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PRIVATE EQUITY ACTION IN ESG SURVEY 2022

KEY FINDINGS

- Energy security and the clean energy transition are leading factors influencing ESG investment and fundraising strategies in 2022.
- A strong ESG mindset is already present for the majority of LPs, notably through their investment in dedicated ESG funds (55%) and how they incorporate risk in their investment process (38%).
- Just under half of those surveyed would choose an investment with solid ESG performance over one with no ESG performance, but a better valuation.
- Top drivers for GPs to implement ESG strategies are slightly different to those of LPs.
- Some 77.89% of LPs found ESG standards in Europe to be more “advanced” than those in North America.
- The quality of ESG metrics for portfolio companies is highly significant in fund selection for investors (57%), just slightly more than clear and audited reporting standards (40%).
- Nearly 74% of LPs said that ESG standards were growing in importance when carrying out due diligence of GPs. Yet, the majority of LPs (60%) believe that the current lack of standardised reporting is threatening the future of ESG.

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ESG PERFORMANCE, NOT VALUATIONS TO DOMINATE LP FUND ALLOCATIONS

Limited partners reveal their ESG fund selection criteria in Conservice's inaugural Private Equity Action in ESG survey

While Conservice's Private Equity Action in ESG survey of limited partners (LPs) was taking place, a major shift in geopolitical and energy supply risk ensued. Russia's invasion of Ukraine spurred bold renewable investment and energy security trade policies that would lead to clean energy investment acceleration across Europe.

This is a prime example of how societal and governmental demands and interrelated risk adjustments can have a major influence on ESG strategies and metrics at the portfolio, fund manager and limited partner levels.

New ESG strategies are already at play and will have an impact on private equity funds' ESG metrics, predominately in the energy transition segment.

In March, US President Biden signed an Executive Order to ban the import of Russian oil, liquefied natural gas, and coal to the United States. He also has prohibited Americans from financing or enabling foreign companies that are making investments to produce energy in Russia.

As of December 2021, Russia was the fourth largest supplier of US oil imports, according to World Population Review. In 2021, the US imported nearly 700,000 barrels per day of crude oil and refined petroleum products from Russia, according to The White House.

Similar political decisions were also made further afield. Great Britain, for example, is aiming to cut off imports of Russian gas by the end of this year alongside an ambitious, quicker expansion of nuclear, wind, solar, hydrogen, and nuclear, including delivering the equivalent of one nuclear reactor a year instead of one a decade.

The European Commission also aims to be independent from Russian fossil fuels, starting with gas, by 2025. By doing so Europe could divert its €1bn daily spend on Russian fuel imports to a 100% homegrown renewable plan.

For markets such as Germany, Europe's industrial powerhouse, this is a significant political shift from its decades' long transformation through trade policy with its recent cessation of the Nord Stream 2 pipeline and historic military restraints.

European Commission President Ursula von der Leyen said that Europe needs to "act now" to mitigate the impact of rising energy prices, diversify the region's gas supply for next winter and accelerate the clean energy transition.

"The quicker we switch to renewables and hydrogen, combined with more energy efficiency, the quicker we will be truly independent and master our energy system," said Von der Leyen.

ESG MINDSET IS STRONG AMONG LPS

One of the most effective and long-term ways LPs can mitigate climate and fossil fuel-related geopolitical risks is to outline their ESG objectives with their general managers sooner rather than later, especially for portfolios with high exposure to industrial and power-hungry sectors. Of the limited partners surveyed by Conservice, a small proportion (4%) engage General Partners (GPs) on ESG reporting every month.

However, as the adoption of ESG auditing becomes more commonplace at the fund and portfolio level, we could see this level of interaction rise. Some 72% of LPs said they intend to increase their discussions on ESG with their GPs. But for now, most are content with annual (39%), quarterly (29%) or half-year (15%) ESG reporting.

According to Conservice's research, a strong ESG mindset is already present for the majority of LPs, notably through their investment in dedicated ESG funds (55%) and how they incorporate risk in their investment process (38%).

