Incorporating ESG across investment portfolios may open access to capital
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Introduction

Integrating environmental, social, and governance (ESG) considerations into private equity investment strategies has seemingly become “table stakes,” as these values increasingly become a condition for accessing capital. COVID-19 impacts have further magnified the importance of ESG considerations, emphasizing how companies are prioritizing the health, safety, and wellness of their employees, customers, communities, and supply chains. Investors have doubled down on their expectations around how this current disruption is stress-testing how effectively companies have integrated ESG into the business strategy to drive resilience, adaptability, and long-term sustainability. With the current shift in capital markets and a shrinking public company market, private equity has become a mainstream investment option among large institutional investors. Accordingly, private equity investors (PEIs) need to be considerate of stakeholders’ expectations and transparent about how their investments, structure, and operations drive value in more ways than economic.

Resilience by the numbers

How integrated ESG standards pay off for you.

70% of responsible investment equity funds outperformed peers in Q1 2020¹

90% of studies have reinforced the long-term benefits and relationship between ESG and company financial performance¹

24 out of 26 sustainable index funds outperformed comparable conventional index funds in Q1 2020²

World Economic Forum’s Global Risks Survey 2020³

- COVID-19 has highlighted the significant economic benefit to be obtained from preparation and mitigation⁴
- Climate risk commands the top five; infectious diseases rounds out top 10
As PEIs strive to expand and promote private equity as a key funding option, PEIs need a clear ESG policy and credible message about how ESG serves as a value driver and can position the organization to navigate environmental and societal market trends. This can improve brand image, increase the ability to attract and retain talent that can help them grow, open opportunities to mitigate risk, and improve investment returns. ESG is not just an important factor in raising funds; it is becoming integral to managing the day-to-day operations of investment portfolio companies.

Many more mature PEIs understand this and have long had strategies in place. They have integrated ESG across their firm and an entire portfolio and have taken the opportunity to launch new strategies, such as impact funds. An impact investment strategy is designed to generate positive, measurable social and economic outcomes in addition to financial return. This can improve PEIs’ ability to raise more capital and potentially attract an entirely new base of investors.

Emerging PEIs, on the other hand, may still be trying to understand what ESG is and how to effectively incorporate it into their strategy. Many still take a reactionary approach to ESG, starting with a checklist approach or creating ad hoc strategies for one-off investments. These firms can leverage leading industry practices, such as establishing an enterprise-wide ESG framework that is consistently applied across the portfolio and throughout the investment life cycle. This can enable systematic evaluation of ESG performance information to identify risk exposure, improve efficiency, and drive additional value for the fund.
Incorporate relevant ESG topics

Consideration of ESG in an investment process requires an industry-specific approach, applied consistently. For example, investing in a retailer requires evaluating the risk exposure to such factors as the company’s data security practices and the environmental impact of the products it sells versus an investment in real estate, which would require evaluation of such factors as energy and water management of its buildings.

However, there are cross-cutting themes that affect almost any industry. For example, as the impacts of climate change intensify, the potential physical and economic disruption from a move to a low-carbon economy will likely affect all industries. This makes it critical to incorporate ESG attributes into the financial, legal, regulatory, and operational aspects of the due diligence and management processes. Continually monitoring and understanding exposure to climate risk, as well as the opportunities that a low-carbon economy provides, can minimize disruption and exploit market opportunities.

Considerations for evaluation risk and reputational exposure

When assessing social compliance concerns related to labor and safety practices, the following considerations may be evaluated:

- The target’s social compliance policies and procedures
- The target’s governance structure, including roles and responsibilities for monitoring and mitigating social risks in the operations and the supply chain
- The means by which the target aggregates categories of noncompliance with policies and develops action plans associated with the severity of risk assigned such as social compliance audits
- The mechanisms used by the target to continually understand industry trends and leading practices, the competitive landscape, and approaches to incorporating sensing and market intelligence to inform risk considerations around social compliance

A systematic evaluation focused on relevant ESG topics can enhance the due diligence phase and position PEIs to act on priority opportunities when closing a deal.
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Integrating ESG throughout the investment life cycle

A leading practice is to integrate ESG into the broader investment analysis throughout the investment life cycle. Generally, this can include:

**Strategy.**
Define ESG investment objectives in the context of the core mission, values, and current investment approaches. Establish a mechanism for evaluating portfolio companies for ESG priority topics.

**Investing activities.**
Develop and integrate policies and training on ESG priorities across the portfolio. Establish procedures to evaluate the ESG performance of target companies. Use ESG to inform decisions.

**Ownership and reporting.**
Identify relevant ESG performance metrics and work with investees to implement solutions for data collection, analytics, and reporting. PEIs can leverage existing financial reporting processes and controls to help advance ESG performance measurement and reporting. Establish a disclosure strategy that aligns with the objectives. Develop a reporting cadence to communicate performance of investments at a fund or portfolio company level. Obtain independent third-party assurance on the ESG performance.

**Exit.**
Evaluate the ESG performance to date in the context of expectations and peers. Assess whether the reporting process to communicate results to investors met their needs.
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Understanding the factors that can affect success

It is important for PEIs to understand influencing factors that help determine the success of ESG initiatives. Questions to consider include:

1. How can ESG be integrated into the business strategy to drive more value?

2. What governance structures are currently in place to define ESG priorities and oversee ESG activities?

3. Does the tone at the top support these initiatives, and are they incorporated into the broader investment strategy?

4. How does the PEI identify and monitor the ESG-related risks and opportunities of both its targets and current holdings?

5. What is a PEI’s mechanism for evaluating companies in different industries?

6. How is ESG data sourced, and how does the PEI get comfortable with the reliability of ESG data?

The ESG landscape is evolving rapidly on a global scale, and no industry is immune. PEIs that establish a clear ESG policy and related governance structure to drive systematic implementation across a portfolio and provide credible performance disclosure to limited partners and the public can likely appeal to a broader pool of investors. Targeting companies that proactively address and manage ESG risks and opportunities can position PEIs for greater investment success. As ESG strategies continue to mature, establishing new strategies, such as an impact investment fund, can help drive more intentional performance tied to positive environmental or societal outcomes and serve as a market differentiator.
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Endnotes

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