ESG COMPLIANCE AND PRIVATE EQUITY

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ABSTRACT

Environmental, Social, and Governance (ESG) factors have become an integral part of the business world more than ever before. With a considerable amount of importance given to sustainable investing by the media, consumers, companies, and most importantly investors, neglecting ESG issues is no longer feasible. As a major part of the financial market, private equity (PE) firms play a crucial role in furthering the agenda of sustainable investing. This article, thereby, aims to highlight the increasing significance given to sustainable investing by investors and how private equity comes into play in the integration of ESG principles.

Keywords: Sustainable Investing, ESG, Private Equity.

INTRODUCTION

COVID-19 has highlighted the importance of integrating sustainability in the operation of businesses and companies, which was earlier just a fifteen-minute boardroom discussion and a decorative factor of a company. However, with the growing pressure from ethical and aware consumers, governments, employees, and most importantly investors, corporations are increasingly focusing on integrating ESG factors in their business activities.[1]

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ESG stands for Environmental, Social, and Governance factors. Environmental factors comprise the initiatives taken by the company to preserve natural resources and the environment by ensuring a responsible environmental footprint, reducing carbon emissions, preventing mistreatment of animals, etc. Promoting work-life balance, fighting against child labor, enhancing community development, etc. are the social commitments of a company. Lastly, Governance involves codes of conduct, policies on fair compensation, prevention of corruption and bribery, and so on. Duly considering these factors in evaluating investment decisions has become the core goal of many investors, thereby increasing the importance of ESG integration in the financial market as soon, more and more corporate leaders will be held accountable for ESG performance. One of the major players in the global economy and the

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[1] Maria Cristina Zaccone and Matteo Pedrini,' ESG Factor Integration into Private Equity'(2020) 12(14) MDPI https://www.mdpi.com/2071-1050/12/14/5725 accessed 24 June 2023

financial market, Private Equity firms, which oversee more than 20 million employees around the world in over 40,000 portfolio companies, have a key responsibility in taking the lead in sustainable investing.

Private equity (PE) refers to investments made into companies that are not publicly traded on stock exchanges. There are four main phases in a PE fund's cycle -fundraising, sourcing, portfolio management, and the final phase exit. It is being observed that an increasing number of Private Equity investors are assessing ESG factors before making their investment decisions. [2]The United Nations Principles of Responsible Investing (PRI) initiative found that approximately 75% of its 633 private equity investors (consisting of 598 investment managers and 35 asset owners) evaluate the materiality of environmental, social, and governance (ESG) factors both at the industry level and the portfolio company level. Among PRI's private equity signatories, two-thirds (66%) acknowledge that ESG considerations contribute value rather than solely mitigating risk, and they actively seek out opportunities for value creation in the majority of their investments.

Before evaluating how PE firms can lead sustainable investment, it is pertinent to understand the reasons why ESG compliance has become so important, especially for investors.

WHY INVESTORS HAVE BECOME INTERESTED IN ESG ISSUES?

Stakeholder capitalism, which was also popular in the 1950s and 60s, refers to the philosophy that businesses have a responsibility that goes beyond their shareholders and it involves being considerate of the impact they have on the society and the environment. Its agenda also includes giving importance to creating long-term value. This philosophy has been propagated further by the COVID-19 pandemic as well as the growing pressure from the public, government, companies, and significant investors.

It is becoming a well-settled fact that companies performing well on ESG matters are considered to be less risky and better prepared for uncertainty, as stated by Vincent TriesschijnDirector, of Sustainable Investing, ABN AMRO. The growing significance of ESG compliance can be inferred from the following findings.