FIGURE 1: Is your firm investing in a dedicated ESG fund(s)?

However, something revealing about ESG performance came out in the findings. Of the 95 LPs that participated some 42 said they would choose an investment with solid ESG performance over one with no ESG performance but a better valuation.

While this marks a significant preference for ESG dominance in fund selection, some 20 LPs are less convinced and would choose financial performance over ESG metrics at this moment in time. That leaves another 28 undecided and another 5 citing "other" specific reasons, including the method of risk evaluation and whether there were clear signs that a target company would likely outperform in the future solely based on its ESG objectives.

"While the jury is still out over which funds have produced materially higher investment returns due to ESG factors specifically, the diversity of strategies incorporating sophisticated risk-management and due-diligence processes will continue to evolve into more nuanced conversations. One useful resource has been the industry-specific SASB standards and, most recently, ESG discussions are heating up between GPs and LPs as they move the conversation from "policies" and "check-the-box" exercises to performance improvement plans and real consequences for not meeting a minimum threshold of ESG performance" says Carlos Solano, ESG Manager at Conservice.

Solano continues, "What will be revealing for everyone is learning which funds will have the right approach. Which funds are measuring the things that matter? Who will outperform once ESG becomes and an off-the-shelf standard?"

FIGURE 2: Are you taking measures to understand climate risk? Do you incorporate climate risk in your investment process?

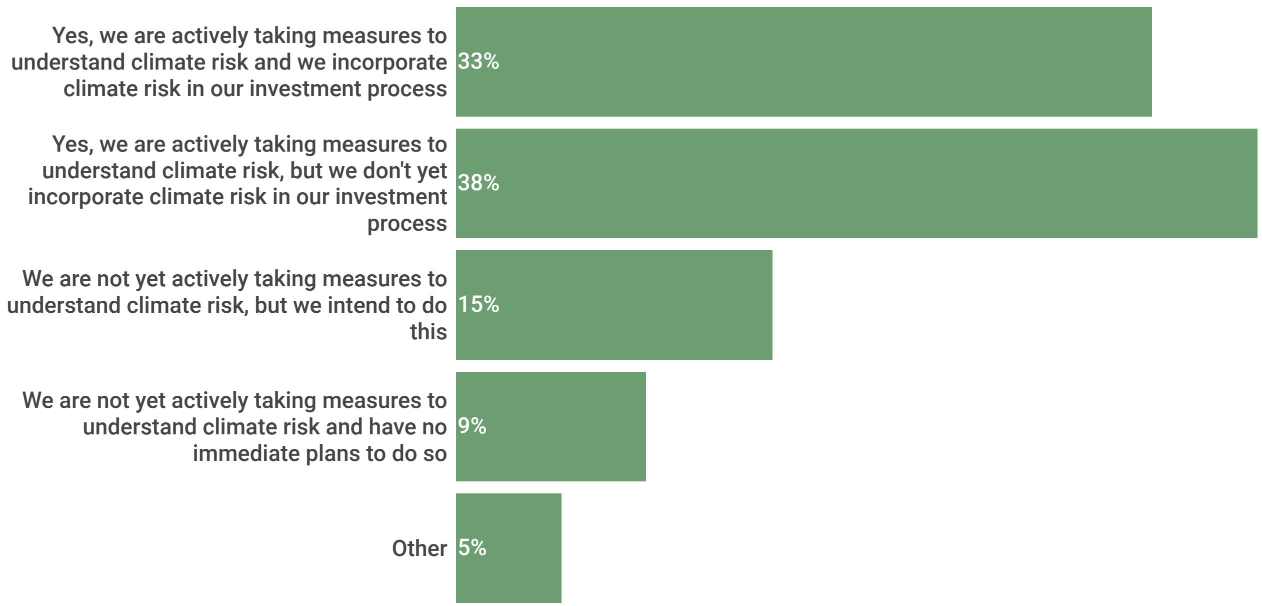
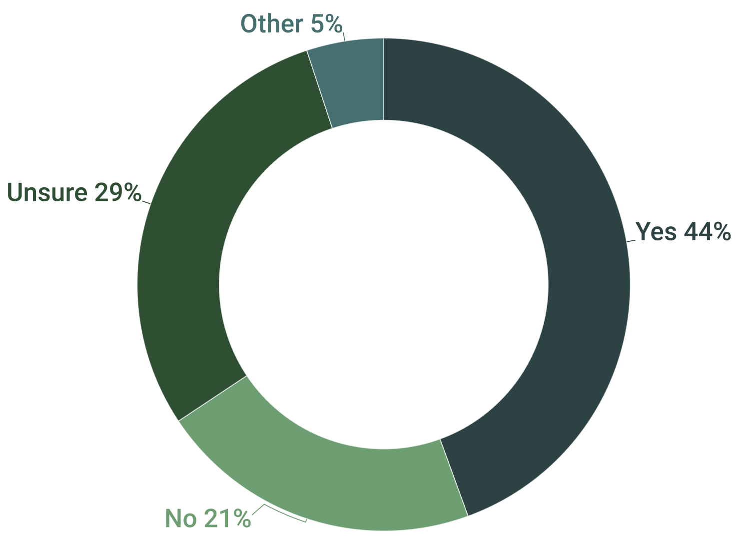


