Adapting ESG in private equity markets for clarity and value

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Limited partner (LP) investors are increasingly turning their attention to how Environmental, Social and Governance (ESG) factors are assessed and actioned in their private equity investments. While 89% of investors have ESG policies in place, two out of three LPs report issues around lack of clarity and impact.[1]

General partners (GPs) also report a disconnect between their efforts and LP expectations. GPs relay that there is an excess of data and transparency demanded, without clear intention on how and why the data links to ESG objectives or decisions. Additionally, LPs' ESG objectives are often too broad to be actionable.[2]

To address these problems, says Emma Cox, Private Equity leader, Deloitte Global "investors—both LPs and GPs—will need to more narrowly focus their ESG priorities, clearly articulating connections with financial outcomes. GPs should define processes for value realization in the deal lifecycle and portfolio management. And they'll likely have to track and interpret how investments can deliver targeted double-bottom-line results."

Link between ESG and growth

To compete in an increasingly competitive fundraising environment, private equity firms should elevate their ESG capabilities. Currently, just 16% of managers control 50% of private equity assets that consider ESG factors.[3] According to a Deloitte US analysis, by 2027 US$1.6B in new fundraising will have some commitment to ESG. This fundraising volume ties to roughly US$20B–US$30B in fees over the same period.[4] GPs that cannot meet LP expectations will likely be at a disadvantage as ESG criteria become more prevalent in new mandate activity.

Survey shows private equity ESG adoption accelerating—and evolving

To better understand the state of ESG in private equity markets, Deloitte US surveyed more than 100 fund managers and asset owners in countries around the world in March and April 2023. The survey findings reveal a rapidly evolving ESG investment landscape, with ESG-focused assets under management growing by 40% compound annual growth rate from 2018 to 2022.

The LPs interviewed see high potential for ESG in private markets, given the greater ability to control outcomes in private markets relative to public ownership. These LPs cited three major drivers for their adoption of sustainable investment:

- Create a positive outcome for clients/investors (64%)
- Meet existing client/investor demands (52%)
- Improve investment performance (47%)

A process disconnect

With this in mind, it's no surprise that 87% of LP investors have a sustainable investing/ESG policy in place, and another 9% have policies planned or in development. But a disconnect emerges when you look at satisfaction—or lack thereof—with their GPs' ESG processes: 69% identify "poorly articulated investment process/philosophy" as a moderate to extreme pain point. The roots of the discrepancy, it turns out, lie in four main challenges:

- **Overly broad definition of ESG.** ESG investments can encompass everything from climate and energy to diversity, inclusion, and health.
- **Loose ties to financial outcomes.** Processes to deliver ESG financial objectives are often lacking.
- **Difficulty measuring and comparing.** There are no consistent methods or standardized metrics for measuring outcomes.
- **Politics and polarization.** Stakeholders can mischaracterize or misunderstand objectives.

Adapting ESG in Private Markets Survey 2023, Deloitte US. [1, 2]
Prequin.[3]
Prequin, Pitchbook, Casey Quirk Global Demand Model, Casey Quick analysis. [4]

Best practices for maximizing ESG adoption and impact

Private equity firms can bridge the gap between ESG process/philosophy and execution/outcome using tested techniques. Some practical steps to consider:

1. Clarify objectives and methods to derive value

Successfully identifying and tracking ESG impact can improve performance and stakeholder understanding. Here are several examples of opportunities to track measurable ESG value within fund investment and management.

Financial outcome	Case example	Potential ESG impact
Revenue generation	Agriculture business realized carbon insets through **price improvement** for net-zero product.	Carbon reduction in the manufacturing process.
Cost savings	A GP instilled a water conservation plan in its portfolio companies, **reducing utility costs across the portfolio.**	Conversation about raw material inputs.
Risk mitigation	GP deal team projected carbon impact on weather, which stood to **materially deteriorate value of the target** physical asset during diligence.	Climate risk led the team to pass on the deal.
Relative outperformance	GP invested in development of new energy infrastructure assets, based in large part on the **thesis that energy transition funding and demand will drive outsized performance**.	Creation of new clean energy capacity, leading to greater decarbonization.

