ACUITY
KNOWLEDGE PARTNERS

BLOG

ESG trends in private equity

Ambarish Srivastava

The UN's 20 Sustainable Development Goals (SDGs) replace the Millennium Development Goals and are scheduled to be achieved by 2030. For this to happen, though, everyone, including the financial industry, has to play a part. The financial and investment world is, therefore, focusing on environmental, social and governance (ESG) frameworks to make the world a better place.

ESG is now an essential among investing stakeholders

Beyond generating returns, asset owners (limited partners, LPs) expect asset managers to undertake responsible investment and focus on ESG themes. 78% of LPs consider ESG factors when selecting a private equity (PE) fund to invest in, but only 19% of general partners' (GPs') investments strongly reflect their ESG policies[1] . LPs' motivation for ESG investing is varied (as revealed by a number of surveys) – 78% of investors are driven by risk management and 77% by return potential[2]
, transparency of corporate oversight and controls[3]
, or "making a difference to make the world a better place"[4].

Although GPs have been moving towards considering ESG factors, the progress has been slow. However, LPs have been undeterred by this lack of progress and are expected to continue pushing for more ESG-focused investing. Moreover, as valuations spike, the number of investible opportunities declines and investment risk increases, ESG may emerge as a key differentiator in due diligence and delta of returns.

Regulators now demand ESG compliance

The EU adopted measures on sustainable finance in November 2019, effective 10 March 2021. These would require integrating sustainability risk into operating models, more details on ESG policies and increased due diligence[5].

Although necessitating only an adjustment in the spreadsheet, this development entails a number of activities, as private asset managers would be required to adhere to Europe's commitments to the Paris Climate Agreement. "LPs and GPs have already responded to a growing realisation that future changes to regulation, shifting consumer preferences, and state-sponsored financial inducements will have a meaningful impact on asset values in the not-too-distant future,"[6]
according to Debevoise & Plimpton.

More asset managers to jump on the ESG bandwagon

When the UN-backed Principles for Responsible Investment (PRI) framework was launched in 2006, 63 asset managers (with USD6.5tn in AUM) committed to incorporating ESG issues into their investment decisions. This had increased to 1,715 asset managers representing USD81.7tn in AUM[7] by April 2018 and 2,800+ investors with USD89tn by 4Q 2019[8] . The PRI directory listed 2,926 signatories as of 10 February 2020.[9] Société Générale estimated USD8.9bn in inflow to ESG funds during 1H 2019.[10] Following the Western markets, the ESG trend is reaching emerging markets, e.g., India's Axis Asset Management launched an ESG-focused fund on 21 January 2020.[11]

We expect ESG-focused funds to grow exponentially in 2020. Global green bond issuance, which grew c.25% to 479 bonds in 2019, is expected to spike on responsible investment. Multinational law firm Linklaters believes this will be driven by "a new set of standards in Europe and an uptick of activity across Asia"[12] .

ESG no more an initiative but a strategy

Studies have revealed that companies that focus on responsible investing and ESG deliver superior returns.[13]

- A Harvard Business School study concluded that companies that developed organisational processes around ESG themes as early as the 1990s had outperformed over the course of 18 years
- Another Harvard study found a direct correlation between performance on ESG issues and financial performance
- In 2017, Nordea Equity Research revealed that "companies with the highest ESG ratings outperformed the lowest-rated firms by as much as 40%"
- Bank of America Merrill Lynch suggested in 2018 that firms with higher ESG scores delivered higher three-year returns, had higher chances of becoming high-quality stock, and were less prone to large price declines or bankruptcy

Hence, 2020 may see increased adoption of ESG, if not for generating higher returns then surely for not being classed as an underperformer. Models may emerge for conducting due diligence not only for viability but also for sustainability, as chief financial officers (CFOs) are said to be taking an active interest in responsible investing and green investing.

Climate-related topics to dominate in the near future

In our study of ESG, we found that climate change was the top criterion in 2019 for asset management firms (representing USD3tn in assets).

As incidence of climate-related disasters increases, including heatwaves, wildfires, drought, flooding, and other extreme weather events, the E of ESG – that is, the environment – is likely to remain the foremost concern. Climate revivalism is trending, with support from a number of events and personalities, including strong support from activists such as Greta Thunberg and President Trump's position on climate change.

Climate-related strategies are expected to remain the key focus of ESG funds, with a strong incentive towards maintaining green portfolios, going forward.

