Private equity and sustainability (SMI)

BRIEFING MATERIAL
Summary

- Private equity is growing strongly – in assets under management, scale, and scope of investments.

- With its strong emphasis on stewardship, private equity is by its nature suited to responsible investment.

- It is recognised that ESG data and reporting for the asset class need to improve, but progress is underway.
Background

- Private equity (PE) has seen unparalleled growth over the past decade, with assets under management (AUM) more than tripling, to reach around $4 tr by the end of 2020 (Figure 1).
  - The largest firms within the class – Blackstone, Carlyle, and KKR – are now, in reality, public companies, each responsible for managing more than $200-600 billion of assets each.
  - Growth of the sector has been spurred by:
    - The post global financial crisis (GFC) low-interest-rate environment, which has encouraged lending and search for yield;
    - Superior returns, which enable investors to meet their required returns targets and balance their portfolios;
    - Many of the investors in Private Equity being pension funds with a strong ESG mandate;
    - Rising stock market valuations;
    - Its attractiveness for high performing talent; and
    - The greater scope and flexibility it offers, relative to publicly listed companies, to rebuild and transform businesses.
  - Within private equity, however, the relative share of traditional buyout funds has declined from around 60% in 2010 to around 40% today, with investors piling into other categories that include ‘growth equity’, ‘venture capital’, and ‘distressed assets’, ‘infrastructure’, ‘real estate’, as well as other ‘opportunistic’ investments.
- Private equity firms also have an increasingly universal reach – not just geographically but also in terms of sectors. The technology sector continues to attract the most attention from PE investors, accounting for nearly one-third of total buyout deal-count in 2020.¹ Other sectors with high investor interest include industrial goods, financial services (especially fintech and payments), and healthcare.

Figure 1: Global private equity assets under management (as of year-end)

Source: Have Classic Buyout Funds Run Their Course? | Bain & Company

- Corporate ownership is also shifting in favour of private companies. While the average company owned by private equity is far smaller than the average publicly-owned firm, private companies with 500-plus employees now outnumber public companies by more than two to one (Figure 2).
Figure 2: The changing landscape of corporate ownership in the US

- Given the increasing scale and scope of private equity, **PE-owned companies have a growing and consequential influence on environmental, social, and governance (ESG) outcomes**.²
  - **ESG is broad and notoriously hard to define.** It is also an evolving concept, encapsulating factors that range from climate change and sustainability, to diversity, human rights, consumer protection, and corporate governance (For more see figure A in endnote).³
  - **Private equity firms wield considerable power in their portfolio companies,** and can play a key role in steering boards to incorporating sustainability in companies’ business strategies.

- To date, **investors have put less pressure on private equity funds than on public funds to adopt ESG programs**. A survey by RBC Global Asset Management found that limited partners (LPs)⁴ are less inclined to build ESG criteria into their portfolio choices for private equity than they are for their public, fixed income, real estate or infrastructure asset classes.⁵
  - Likewise, general partners (GPs) have tended to view ESG as a sideshow – something good to do in addition to a fund’s normal business of buying and shepherding companies.

- **Attitudes are shifting however,** and there is a growing realisation within PE that sustainability issues are not just a ‘nice to have’ but are becoming a **critical element in raising capital, gaining market share, and engaging and retaining employees**.
  - There is a growing trend towards LPs, government pension funds, long term funds and others demanding more climate / ESG data.

- **Private equity investors can address sustainability across a spectrum of ESG commitments**, from mere risk management to fully philanthropic mandates (Figure 3).
In line with the broader industry trend, the amount of capital raised by dedicated impact funds has accelerated. Since 2015, impact PE/VC fund assets raised, or currently being raised, have grown by 154%, to $28 billion (Figure 4).