FIGURE 3: Would you choose an investment with solid ESG performance over one with no ESG performance but a better valuation?



ARE LP AND GP ESG METRICS ALIGNED?

The number one driver for LPs when making ESG investment decisions is investment potential, notably "better returns" (31%), which is in sync with those LPs that said they had growing confidence in choosing funds with a strong ESG performance ***(see Figure 1).***

According to a McKinsey report ***(Five Ways That ESG Creates Value)***, a strong ESG proposition correlates with higher equity returns, from both a tilt and momentum perspective. Better performance in ESG also corresponds with a reduction in downside risk, as evidenced, among other ways, by lower loan and credit default swap spreads and higher credit ratings.

Other factors driving LPs to take ESG action in their private equity portfolios ESG include, in this order of importance:

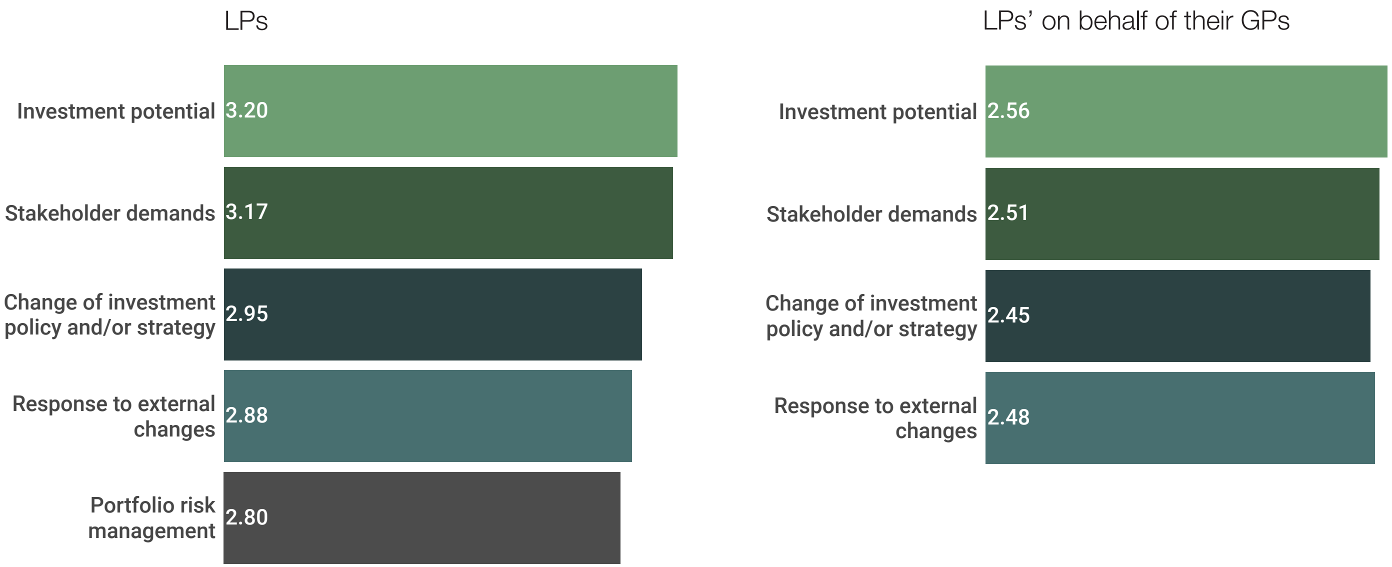
1. A change in investment policy and strategy such as replacing "sin investments" with carbon-neutral ones (20%)
2. A response to external changes, such as regulations or societal change (18%)
3. Stakeholder demands and investment committee decisions (18%)
4. Portfolio risk management (13%)
5. Better returns (31%)