[2]Robert G. Eccles, Vinay Shandal, David Young and Benedicte Montgomery,' Private Equity Should Take the Lead in Sustainability'(*Harvard Business Review,* August 2022) <https://hbr.org/2022/07/private-equity-should-take-the-lead-in-sustainability> accessed 26 June 2023

In the 2020 EY Climate Change and Sustainability Services (CCaSS) Institutional Investor survey, it was revealed that out of the investors surveyed, 98% assessed ESG (Environmental, Social, and Governance) factors. Within this group, 72% conducted a structured review of ESG performance, which marks a significant increase compared to the 32% reported in the previous survey conducted two years prior. Additionally, a considerable number of investors currently using an informal approach expressed their intention to transition to a more rigorous ESG evaluation framework, with 39% indicating such plans.

Also, in a recent extensive interview conducted with 70 senior executives from 43 major global institutional investment firms, including industry giants like BlackRock, Vanguard, State Street, CalPERS, CalSTRS, and government pension funds from Japan, Sweden, and the Netherlands, it was observed that ESG (Environmental, Social, and Governance) considerations were almost universally at the forefront of these executives' minds. This research effort stands out as one of the most comprehensive initiatives involving senior leaders from such a wide range of prominent investment firms.

These statistics indicate that ESG compliance is one of the critical factors evaluated by investors, however, it is critical to understand the reasons behind the same.[3] The first is the size of the investment firms. The top five asset managers hold 22.7% of externally managed assets, and the top 10 hold 34%. This means that the investment industry is highly concentrated. The small investment firms have leverage, unlike the big ones as they can hedge against climate change. However, the big firms are too big to let the planet fail. Also, large asset owners like pension funds are obligated to take the long-term view since they have long-term liabilities. As, Hiro Mizuno, the chief investment officer of Japan's Government Pension Investment Fund (GPIF), which manages assets worth $1.6 trillion, emphasized the fund's status as a "classic universal owner" with intergenerational responsibilities. This characterization reflects GPIF's recognition of its role as a long-term investor and the need to consider the impact of its investment decisions on future generations.

Second, financial returns have also been driving investors towards sustainable investing. According to a study conducted by Nordea Equity Research, the largest financial services group in the Nordic region, it was found that between 2012 and 2015, companies with the highest Environmental, Social, and Governance (ESG) ratings outperformed the lowest-rated

[3]Robert G. Eccles and Svetlana Klimenko,' The Investor Revolution'(*Harvard Business Review,* June 2019)<https://hbr.org/2019/05/the-investor-revolution> accessed 27 June 2023

firms by as much as 40%. This suggests a positive correlation between strong ESG performance and financial outperformance.

In a separate research effort, Bank of America Merrill Lynch conducted a study in 2018, which revealed that companies with better ESG records compared to their industry peers demonstrated higher three-year returns. Additionally, these companies were more likely to be considered high-quality stocks, less prone to experiencing significant price declines, and had a lower likelihood of facing bankruptcy.

These findings highlight the potential financial benefits associated with superior ESG performance. They suggest that companies with a stronger commitment to ESG factors may not only mitigate risks but also generate enhanced financial performance, making them attractive investments for investors. The financial performance is also dependent on the material issues of the company. If a company focuses on addressing all of its ESG issues, then it is likely to bear its unfavorable consequences. A material issue of a company is based on the industry it operates in. For example, a food retail company will have material issues revolving around access and affordability, greenhouse gas emissions, fair marketing, advertising, etc.

A study conducted by Muzaffar Khan, George Seraphim, and Aaron Yoon supports the notion that good performance on material issues has a positive impact on financial returns. Therefore, investors are interested in portfolio companies that focus on essential material issues that are relevant to their industry instead of some vague and ill-defined notion of sustainability. Furthermore, the growing demand for sustainable investing among high-net-worth individuals has also contributed to the increasing importance being given to ESG compliance as these wealthy individuals are more concerned about what differences their investments are making in evolving the world into a better place.