ESG: Risks and opportunities

- Climate change, but increasingly also societal and governance issues, are some of the most pressing issues of today, creating unprecedented risks but also opportunities for investors across all asset classes. A systematic and informed approach to identifying and managing ESG issues across the portfolio will protect, and can significantly enhance, investment value.
  - There is, of course, some overlap in terms of the risks and opportunities faced by PE investors and the wider investment community; but there are also some more specific challenges as well as upsides that are unique to the PE industry.
The risks

- **Systemic financial sector risk.** Financiers and chief executives are now realising that there are big potential losses that need to be avoided. Former Bank of England Governor Mark Carney, who as Chair of the International Financial Stability Board spearheaded work in the area of climate change, warned in 2015 of a "climate Minsky moment".⁶
  - Central banks globally are becoming increasingly concerned about the potential risks from global warming, and thereby climate change, and are starting to incorporate these considerations into their policies.
- **Physical climate risk.** The costs of ‘physical climate risk’, including acute risks (e.g., extreme weather-related events) and chronic risks (e.g., sea-level rise) are increasingly recognised as set to rise.
  - Globally, it has been estimated that there were 416 natural catastrophe events in 2020, resulting in $268 bn worth of economic damages, 8% above the average annual losses for this century.⁷
  - In the US, the number of billion-dollar weather and climate disasters has increased 7-fold since 1980.⁸
- **Transition risks.** In the process of moving to low-carbon economies there stand to be large changes in the relative fortunes of the ‘winners’ (e.g., renewable energy producers) and the ‘losers’ (e.g., oil and gas sector).
- **Stranded assets.** Many assets will turn out to be worth less than initially expected as a result of changes associated with the energy transition (e.g., oil and gas sector).
  - Moody’s cites research that suggests that, by 2050, Europe’s financial sector will have $5 tr of so-called ‘stranded assets’, with another $3 tr in America, and $1 tr in Japan.⁹
- **Technological risks.** Increasing numbers of established technologies will become obsolete and/or be disrupted by emerging technologies.
- **Regulatory risks.** These are becoming increasingly important to companies and investors as the scope of ESG-related disclosures becomes clearer, and as/when reporting requirements extend to (at least larger) private companies.
- **Reputational risks.** Investors are becoming progressively more aware of the reputational risks of their investments. As one private equity partner put it: "We apply the WSJ-test: we ask ourselves how we would feel if a certain issue or deal made the front page of the Wall Street Journal."¹⁰
- **Litigation risks.** PE firms can be sued for not taking due account of climate change (and/or broader sustainability) information that was available when they made their investments.

The opportunities

- On the flipside, it is increasingly recognised that profits and climate-aware and climate-resilient investing are not mutually exclusive. As the managing partner of CVC (a leading PE company), Jean-Rémy Roussel, said in a recent episode of Bain’s Dry Powder podcast:¹¹
  "It’s not a trade-off, it’s not a risk management/litigation issue, it is not conformance to regulation. It is a unique opportunity."
- Companies that can navigate these emerging challenges – from physical risks to policy shifts and technological disruptions – and seize the mounting opportunities of the energy transition are likely to have the prerequisite climate resilience to thrive in a changing world.¹²
• The approach is rooted in the judgement that achieving private-equity's traditional aim of creating long term economic value for companies and investors is best achieved by focussing on environmental sustainability, along with customer loyalty and employee satisfaction. This focus ultimately generates more value and thereby higher multiples.\textsuperscript{13}
  - Research by Carlyle showed, for example, that increasing renewables’ share of total revenue of a typical energy company from zero to 40% could lead to a doubling trailing EBITDA multiple.
  - Carlyle also suggests more broadly that valuation multiples have already adjusted to energy transition risk in advance of changes in fundamentals.\textsuperscript{14}
• This shift in attitudes is accelerated as new research demonstrates a positive correlation between ‘high sustainability’ companies and positive equity returns.
  - One influential paper looked at 90 matched pairs of companies — one ‘high sustainability’, and one ‘low sustainability’ company, from the same sector (two retailers, two energy producers, etc.). The ‘high-sustainability’ companies significantly outperformed their counterparts in terms of both financial and stock market performance. Such research has helped convince that a focus on sustainability does not imply a trade-off with financial performance.\textsuperscript{15}
  - Likewise, a meta report of more than 2,200 individual studies concluded that “… roughly 90% of studies find a non-negative ESG–corporate financial performance relation. More importantly, the large majority of studies report positive findings.”\textsuperscript{16}
  - That said, the question of causation versus correlation remains, i.e. whether ‘high-sustainability’ companies outperform because of a focus on ESG or, alternatively, deliver good financial results because ESG is just one feature of a company that has above-average management and is well run overall.