Top drivers for GPs to implement ESG strategies are slightly different to those of LPs, according to the findings. GP Drivers in order of importance:

1. Investment potential and better returns
2. LP, regulatory or societal pressure
3. Stakeholder demands, such as a change in policy at the management firm, a portfolio manager's commitment, or changes at the investment committee level
4. Change of investment policy shifting from "sin" investments towards "carbon neutral" ones

FIGURE 4: What are LPs' and GPs' top drivers for ESG?

Analyst note: LPs were given five options for themselves and four on behalf of their GPs. Weighted average based on a 1-5 ranking with 5 top.



ROLE OF JURISDICTION AND ESG ACCOUNTABILITY: EUROPE V NORTH AMERICA

Respondents resoundingly (78%) found ESG standards in Europe to be more "advanced" than those in North America, with 17% seeing ESG standards between the two jurisdictions as "broadly similar," and 5% believing North America's ESG standards were more advanced than in Europe.

Solano explains the likely reasoning behind the mixed views: "Europe is taking a multi-stakeholder approach by not just looking at internal relevance but also encompassing broader impact – primarily for investors, but other sustainability topics and stakeholders as outlined by the Globarl Reporting Initiative (GRI). Another relevant framework that is sometimes considered in more "impact first" circles is IRIS as part of the work from the Global Impact Investing Network."

Kylie Ford, Conservice's Principal ESG Consultant, says the overarching agreement among LPs that Europe may have stronger ESG standards "in a regulatory sense is very much spot on."

However, she adds, "In terms of market tolerance, and perception, I'm not sure that the divide is quite as big as people perceive. For example, when it comes to how much importance valuation plays a part in the ESG assessment of an asset, I would say it's actually about the same in America as anywhere else. Europe has just had a more structured way of looking at things."

While ESG standards may be perceived as more "advanced" in Europe, Solano argues that ESG action and auditing could largely be swifter in North America because ESG accountability lies with companies and not investors, the latter of which is the case in Europe.

"Companies really need to start putting a price on their emissions. This will vary industry by industry. But it's worth noting that the difference between Europe and the US, is that the US puts the burden on companies themselves. Europe puts the burden on investors. LPs in Europe must request the data through their GPs. In contrast, US funds and LPs are more or less protected," says Solano, who suggests there is a risk that the European ESG data gathering process could decelerate ESG adoption yet adds that it will be interesting to see how these very different approaches play out in the coming years.

Ford sees regulation as the main driver that will flesh out exactly what companies need to be "on the hook for," whether that's regulation coming out of the US, Canada or the EU Taxonomy, the latter of which is in the early stages implementing Article 8 and 9 regulations.

"We have to be patient yet prepared to get the baseline of [all the metrics] that we can now, knowing that with more clarity things will calm down," says Ford.

