

ESG in private equity: will integration tools be matched by pressure to use them?

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Summary

Covid-19 is likely to accelerate pressures for the meaningful integration of environmental, social, and governance (ESG) factors into the private equity (PE) industry. The twin dynamics of a greater public focus on investors' ESG credentials and an increased scrutiny of the PE industry writ large could combine to encourage greater use of existing integration tools. With mounting expectations that limited partners (LPs) adopt sustainable investment strategies, incorporating ESG factors into investment processes will increasingly become accepted best practice. In response, general partners (GPs) may well need to offer more robust ESG policies in order to remain competitive in a crowded market down the line. Both LPs and GPs need to start planning for these shifts now, as the potential for closer public, political and regulatory scrutiny looks set to grow.

The pandemic has thrust two investment themes further into the public spotlight: environmental, social, and governance (ESG) issues on the one hand, and the role and impact of the private equity (PE) industry on the other. What has received less attention is the question of how scrutiny of the two might join up. Specifically, could the crisis accelerate increasingly material pressure on the industry to accommodate ESG factors? Given that PE firms and their investors are now equipped with a growing toolkit to integrate ESG risks into investment processes, this question needs to be considered by general partners (GPs) and limited partners (LPs) alike.

So, where do things stand currently? The industry has developed an increasingly positive rhetoric on ESG in recent years. For example, Carlyle co-CEO Glenn Youngkin [said at Davos this year](#) that all of the firm's portfolio companies now have an ESG plan. Despite this, the industry's overall progress remains limited. Coming into the pandemic, [under a third of GPs](#) were - or intended to become - formal signatories of the UN Principles for Responsible Investment (UNPRI) or similar initiatives. Even the gains made so far have been questioned, with a [recent investigation](#) claiming that the "vast majority of private equity ESG efforts remain nascent and superficial". Intentions, such critics argue, have largely triumphed over actions.

However, the tools available to turn intention into action are now considerable. Most notably, in April the UNPRI published [a technical guide](#) for LPs on ESG integration in PE. This brings together existing and new material setting out how LPs can assess and engage with GPs on ESG factors at all stages of the investment process. Pre-investment, this includes using a due diligence questionnaire to evaluate GPs and considering guidance on how commitments to responsible investment can be reflected in limited partnership agreements. After committing capital to a fund, LPs are encouraged to continue assessing a GP's ESG performance through a monitoring, reporting and dialogue framework.

How could covid-19 accelerate pressures for ESG integration in PE?

The pandemic could help close the gap between the tools available and their actual use by accelerating pressure on both LPs and GPs to integrate ESG into investment processes. It has already strengthened the public focus on investors' ESG credentials, particularly on 'S' and 'G' issues. Expectations that investors and the companies they have stakes in engage with these issues - and reputational and commercial penalties for failure to do so - have never been higher. This has been most visible, so far, in public markets. One striking case is Boohoo:

allegations of links with unsafe working conditions and illegal pay levels during lockdown attracted intense media criticism and political attention, leading the firm [to lose nearly £2 bn](#) in market value in under a week and [one major shareholder](#) to sell nearly all its stock. More broadly, media coverage of publicly-listed firms' responses to the pandemic [was linked](#) with their share price performance during the sell-off.

Investors have responded by increasingly engaging on issues like worker rights, human capital management, diversity and inclusion, and executive remuneration throughout the 2020 AGM season. Investors at large asset managers have also indicated that they will regularly follow up on these issues, and high-profile asset owners have [recently indicated](#) that they will abandon large positions in ESG-negative assets like tobacco and coal stocks. As internal investment committees respond in such ways to the growing pressure for stronger ESG investment credentials, it is highly unlikely that this shift will be confined to their public markets assets.

The pressure on public markets investors is particularly likely to spill over into PE given that the crisis has prompted wider scrutiny of the industry and calls for it to change. A surge of PE-backed bankruptcies in [May](#), for instance, fed accusations that leveraged buyouts have helped to load portfolio companies with debts that enable quick profits for PE firms but are unsustainable in the event of a downturn. Such scrutiny may well intensify in coming months. Not only are defaults of PE-backed firms [continuing to rise](#), the combination of record levels of dry powder - [now at](#) nearly \$1.5 trn - and the impact of lockdowns means that there is likely to be a rush of distressed assets being snapped up. In a world where bailouts and stimulus are giving governments and taxpayers a growing share of the risk, and where redundancies will be highly sensitive for a long time to come, politicians and the public are likely to take a closer look at how PE firms acquire and manage portfolio companies in future. One key political bellwether to watch in the US, for instance, is whether the thinking of progressive Democrats such as Elizabeth Warren - who last month warned the industry could [“exploit this crisis”](#) - shapes the policies of Democratic nominee Joe Biden on PE. Either way, the depiction of the industry in recent months sits uncomfortably with the mounting pressure for an ESG-friendly rethink of investment.