ESG in private equity: progress to date

• Asset management more broadly is becoming increasingly sustainability-focused, acknowledgement of its critical role in transitioning to a lower-carbon world.
• Signatories to the United Nations’ Principles for Responsible Investment (PRI) now include more than 3,000 institutional investors and PE firms, an increase of 28% in 2020, and representing slightly over $100 trillion of AUM.\textsuperscript{17}
• A number of industry initiatives have been launched for PE managers to coordinate and cooperate in their drive to lower-carbon portfolios and economies more broadly. For example:
  - One Planet Private Equity Funds Initiative (OPPEF) – a group of PE investors committed to integrating climate change analysis into their investments,\textsuperscript{18} and
  - Initiative Climate International (ICI) – a collective commitment to understand and reduce carbon emissions of private equity-backed companies and secure sustainable investment performance.\textsuperscript{19}
• That said, there is a recognition that action on sustainability needs to move beyond mere virtue signalling. While the PRI 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.\textsuperscript{20}
• **Geographical differences.** There is also a wide gap in adoption of sustainability principles between the PE industry in North America and that in Europe.
  - While 80% of the top 20 EU-based institutional investors have committed to either the PRI, the UN’s Net-Zero Asset Owner Alliance, or the Task Force on Climate-related Financial Disclosures, less than one-half of the top 20 North American institutions have done so, and many of those are based in Canada (Figure 5).

![Figure 5: PE allocation of top 20 institutional investors by region](image)

**Figure 5: PE allocation of top 20 institutional investors by region**

- Percentage of funds with commitment to Principles for Responsible Investment, Net-Zero Asset Owner Alliance or Task Force on Climate-related Financial Disclosures

Source: The Expanding Case for ESG in Private Equity | Bain & Company

- While European limited partners have embraced ESG much more eagerly than have those in North America, there is still room to grow (Figure 6).
  - For example, less than one-third of portfolio companies report any CO₂ emissions, and the proportion is minuscule as regards Scope 3 emissions.

![Figure 6: ESG metrics in Europe vs North America](image)

**Figure 6: ESG metrics in Europe vs North America**

- EcoVadis scores by ESG-related categories (2017-H1 2020, large companies)
- Share of portfolio companies taking environmental measures (2017-H1 2020, large companies)

Source: The Expanding Case for ESG in Private Equity | Bain & Company
What can be done to advance sustainability further in private equity?

With a strong emphasis on stewardship, and close contact between the General Partner (GP) and company management, private equity is naturally suited to responsible investment. Private equity firms can address sustainability issues on a number of levels:

1. As part of the mandate and goals set by limited partners;
2. As part of their individual portfolio investments; and also
3. Within their own operations.

As regards PE investments, sustainability principles should be fully embedded in the entire private equity value chain, from deal sourcing through ownership to exit (see Figure 7 for the summary).