ESG'S INFLUENCE ON FUND SELECTION CRITERIA

Fund managers that have clear ESG policies in place at the time of fundraising – at the manager and fund level – will have a higher likelihood of attracting new and existing limited partners, according to the findings.

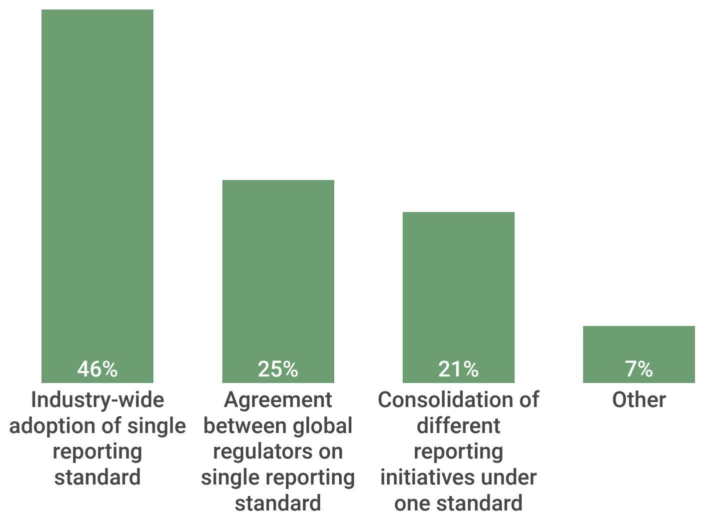
The quality of ESG metrics for portfolio companies is highly significant in fund selection for investors (57%) just slightly more than clear and audited reporting standards (40%).

Nearly 74% of LPs said that ESG standards were growing in importance when carrying out due diligence of GPs. Yet, the majority of LPs (60%) believe that the current lack of standardised reporting is threatening the future of ESG.

Until a global standard is set, LPs could be dealing with a mix of reporting frameworks. At present, the leading reference for LPs is UNPRI (57%), followed by TCFD (Task Force for Climate-Related Financial Disclosures) (25%), SASB Standards (Sustainable Accounting Standards Board) (32%), GRI (Global Reporting Initiative), (24%) and undecided or other (15%).

Many LPs would like to see certain advances in standardization, namely a consolidation of different reporting initiatives under one standard. However, one LP said that "one standard could not possibly catch all asset classes." Another investor suggested agreement should be made between global regulators on a single reporting standard.

FIGURE 5: How would you like to see advances in standardization?



> “DIVERSITY OF THOUGHT, FOR EXAMPLE, IS PROVING COMMERCIALLY VIABLE IN PRODUCT DEVELOPMENT TO IMPROVE FINANCIAL OUTCOMES AND CUSTOMER ACQUISITION”

Often the first battle is understanding which metrics to measure. Ford offers suggestions: “Carbon is an obvious metric that you can start measuring since it is associated with higher prices and costs connected to emissions. I believe diversity is another metric that can help determine future performance.”

She explains: “Diversity of thought, for example, is proving commercially viable in product development to improve financial outcomes and customer acquisition. There are already signs that talent retention is positively correlated with stronger revenues. High employee turnover, on the other hand, is leading to more costs and revenue losses [as we have seen in several sectors ranging from retail to air travel]. These are metrics that companies can measure and improve now.”

When it comes to measuring diversity, LPs overall put more importance on diversity at the management firm level than portfolio company level ***(See Figure 7).***

“One of the most striking findings of the survey was that nearly 20% of limited partners believed that the diversity and gender equity was “good” at an executive level among their GPs’ portfolio companies,” says Ford. “I would be interested in knowing what standards they’re using for that given the known compositions of most teams which could very likely be one female among a sea of 8 males.”

That said, 46% of those surveyed said diversity, gender equity and inclusion were “average, but improving” with nearly 18% admitting these figures were proving “poor”.