Moreover, senior leaders are now making sure that ESG compliance is also being integrated into the fundamental financial activities that are performed by analysts and portfolio managers who take the day-to-day investment decisions. This is in contrast to what happened historically when the ESG group at investment firms was separate from portfolio managers and sector analysts. These developments will have a significant impact on how investors engage with companies. The integration of ESG considerations into financial analysis at BlackRock, the world's largest asset manager with $6.1 trillion under management, serves as

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an illustrative example. While BlackRock's CEO, Larry Fink, has been emphasizing the importance of sustainable investing for several years, the complete integration of ESG criteria into the firm's investment strategies has been a gradual process. Tariq Fancy, the chief investment officer of sustainable investing at BlackRock, compares the process of integrating ESG considerations into traditional financial analysis to a behavior change exercise. While some investors are naturally inclined to incorporate ESG factors, others may take more time depending on factors such as asset class, geography, and investment style. Fancy's background as an investor, rather than coming from an environmental or social NGO, lends credibility in working with the investment teams.

Considering the scale of BlackRock, changing investor behavior throughout the organization requires dedicated effort and time. However, Fancy believes that if such integration can be achieved at BlackRock, it can also be extended across the broader capitalist system. This reflects the belief that with concerted efforts, ESG integration can become a standard practice in the investment industry, benefiting both financial performance and sustainability goals. From the abovementioned discussion, it can be concluded that ESG considerations cannot be ignored further by the companies as investors are more inclined towards sustainable investing through efficient ESG compliance. Considering the vast capital holdings of PE firms, it can be inferred that these Private Equity firms are well-placed to take the lead. The following section will analyze the integration of ESG in Private Equity.

WHY PRIVATE EQUITY FIRMS SHOULD LEAD SUSTAINABLE INVESTING?

Private equity has certain clear advantages over those investors who invest in public equity, in taking the lead in accelerating the adoption of ESG principles.

First, PE firms have more control over the portfolio company as they have one or other of their representative on the board, have access to key information pertaining to financial and sustainability performances which public equity investors do not have, plus they have the power to fire a CEO as well. Secondly, they have a longer time horizon than publicly traded companies which gives the General partners as well as the CEOs, much more flexibility to integrate ESG principles.

ESG is becoming essential to the Limited as well as the General Partners which is a key force driving ESG into Private Equity. According to the INSEAD's Global Private Equity Initiative, 90% of LPs factor ESG criteria when evaluating potential investment opportunities

and 77% of them use ESG as a criterion in selecting general partners. Another reason for accelerating ESG into PE is the importance of continuing to deliver high returns, for the private equity firms. Moreover, increased recognition of ESG issues by portfolio companies has had a powerful impact on pushing ESG into the industry.

Nowadays, leaders are taking sophisticated measures to facilitate the integration of ESG matters. They are focusing on integrating ESG in the due-diligence process by analysing how well a particular portfolio company is adopting ESG issues into its business. Also, there is growing transparency between LPs and GPs. Apollo, a private equity firm, has been providing reports on environmental, social, and governance (ESG) matters to its limited partners for 12 years. In recent times, Apollo has taken the additional step of making its annual ESG report publicly accessible on its website. This transparency in sharing ESG information has been adopted by several other general partners as well. Furthermore, LPs are increasingly requesting ESG data at the portfolio-company level. General partners are also well-placed in helping these portfolio companies improve their ESG integration by providing them with essential tools and expert insights. These are some of the ways through which private equity firms are enhancing ESG integration, however, there still remain a lot of improvements to be made like standardising ESG reporting, increasing diversity, etc. to further the agenda of ESG integration.

CONCLUSION

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The above discussion has clearly settled the fact that sustainable investing is the future, as those companies who perform well in ESG compliance are considered to be profitable for the investors. The COVID-19 pandemic has showcased the potential for substantial carbon emission reductions and swift behavioral changes. This highlights the importance of emphasizing ESG performance for achieving success in a post-pandemic world, acknowledging the significant role ESG considerations play in shaping the future.

Sustainable investing has highlighted the role of private equity as well, in facilitating integration of ESG principles, though it is still in its infant stage. For further improvements, private equity leaders should openly and frequently emphasize the significance of creating sustainable value. They should actively seek individuals who genuinely care about sustainability in its broadest sense, rather than solely being attracted to the industry for its potential financial rewards.