![Figure 7: Responsible investment principles in private equity](https://www.unpri.org/download?ac=10226)

Some of the practical steps that PE firms can take to incorporate sustainability into their activities include:

- **Integrate climate risk assessment into due diligence processes** so as better to understand the risk of sea level rise, extreme weather events, and insurability of assets.
- **Engage in Negative screening.** For example, exclusion of investing in, or financing, thermal coal unless the investment is to repower the asset to lower carbon energy generation.
- **Work closely with management.** PE firms are well placed to help shape more sustainable business strategies.
- **Use bottom-up carbon footprint disclosure** in portfolio companies.
- **Educate their portfolio companies** on emerging climate-related risks and opportunities that are material to their businesses.
- **Exercise carbon neutrality within their own operations** in addition to portfolio companies.
- **Invest in internal ESG capabilities.** While ESG enthusiasm is often present, specialised understanding can be lacking. Most PE firms that have adopted ESG principles have started with risk mitigation and compliance issues. Taking the next step to value creation requires adding internal capabilities to identify, track, and manage ESG risks and opportunities effectively.
Outstanding issues

- **Data, metrics, and transparency.** The opacity of ESG reporting and disclosure by PE firms contrasts with the increasing transparency provided by many public companies. Although public companies’ sustainability information remains mostly unaudited and imperfect, reports adhere increasingly to one of the major sustainability standards (either the Global Reporting Initiative or the Sustainability Accounting Standards Board).\(^{22}\)
  - For PE, ESG data is even more of a concern: whereas public companies have regular and extensive reporting requirements, most private equity firms deal with non-listed companies, which disclose far less.
  - Furthermore, unlike an investment in an e-commerce site or in machinery to improve productivity, an investment in ESG is often hard to quantify.

- **Mismatched time horizons and incentives.** PE firms face a unique mandate to produce substantial returns quickly. The median hold period for a PE-owned portfolio company is only 4.5 years.
  - According to a study by State Street, more than 40% of asset owners and asset managers thought that the right time horizon to deliver ESG outperformance was greater than five years. However, only 10% to 20% use these same time frames to evaluate financial performance.\(^{23}\)
  - Sustainability related investments in portfolio companies must compete with other requests for funding. As a result, sustainability investments are often accorded a low priority, given limited resources, a desire to show financial improvement over a tight timeline, and the competitive landscape for new funds.

- **Collective action by limited partners.** Although one-off demands from limited partners can motivate, collective action by a consortium of LPs would have a better chance of driving systemic change. PE investors are in a position to push for standardisation of ESG data and disclosures by portfolio companies.
  - A growing number of LPs are increasingly taking ESG considerations into account. According to the 2020 *Edelman Trust Barometer Special Report: Institutional Investors*:
    - 88% of LPs globally use ESG performance indicators in making investment decisions, and
    - 87% said that they invest in companies that have reduced their near-term return on capital so that they can reallocate that money to ESG initiatives.\(^{24}\)

- **Regulation.** One reason that European firms are addressing ESG more urgently than are their US counterparts is that EU regulators have been more proactive in this matter.
  - The EU Taxonomy, a landmark initiative aimed at channelling private capital into sustainable assets, will come into effect in December 2021.
  - It will oblige asset managers in the EU to disclose their share of taxonomy-aligned assets under management, inevitably creating an incentive to raise that share to remain competitive.\(^{25}\)
  - Similar initiatives are lagging today in the US and the rest of the world.
Conclusions

• Private equity, and asset management more broadly, has a growing ability positively to influence mounting social and environmental challenges.
• With a strong emphasis on stewardship, and close contact between the general partner and company management, private equity is by its nature suited to responsible investing.
• It is increasingly being recognised as both important and urgent to translate the promise of private equity in addressing sustainability issues into practice, and factor ESG into every facet of their operations and investment process. Sustainability in private equity will perforce be reflected in all three layers:
  1. ESG goals and mandates set by limited partners;
  2. The way in which these objectives are put into practice within portfolio companies; and
  3. The sustainability of private equity firms’ own operations.
Useful sources


Blackstone ESG: Blackstone | How Sustainability Makes Companies Stronger - Blackstone