2. Incorporate ESG into the deal lifecycle

From due diligence to exit, ESG leaders in private markets can use multiple practices to add or protect value at each stage of a deal:

Investment sourcing

- Determine ESG screening criteria
- Position the company against industry ESG trends
- Evaluate risks that could affect deal pricing
- Understand management team's willingness to adapt

Due diligence

- Assess maturity and effectiveness of the target's ESG management
- Benchmark performance against peer performance and stakeholder expectations
- Assess current and potential contribution of the business to the sustainable economy
- Quantify the value of ESG

Exit

- Assess current risks and mitigation strategies in preparation for sale
- Perform final ESG due diligence on the company to measure progress
- Conduct post-investment reviews for self-assessment

3. Establish ESG value-creation processes in portfolio companies

To fully realize the value of ESG commitments, private equity firms should help portfolio companies establish clear, actionable ESG processes. A four-step approach for supporting acquisitions:

Coach and outline ESG expectations

Narrow the focus to a few actionable items. Determine clear goals and set a target rate of change. Use GP board seats to educate management and help establish ESG ownership and expectations, driving toward a common understanding of value-creation opportunities across GP and portfolio companies.

Establish foundational data collection

Clearly define ESG metrics and related risks. Use industry-specific reporting templates to track common metrics such as greenhouse gas emissions; board diversity; employee diversity, equity, and inclusion (DEI); energy transition and consumption; and work-related injuries. European Corporate Sustainability Reporting (CSRD) will likely increase transparency and comparability between companies.

Transform data into action

Hire functional specialists who can work with portfolio company management teams to create action plans and realize objectives. Incorporate ESG targets into compensation structures for leadership positions to ensure alignment.

Continuously evolve

Identify execution challenges and areas for needed support. Assess and respond to changing expectations from LPs, industry, and external regulators, with an eye toward how they might accelerate or delay progress toward objectives. Track improvements and maintain ESG value beyond GP exit.

4. Manage stakeholders

For LPs, it can be difficult for any ESG initiative to achieve its goals, either financially or in terms of social/environmental impact, without engaged, involved stakeholders, such as board members, plan participants, or regulatory bodies. Add in the effects of political polarization and varying levels of subject expertise, and it becomes increasingly important to educate stakeholders and manage expectations. A three-part process for effecting stakeholder change:

Educate stakeholders

- Review the application of ESG philosophy in public vs. private markets
- Identify potential tradeoffs that come with the investment approach
- Evaluate the timing and scale of each investment's potential impacts

Align expectations

- Conduct a workshop to establish common understanding and priorities for executive, investment, and legal teams plus other important stakeholders
- Ensure that the ESG framework is consistent with external commitments (e.g., net-zero commitments from the parent organization)
- Align measurement and reporting expectations with those of key stakeholders

Clarify implications for the investment process

- Highlight investment objectives such as risk reduction, enhanced returns, and creation of a double bottom line
- Specify material factors to the investment engine
- Outline portfolio implementation through divestment, impact investing, etc.

Private equity firms that are ESG leaders:

- Hire specialists in areas of ESG to complement the internal skills in focus areas
- Standardize techniques for data measurement and reporting, including consistency in format and frequency
- Tie incentives to specific, measurable ESG outcomes
- Establish an agreed-upon pace of change in portfolio companies
- Clarify GPs' ESG approach with back-book vs. new investments

Best practices for ESG reporting

- Identify relevant performance metrics that are material ESG priorities of GP and are relevant for the specific portfolio company investment; work with portfolio companies' leadership to set targets and implement consistent data collection, analytics, and reporting processes
- Integrate ESG data into existing financial and investment reporting systems to help advance ESG performance measurement and reporting outputs, as well as reduce the burden of one-off data collection on deal teams and portfolio management
- Establish a disclosure strategy that aligns with ESG objectives
- Develop a reporting cadence to communicate investment performance at the fund or portfolio-company level
- Obtain independent third-party assurance of ESG performance

Getting the most from ESG

As select LP investors drive the maturation of ESG, the most vocal will press for rising standards from their private equity investment partners. While there are efforts at broader standardization underway, GPs do not have the luxury of waiting for consensus in a market with diverging regulatory and investor perspectives. To compete effectively for capital, private equity leaders will need to tie their ESG commitments to investment outcomes. Additionally, they will need to be flexible in managing cost and complexity amid ambiguity. Those that effectively bridge the gap and meet investor expectations will be more likely to attract and retain capital.

Let our professionals help your firm or investment team clarify your ESG vision and identify the commitments needed to achieve it. Together, we can make an impact that matters.

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