

Private Equity Must Make ESG Strategy a High Priority

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It should be clear by now that the ESG “trend” is, in fact, not a trend at all.

Rather, the global business community’s embrace of ESG and sustainability marks a seismic cultural shift that will materially transform “business as usual” for decades to come. Performance on ESG factors is increasingly used together with traditional financial indicators as a core component in assessing the fundamental performance and value of portfolio investments. That is particularly true for the private equity industry.

However, many private equity funds (particularly midcaps in the United States) are still stuck playing defense when it comes to ESG, adopting reactive tactical changes while they try to wrap their heads around the broader implications of commitments being made to a more sustainable planet in global financial markets. Rather than risk being a laggard on issues of sustainability or rushing to make reactive program changes because of last-minute requests for ESG data from a limited partner, for example, funds should begin developing their ESG strategies now. They can do so in two practical ways.

First, funds should focus on the basics by making a few proactive (rather than defensive) policy and procedural enhancements in their existing portfolio strategies, creating ESG policies that are fully aligned with their overall investment strategy.

Second, they should take an active, direct role in assisting management at the portfolio level in the design, enhancement and implementation of their respective ESG programs. Making those two changes may not put the fund at the front of the line on ESG, but, at a minimum, they will go a long way toward ensuring that the fund is not punished for being behind the curve on matters of sustainability.

The Case for ESG

The reasons for the embrace of ESG in private equity markets should be abundantly clear. Most importantly, ESG-friendly funds are better positioned to manage the many downside

risks arising from the clean energy transition, supply chain disruptions caused by natural disasters and human rights issues, and heightened scrutiny from a broad group of stakeholders. Moreover, many limited partners (LPs), including pension funds and endowments, have already made their own ESG commitments and must report the results to their own stakeholders. General partners (GPs) and LPs committed to ESG reap the benefits of expanded availability and lower cost of capital, cutting financing costs in fundraising. ESG also creates opportunities for competitive positioning for the underlying portfolio company, increasing the horizons for strategic value creation by getting out ahead of the curve on issues of increasing importance to clients, customers, employees and the broader community. In short, it pays for private equity to be a good corporate citizen.

Get Ahead of ESG: Move from Reactive to Proactive

Despite the advantages and benefits of incorporating ESG into portfolio strategies, too many funds still take a reactive,



defensive approach to sustainability, playing “catch up” after an LP or outside investor requests data around performance on matters of sustainability. But doing ESG right requires wholesale strategic changes to move the needle with respect to sustainability and stakeholder management — and to eventually generate meaningful and accurate ESG data. There are a few strategic steps PE funds can take now to prepare for a future where reporting requirements and data requests are more standardized and comprehensive.

- **Define your overarching ESG goals and strategy.** Develop an ESG strategy that is aligned with the risk/return objectives of your portfolio. Don’t focus solely on risk mitigation, but also how your portfolio companies will be able to take advantage of the opportunities and growth prospects offered by position as a sustainability leader. Further, define the items that are going to be managed at the fund level versus those that will be managed at the portfolio company level.
- **Better leverage current commitments and establish big picture goals.** Map out and assess current commitments, policies, procedures and systems as they pertain to sustainability and ESG. Portfolio companies are rarely starting from ground zero, so it is important to have a baseline understanding of the existing level of commitment, as well as visibility into current talent who have experience on ESG issues. Even if the GP does not have any ESG policies, protocols or professionals in place, some of its portfolio companies may already be much further along on the continuum. Set out macro-level goals and objectives and establish a reasonable timeline for implementation.
- **Design and implement basic policies and governance structures at GP and portfolio levels.** Establish a responsible and sustainable investment policy at the GP level. Ensure ESG goals and objectives are incorporated into all other policies at GP and portfolio company levels, including DEI, environmental initiatives, anti-money laundering (AML), code of conduct/ethics, compliance, conflicts of interest, insurance, policy/charitable contributions, privacy, risk management policy and whistleblower policy. Modify governance structures to oversee ESG performance and ensure adequate disclosure up the chain, including oversight and implementation responsibilities from the board of directors and management. ESG objectives should be incorporated into performance reviews and incentive mechanisms.
- **Invest in ESG due diligence. ESG due diligence should be more than a policy check.** Understand the company’s ESG risks and opportunities and their alignment

with the fund’s overall ESG strategy. Run an in-depth assessment of the target’s program, including the governance structure behind it. In the decades to come, your path to achieving desired returns will depend on ESG as much as it depends on the financial and commercial prospects of the target.