2 https://www.institutionalinvestor.com/article/b1m8spzx5bp6g7/private-equity-makes-esg-promises-but-their-impact-is-often-superficial

3 Figure A: Examples of Environmental, Social and Governance issues

<table>
<thead>
<tr>
<th>Environment</th>
<th>Effluents and waste</th>
<th>Emissions</th>
<th>Water</th>
<th>Land use</th>
<th>Biodiversity</th>
<th>Energy</th>
<th>Materials</th>
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<td></td>
<td>Safe disposal and focus on recycling, reuse or recovery as energy</td>
<td>Emissions reduction and carbon offsetting</td>
<td>Water efficiency and sustainable use in farming and production</td>
<td>Sustainable land management and protection of ecosystems</td>
<td>Protection of biodiversity and ecosystems within operational range</td>
<td>Energy efficiency, use of renewables and coproduction (biofuel)</td>
<td>Responsibly sourced materials</td>
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<th>Social</th>
<th>Labor practices</th>
<th>Occupational health and safety</th>
<th>Human rights</th>
<th>Diversity and equal opportunity</th>
<th>Health and wellness</th>
<th>Product safety</th>
<th>Corruption</th>
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<td></td>
<td>Safe working environments</td>
<td>Respect for rights like freedom of speech and assembly</td>
<td>Equal rights and opportunities for all employees</td>
<td>Promoting and enabling healthy lifestyles</td>
<td>Ensuring all products and services are safe for consumers</td>
<td>Strong code of ethics supports by employee training</td>
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<th>Governance</th>
<th>Competitive behavior</th>
<th>Responsible employment</th>
<th>Indirect economic impacts</th>
<th>Procurement practices</th>
<th>Fair trade</th>
<th>Governance and transparency</th>
<th>Tax</th>
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<td></td>
<td>Nonpredatory pricing</td>
<td>Local hiring at reasonable wages</td>
<td>Supplier financing infrastructure investment</td>
<td>Local suppliers and sourcing</td>
<td>Fair pricing for local suppliers</td>
<td>Responsible engagement in public policy</td>
<td>Compliance with all legal tax obligations</td>
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4 Typical structure of a private equity fund:

Source: investments.gif (362×385) (venturechoice.com)
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For more, see also:
Carney, M. 2019b. TCFD: strengthening the foundations of sustainable finance. 8 October.
Carney, M. 2019c. Remarks at a panel to launch the third annual America's Pledge report, at the 25th anniversary of the Parties. 10 December.


Figure: US billion-dollar disaster events, 1980-2020

Source: National Centers for Environmental Information
Full link to data: https://www.ncdc.noaa.gov/billions/time-series


Private equity investors are warming up to the idea that ESG investing doesn't compromise performance

Note: Net ratings based on difference between proportion of positive and negative mentions

Source: Investing with Impact: Today’s ESG Mandate - Private Equity | Bain & Company

Private Companies
Receive Capital

 nineteenth century
Valuation multiples have adjusted to energy transition risk in advance of changes in fundamentals


14 Multiple
90.00X
80.00X
70.00X
60.00X
50.00X
40.00X
30.00X
20.00X
10.00X
0.00X

Energy Transition

Integrated Oil and Gas
S&P Global Utilities
Wind Turbine & Solar Technology
EV & Battery Manufacturers
Renewable infra Facilities

15 https://www.institutionalinvestor.com/article/b1m8spzx5bp6g7/private-equity-makes-esg-promises-but-their-impact-is-often-superficial
18 https://oneplanetswfs.org/
19 https://collaborate.unpri.org/group/761/stream
20 https://www.institutionalinvestor.com/article/b1m8spzx5bp6g7/private-equity-makes-esg-promises-but-their-impact-is-often-superficial
22 https://www.institutionalinvestor.com/article/b1m8spzx5bp6g7/private-equity-makes-esg-promises-but-their-impact-is-often-superficial
24 Ibid.
25 Ibid.