In time, when set standard metrics are adopted and ESG auditing is commonplace, Ford argues that the data will override sentiment, the latter of which can lack transparency.

FIGURE 6: Is the current lack of reporting standardization a threat to the future of ESG?

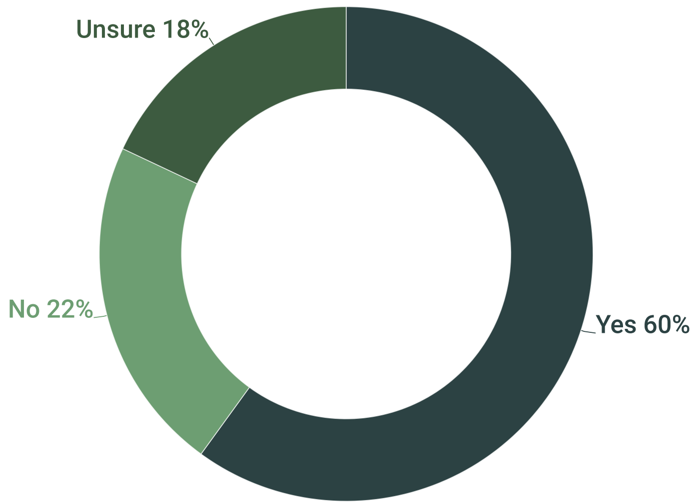


FIGURE 7: How significant a part does the following play in the due diligence of GPs and ESG policies?

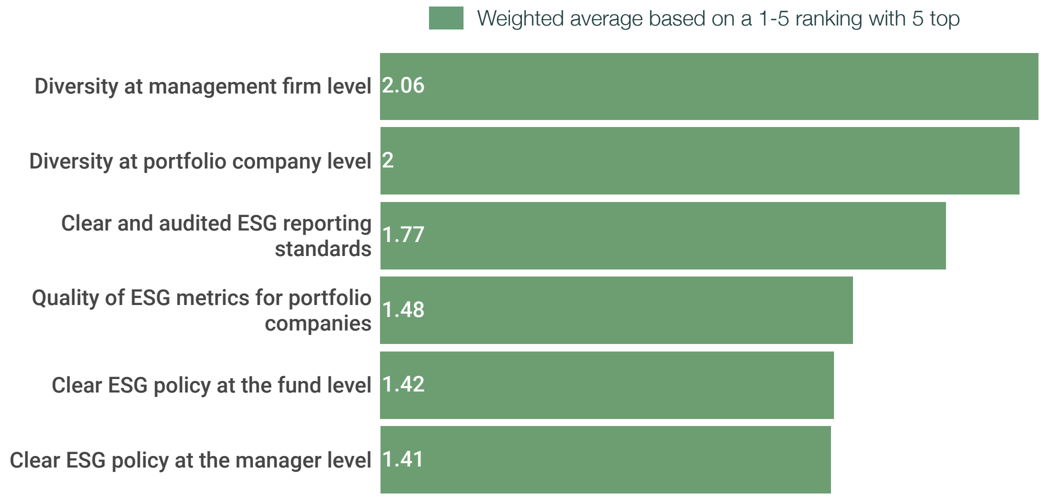


FIGURE 8: How good is diversity, gender equality and inclusion at the exec level of your GP's portfolio companies?

