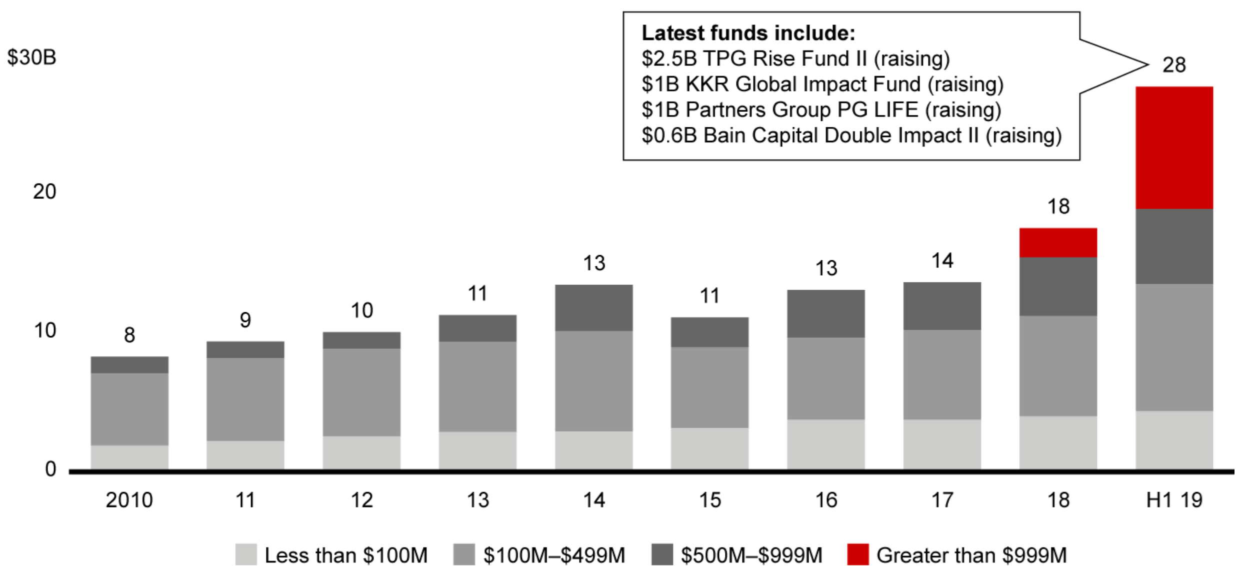
Customers want the custodians of their pension funds and investments to care about their finances, but they also increasingly care about how and where their money is invested. Fund managers therefore study both financial and ESG factors that could affect an investment and then engage with companies to foster sustainable behaviours, and so serving the financial needs and expectations of customers and investors.

By investing responsibly, fund managers create better outcomes for customers and investors, foster a sustainable mindset in the companies they invest in and help to finance a more sustainable economy for everyone.

Stakeholders of all kinds, including consumers, employees, limited partners, bankers and regulators, want companies to be more sustainable, socially conscious and well governed.

The PE firms that are doing this well, like TPG, not only consider sustainability as an important factor during due diligence but it also remains part of their long-term relationship post investment. They work closely with their portfolio companies to identify areas for improvement and value creation across areas such as energy consumption, waste reduction and water efficiency. They also provide input on developing revenue-enhancing opportunities such as creating more sustainable products and services, as well as broad stakeholder engagement with suppliers and potentially NGOs, for example.

The UNPRI is an initiative to promote responsible investment amongst all asset classes, including private equity and is rapidly becoming mainstream. However, although the signatory list includes 431 PE firms from around the world, only 16 of them disclose ESG's impact on financial returns, according to Institutional Investor, and only half use ESG principles in monitoring more than 90% of their portfolio companies.



Notes: Data as of December 2019; includes private equity and venture capital funds classified as "socially responsible" or "environmentally responsible" by Preqin; total AUM calculated as sum of AUM for all funds launched in the past seven years (i.e., lifetime of each fund assumed to be seven years)
Sources: Preqin; Bain analysis

So, surely everyone in their right mind agrees this is the right direction of travel. What's not to like?

Firstly, tick-boxing and tokenism.

The term 'greenwashing' has been coined for giving the illusion of doing something about environmental issues - words but not necessarily actions.

Diversity & Inclusion (D&I) is a case in point. Women on boards and the gender pay gap, for example, has been a talking point for years. But most advocates want to see a levelling out based on meritocracy not just being seen to do the right thing, in other words by providing equal opportunities and stamping out discrimination.

SFDR, a new legislation stemming from the EU Action Plan for a greener economy, requires all asset managers domiciled in Europe or marketing to European customers to classify all their investment products into one of three categories ('grey', 'light green' and 'dark green') on the basis of sustainability. It came into effect this March 2021 and will inevitably affect UK PE funds as well with the aim of redirecting capital flows towards more sustainable investments, incorporate sustainability into risk management, and foster transparency and long-term vision in financial and economic activity.

And then the next stumbling block is returns: the lack of evidence linking ESG to returns. Until there is consistent data establishing a positive link between ESG investing and financial returns, there will always be scepticism amongst private equity investors.

PE firms face a unique mandate to produce substantial returns quickly

But how exactly does a strong ESG proposition lead to financial returns? According to McKinsey, ESG links to cash flow in five ways: 1) facilitating top-line growth, 2) reducing costs, 3) minimising regulatory and legal interventions, 4) increasing employee productivity, and 5) optimising investment and capital expenditures. Some will apply more than others for various industries and in different geographies but each of these five levers should be part of a board's checklist when approaching ESG opportunities.