- **Think strategically when communicating your sustainability efforts.** Communication is a key component of sustainability efforts. Sustainability frameworks and standards are used to make the information more relatable to certain stakeholders and to allow them to compare a company’s sustainability profile with that of their peers. Given that PE funds and their LPs are investors and exit strategies demand focus on metrics that will be evaluated by other investors, PE funds should prioritize sustainability investor-focused sustainability frameworks such as the Sustainability Accounting Standards Board and the Task Force on Climate-Related Financial Disclosures. This is key, especially if an IPO is a probable exit strategy. Despite their importance, ESG communications need to go beyond the demands of a certain framework. An effective narrative that explains the rationale behind a company’s sustainability strategy is the only effective tool to protect its license to operate and access new commercial opportunities.

Directly Assist with Implementation

Generating accurate, decision-useful information and creating an effective control environment are the hardest parts of sustainability. Too often, PE firms take a hands-off approach to implementation and do not offer enough tangible assistance to their portfolio companies in designing and implementing the controls, procedures and systems needed to ensure compliance with paper policies and goals. That leaves portfolio management with short-term tactical commitments and goals set out by the fund, but with limited to no practical guidance or resources on how to implement their programs. Risk assessments, data management, training, segregation of duties, approvals, third-party onboarding requirements, prohibitions and systems enhancements are left almost entirely to managers who are ill-equipped to address those areas by themselves. Focusing on ESG is rarely part of the expectations for their job.

Funds need to directly manage and support management with implementation of ESG programs, providing both resources and the necessary leadership toward achieving their strategic ESG goals and objectives. That includes assisting with ongoing risk assessments to identify, understand and mitigate cross-function risks in the business and advising

on enterprise resource planning, customer relationship management, onboarding, procurement and compliance systems to generate relevant and useful ESG data to measure goals across functional groups. Funds should ensure that internal audit at the portfolio level maintains functional responsibility for reviewing performance of priorities and targets and compliance with policies and procedures. They should also periodically audit and test controls and systems themselves, ideally using third-party ESG specialists who can assess the effectiveness of controls and minimize misstatements and errors in the data. Likewise, funds should consider explicit ways to help portfolio companies share best practices with one another, such as by holding fund-wide periodic seminars and group events where practitioners from the fund's portfolio companies can share their respective experience and know-how on ESG issues.

A final byproduct — but not the final objective — of an effective ESG program should be frequent reporting of progress. Certainly, portfolio companies should present integrated reports, including quantitative performance on goals and qualitative discussion of ESG matters that impact financial performance. However, funds often get that in reverse, trying to push for quick and easy reporting while avoiding the

necessary hard work of implementing an effective ESG program and making the strategic enhancements necessary for meaningful change. That results in the sort of short-term defensive posturing from portfolio management that funds should seek to minimize.

As sustainability becomes “business as usual,” PE funds must ensure that their portfolio investments’ ESG programs and also their own ESG programs are robust and fundamentally sound. Funds are already pressured to provide some degree of ESG reporting, whether voluntarily or through regulation, but many funds take a reactive approach to avoid appearing negligent or behind the curve. Increasing market expectations and reliance on robust, multiyear ESG data and KPIs in IPOs or secondary sales also means valuations will be negatively impacted by nonexistent, de minimis or questionable ESG data. Ultimately, many of these straggler funds would benefit by defining their ESG strategies and taking a more direct approach toward assisting portfolio companies. ■

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