What are the direct implications for LPs and GPs?

These general pressures could tilt LP and GP preferences towards ESG integration in three specific ways. First, they will up the ante on LPs to engage and report on their sustainable investment ownership. Whilst one [survey](#) from the start of the

Resources for LPs on ESG integration

ESG integration is an evolving field with growing resources and tools for LPs, including from:

- The UNPRI: [this](#) technical guide offers LPs holistic advice on integrating ESG factors
- LPs' experience and practical insights: [this webinar](#) details how USS, AP6, and Harvard Management Company approach ESG and PE
- The Institutional LP Association: resources include an [ESG best practices roadmap](#) and [portfolio company metrics template](#)
- ESG standard-setters: [SASB](#), [GRI](#), [CDP](#) and others offer guidelines on issues such as disclosure

year found that only a minority of institutional alternatives investors require ESG reporting from fund managers, close to two in three thought that ESG would become more integral to the industry in the next three years. Given that a significant proportion of those surveyed saw stakeholder and public perception as a key draw for having an ESG policy, together the increased scrutiny of PE and the emphasis on ESG credentials prompted by the pandemic will likely contribute to closing this gap. This dynamic will only be heightened by increasing expectations for LPs to actively press GPs to change. For instance, the UNPRI chief [last month](#) publicly called out LPs for not doing enough.

Second, growing LP demand for responsible investments will in turn increase pressure on GPs to accommodate ESG factors, including in disclosure and reporting. LPs - using tools such as those set out by the [Investor Forum](#) - are increasingly well-equipped to engage PE firms on ESG issues. In the short-term, pandemic-induced PE fundraising pressures will sharpen the need for GPs to listen to the preferences LPs put forward. Although megacap PE funds with solid performance records may actually attract higher shares of inflows as a result of the crisis, this would only heighten the pressure on the majority of funds. After a decade in which GPs have had the upper hand in negotiating fund terms, this could shift the balance of power in favour of LPs [as it did after the financial crisis in 2008](#). In the context of growing LP interest in sustainable investing, Prequin [expects](#) this shift to be especially marked in non-economic areas such as governance issues. Even when fundraising pressures dissipate, GPs will still be expected to offer more robust ESG policies as they become accepted best practice. This means that ESG credentials could

become a prerequisite for being competitive in a crowded market. As the UNPRI chief [put it](#) recently - if “GPs found that LPs weren’t coming to them because they [were] not doing enough around these issues, they would make change[s]”.

Third, tying LP and GP interests together, the value case for incorporating ESG into investment decisions also seems to have been bolstered by the pandemic. If the growing scrutiny of investors’ ESG credentials and the PE industry as a whole is the stick, this is the carrot. Longstanding views that ESG is an end-of-cycle nice-to-have to be ditched in a downturn have not stood up well. Rather, the stark outperformance of ESG-oriented assets during the covid-19 market rout demonstrated their [downside protection benefits](#). As such, ESG funds saw [average excess returns of up to 1.83%](#) during the Q1 2020 sell-off, a result that suggests ESG integration can add value throughout the market cycle. Recent [studies](#) have shown ESG outperformance across multiple asset classes and geographies both during the crisis and in the longer-term. [Early indications](#) following the pandemic also show that investor views are shifting accordingly, with many seeing ESG as a tool for hedging against risk during volatile periods like Q1 2020. Although not focused on PE, such findings will only strengthen the [argument](#) of Michael Cappucci, a managing director at Harvard Management Company, that those LPs and GPs who overlook ESG factors are increasingly “shirking their fiduciary duty and putting their portfolios at greater risk”.

Both ESG and PE have been put under the spotlight since the onset of covid-19, and are likely to stay there for the foreseeable future. As these two areas become more intertwined, LPs and GPs need to begin planning for increasing pressure on ESG disclosure, reporting, and investment strategy. The lack of meaningful uptake of ESG in the PE industry thus far risks making the industry a target for public anger and regulatory action, and GPs that prepare for such a scenario now may find themselves in a better position later. Given the nature of the PE industry, including the direct influence that funds have over portfolio companies, both GPs and LPs will need to consider how ESG integration can be best achieved in their specific circumstances. Indeed, although the available toolkits provide a general template for action, careful consideration tailored to distinct investment strategies will be needed as pressures for meaningful ESG integration continue to grow.

This Global Counsel Insight note was written by Felix Cazalet, Associate and Thomas Atherton, Senior Associate at Global Counsel.

To contact the authors, email:
f.cazalet@global-counsel.com

The views expressed in this note can be attributed to the named authors only.

A: 1050 Connecticut Ave NW, Suite 500, Washington, DC 20036
T: +1 [202] 742 6764
E: info@global-counsel.com
www.global-counsel.com
[@global_counsel](https://twitter.com/global_counsel)

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