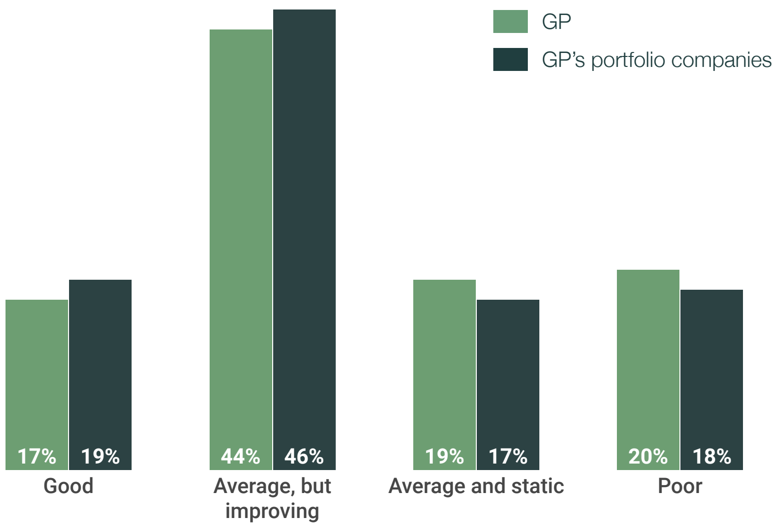
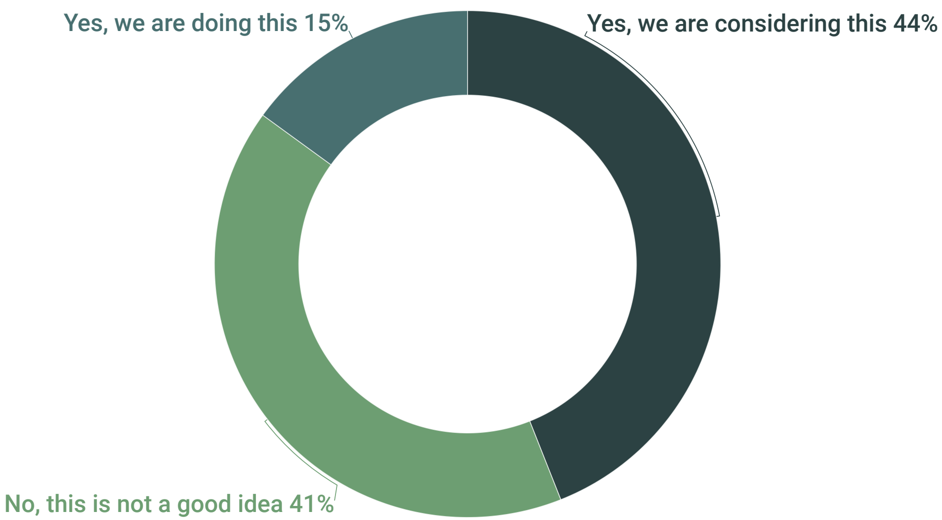


FIGURE 9: Should these diversity, gender equality and inclusion goals be tagged to executive remuneration plans?



> "WE MUST HAVE AN UNDERSTANDING AROUND IMPACTS BECAUSE NOT EVERYONE IS GOING TO BE TRACKING THE SAME THINGS. WE NEED TO UNDERSTAND BETTER WHAT METRICS WILL LOOK LIKE WHEN WE CREATE STRUCTURE IN A MEANINGFUL AND ROBUST WAY THAT CREATES A MORE SUSTAINABLE WORLD"

Ford says all parties in the investment chains are going through this "awkward adolescent phase" of deciphering ESG metrics.

"We must have an understanding around impacts because not everyone is going to be tracking the same things. We need to understand better what metrics will look like when we create structure in a meaningful and robust way that creates a more sustainable world.

I believe that we will find metrics that tie into not just valuation, but people's willingness to engage in the long term, and we're going to perhaps find some metrics that no longer have to be tracked because they are not providing positive impact, but rather embracing a company's culture," says Ford. Solano points out that certain sectors' talent pools can be single-gender-dominated. This can be out of a company's control if historically more females (e.g., health and social care) or males (e.g., engineering and industrials) take up careers in those industries.

He suggests ESG regulations may even have to adapt to gender-specific metrics when it comes to certain industries. This method he says could help avoid penalising certain industries unfairly. That is not to say that gender imbalance in certain industries cannot change over time through either government or industry-led career initiatives to attract a more gender-diverse workforce. But until such changes materialise, Solano suggests certain safe harbors or other considerations may have to emerge.