Adoption of ESG reporting standards in private markets is inevitable

Following the adoption of ESG reporting standards in public markets, private markets are witnessing a spike in activity. An LP Footprint Project in 2018 by IHS Markit found that LPs have public policies relating to ESG (63%), are signatories to the PRI framework (59%) and publish public annual reports on ESG activity (40%).[14] The push from LPs is very strong (85% of LPs consider ESG factors during due diligence on PE funds) but not from GPs (only 19% of LPs believe that GPs' investments strongly reflect their ESG policies).[15]

A reason for low adoption by GPs is the challenges inherent in ESG reporting. Many managers have delayed adoption of ESG reporting and rating, citing data inconsistencies and talent shortages.[16] However, GPs are expected to adopt more of the best practices related to ESG reporting and reporting standards. In the absence of detailed ESG data, however – which itself is emerging for type of data, characteristics, analysis, storage and mining – GPs and other investors may need to tolerate a higher degree of uncertainty and a low level of clarity for a while.

The hunt for ESG talent to intensify

PE firms are increasing their ESG recruitments and designing positions including many perks and incentives, which will likely increase their wage bills. However, talent in the ESG market is expected to remain in undersupply, with the shortage more acute in the US than in Europe, as Europe has been working on philanthropic themes for the past two decades.[17]

"The massive growth is driving demand for top talent, and finding talent with a "finance brain and philanthropist heart" is a bit like discovering a unicorn" – Kate Shattuck, Co-leader, Korn Ferry's impact investing practice[18]

Talent hunters are, therefore, likely to find it difficult to attract and retain ESG talent, while keeping personnel costs in check. Moreover, as ESG data and ESG reporting and rating standards have evolved especially in relation to private capital, identifying and defining the required skills is likely to be a challenge.

GPs will require assistance and expertise to meet ESG-related workloads

Driven by the push from LPs and regulators, asset managers have limited choice in further delaying their ESG activities. Considering the emergence of ESG activity within a short period of time and the volume of investment activities yet to be considered and evaluated from an ESG perspective, we believe a large number of GPs are ill-prepared to handle this transition. They would require assistance in numerous areas such as in understanding and devising ESG strategies, developing evaluations and benchmarks, streamlining reporting, and evaluating ESG parameters at all stages of the investment lifecycle. They are still likely to face constraints in terms of talent, as ESG themes have mostly been encountered in the philanthropic domain, with a limited presence in the investment world.

A new set of service providers is, therefore, likely to emerge, albeit with expertise in the novice stage, offering services for firms to navigate the ESG space.

In such a scenario, established and experienced service providers would be crucial for addressing asset managers' ESG requirements. Acuity Knowledge Partners is a service provider that has served the PE industry for over a decade across strategies, investment themes, regions and asset classes, and would be a strong partner and contributor to a company's decisions in this regard.

Sources

1. https://d16yj43vx3i1f6.cloudfront.net/uploads/2019/07/PERE19_03-InvPersp.pdf

2. https://www.morganstanley.com/assets/pdfs/sustainable-signals-asset-owners-2018-survey.pdf

3. https://www.finextra.com/blogposting/16582/top-3-esg-trends-in-the-private-markets

4. https://hbr.org/2019/05/the-investor-revolution

5. https://www.investmenteurope.net/opinion/4008943/embracing-esg-sustainable-growth-measures-reporting-risk-management-return-optimisation

6. https://www.debevoise.com/insights/publications/2019/05/european-sustainability-regulation

7. https://hbr.org/2019/05/the-investor-revolution

8. https://www.unpri.org/download?ac=10019

9. https://www.unpri.org/searchresults?qkeyword=&parametrics=WVSECTIONCODE%7c1018

10. https://www.forbes.com/sites/brendancoffey/2019/11/01/here-are-the-most-popular-esg-stocks-with-fund-managers/#524f2afda2dd

11. https://esg.theasset.com/ESG/39710/domestic-asset-managers-follow-global-counterparts-in-esg-integration-

12. https://www.cnbc.com/2020/02/14/esg-investing-numbers-suggest-green-investing-mega-trend-is-here.html

13. https://hbr.org/2019/05/the-investor-revolution

14. https://ipreo.com/knowledge/resource/special-report-lp-footprint-project/

15. https://www.finextra.com/blogposting/16582/top-3-esg-trends-in-the-private-markets

16 https://www.bloomberg.com/news/articles/2020-02-06/why-hedge-fund-managers-say-they-avoid-sustainable-investing

17 https://www.pionline.com/article/20190527/PRINT/190529885/more-managers-adding-esg-positions-to-meet-demand

18 https://www.kornferry.com/insights/articles/impact-investing-talent-acquisition

About Acuity Knowledge Partners

Acuity Knowledge Partners is a leading provider of high-value research, analytics and business intelligence to the financial services sector. The company supports over 350+ financial institutions and consulting companies through a team of over 3,000+ subject matter experts who work as an extension of the clients' teams based out of various global delivery centres.

We empower our clients to drive revenues higher. We innovate using our proprietary technology and automation solutions. We enable our clients to transform their operating model and cost base.

contact@acuitykp.com | acuitykp.com