If we accept long-term returns will accrue if companies adopt ESG policies, is there a hit to the P&L and cashflow in the short-term? And what does this mean for small companies with cash burn who don't have the luxury of a long-term view? Many businesses in this camp will not be able to allocate budget towards recruiting independent directors or ethically sourced materials for example. Surely businesses on wafer-thin margins can only generate profits if they outsource manufacturing where labour is cheaper, some will say.

The answer is not straightforward. Improving one's ESG need not always come at a price. Companies need to apply proportionality but at the same time take it seriously and consider the downside risks, such as exclusion from funds, risk of employee whistle-blowers, media scrutiny, etc. It doesn't cost much to ensure thorough due diligence of one's supply chain to ensure ethical working practices are in place but a failure to identify red flags could result in reputational damage and, ultimately, business collapse. The idea that sustainability comes as a trade-off is often a self-fulfilling prophecy. Companies that separate their sustainability strategies from their approaches to growth and profitability will find it costs more. Instead, if you integrate environmental and social considerations into your core decision-making - ask what needs to be done to ensure you can be profitable over the coming decades - sustainability and profitability become mutually enforcing.

McKinsey provides credible rationale for the ESG-returns equation but scepticism around ESG will persist as long as we lack empirical evidence that it pays off. Devising the right measures will take time and consistency of reporting.

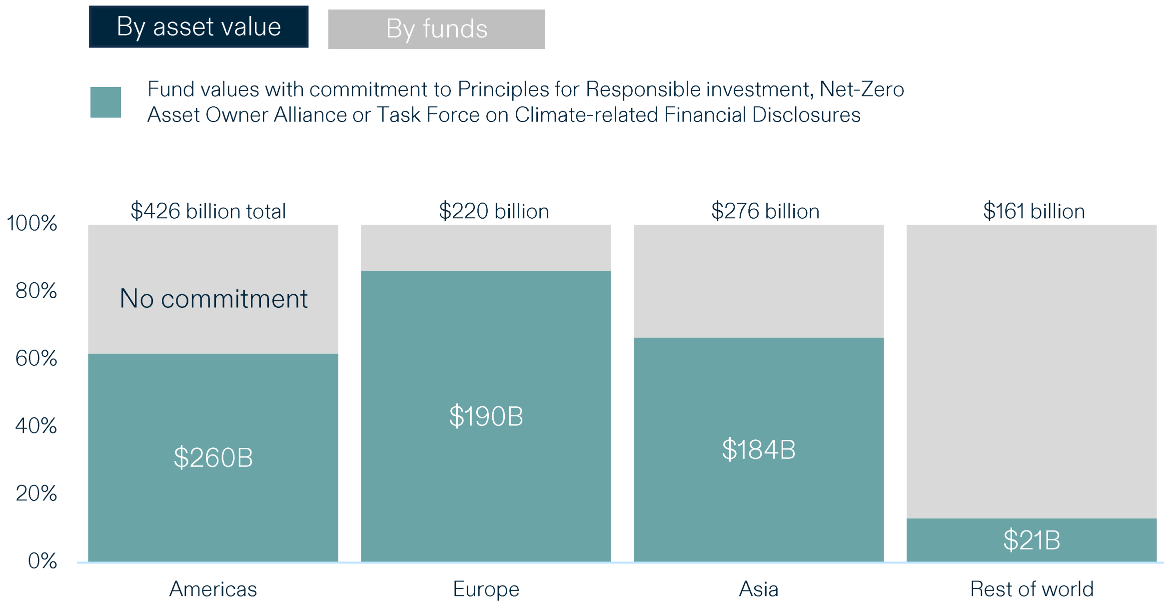
There remains an issue with lack of standardisation in reporting ESG metrics, though PRI and the UN SDG's are a step in the right direction.

In order to enable all those diverse investors to classify their portfolio companies on the basis of sustainability, it is absolutely vital that those companies step up and ramp-up their non-financial disclosure. It is crucial that companies self-assess and report to consistent KPIs. finnCap has developed a simple solution that enables SMEs with limited internal resources and no 'Heads of Sustainability' to do just that. A simple 15 point scorecard which it recommends particularly for smaller companies who are at the start of their ESG journey, against which it can tick off where they comply and where they fall short.

"At WestBridge, we understand the direct link between responsible investing and creating value, therefore our approach to ESG is aligned to our investment objectives. Many larger private equity investors have been incorporating ESG into their investing for the last 5+ years with dedicated teams and pressure from LP's and the media. In the lower mid-market however, with smaller teams and less public scrutiny there hasn't been as much of a focus on ESG outside the impact funds. We are in the business of creating long term value for investors, and so responsible investing and a clear strategy on ESG will generate sustainable growth in our portfolio and help drive returns for investors. This is why we take ESG seriously and incorporate it into all aspects of our investment process."

James MaCleay, Westbridge Capital

Limited partners in Europe lead the world in committing to global standards for responsible and sustainable investment



Notes: Excludes funds of funds; includes all other investors with a known allocation to private equity, Asia excludes Australasia, PE allocation amount for some investors not available. Source: Prequin, accessed June 2020

Conclusion

What's made the PE industry successful in the past is its ability to anticipate future trends of value creation and to adapt accordingly. This is one of those moments. Sensing that broader economic forces are rapidly changing behaviours and attitudes, many firms aren't waiting for ROI studies to be published and rubber-stamped before taking the path of ESG. The tipping point has been reached.

Private equity has always focused on governance risk. There is close to universal acceptance on the environmental side that changes need to be made. And in social policies, tailwinds exist.

The pace of change is like nothing we have seen before.

PE can't afford to be left behind. Public perception of the industry has been knocked many times before with tales of asset-stripping and financial engineering. It can ill-afford further knocks by being seen to put its head in the sand over ESG.

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