This sector metric example illustrates that fund managers and their portfolio companies are not decided on how diversity, gender equality and inclusion goals should be tagged to executive remuneration plans ***(see Figure 9)***.

Some nearly 15% of LPs are already integrating ESG-linked remuneration plans as part of their GP holdings, but the balance of LPs have very different views on the subject. 44% of LPs are considering ESG-linked remuneration, while 41% believe this is "not a good idea."

CONCLUDING THOUGHTS

If the geopolitical uncertainties over clean energy supplies and the rising cost of fossil fuels of late are anything to go by, limited partners can expect an uptick in private equity players raising funds in line with Article 9 as early as this year. This is a positive step forward with such funds - Taaleri Bioindustry I is one of the first private equity funds to be classified as Article 9 in Finland. Ardian also just raised a fund - already launched in Europe.

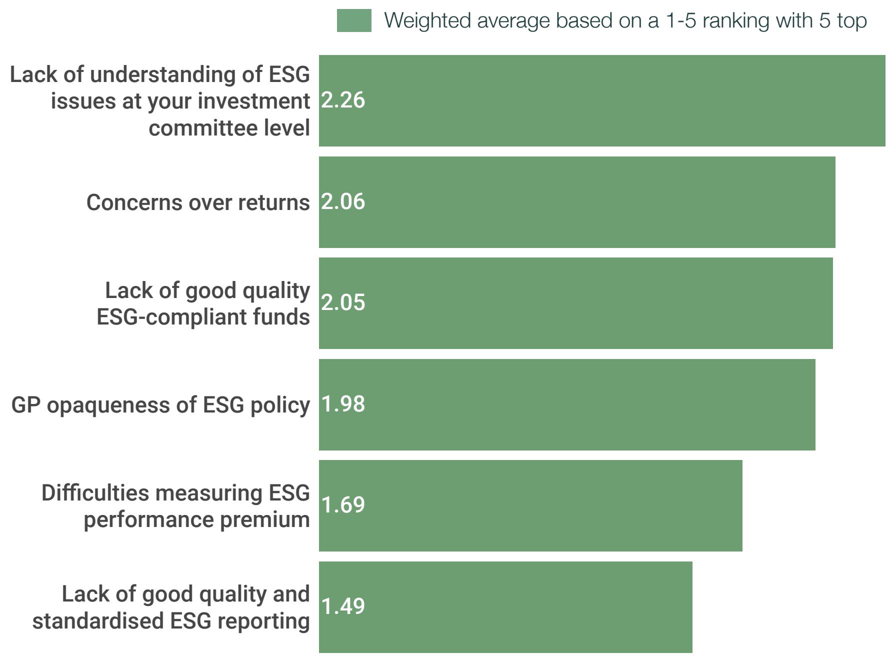
However, several barriers to greater adoption of ESG across portfolios remain, namely a lack of good quality standardized ESG reporting, with close to 57% of LPs saying this was a "highly significant" barrier impacting their portfolios. Other barriers concerning LPs include "GP opaqueness over ESG policies," difficulties in measuring "ESG performance premium" and "concerns over returns."

In terms of diversity, optics are playing a larger role when it comes to talent acquisition and in-house promotion at the portfolio company level. This is another positive indicator of change.

Just over 24% of LPs are promoting diversity gender equality and inclusion at the executive level of GP holdings, with an encouraging 39% saying they too are promoting such metrics but admit they "need to do better". Yet, despite these positive signs, some 37% of LPs feel they have higher priorities than promoting these metrics at the portfolio company level.

Gatekeepers, such as fund administration specialists and FASB-certified accountants with SASB credentials, will have a significant role to play in the coming years, according to Solano. He says such specialists could help GPs, LPs and portfolio companies alike become more comfortable with the metrics and data measuring process. Having independent specialists will also provide general partners with the assurance they need when it comes to putting their name to ESG audited reports.

FIGURE 10: What are the most significant barriers to greater adoption of ESG across your investment portfolio today?



For more information, visit us at esg.conservice.com

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