KEYNOTE INTERVIEW

Private equity's ESG sea change

The asset class has made notable strides on ESG, with the drive towards standardisation, the focus on ESG as a value driver, and a shared industry voice as priorities moving forward, say KPMG's Tania Carnegie and Glenn Mincey

Q How are private equity firms focusing on ESG today? What has changed and how will this evolve over the next five years?

Glenn Mincey: The pandemic, together with societal issues front and centre, has accelerated the pace of change over the past two years around ESG.

It is hard to imagine investing in a company without putting an ESG lens on all aspects of the business. This has become business as usual with all sides aligned – LPs, GPs and talent – around the acknowledgement that this is the way forward.

SPONSOR
KPMG

Tania Carnegie: In the last 12 months we have witnessed a sea change. Funds are making significant investments in bringing high-level talent into newly created, senior positions to lead their ESG agendas.

These appointments are happening throughout firms – clients are adding global heads of ESG, ESG leads for different parts of the business and implementing ESG learning programmes for professionals within the business. These newly hired executives have a real voice and influence as part of the C-suite.

The other area we are seeing significant investment is around ESG data management. Private equity firms are increasingly seeking robust technology platforms to capture and manage ESG data to support regulatory and investor reporting, and to leverage data to inform investment decisions in new ways. This is a top priority area.

Q How will ESG continue to influence investment decisions and approaches to portfolio management?

TC: We are seeing our clients

becoming much more intentional about the types of investments they want to pursue. For example, many have made commitments to invest to enable the transition to a low-carbon economy either through dedicated funds or as part of their overall approach.

We are assisting clients to incorporate ESG more robustly earlier in the investment process. Previously, ESG considerations during due diligence were focused on identifying key risk factors that could prove problematic later on. Now, deal teams are also looking through an opportunity lens and how ESG could drive value during the hold period. Early on, they are identifying climate factors from both a risk and opportunity perspective, for example, seeking to understand the decarbonisation pathways they could pursue.

Once a company is in the portfolio, sponsors want to quickly understand the ESG maturity of that company, key material risks and opportunities that should be addressed in the near term, and how to prioritise longer-term investment in ESG improvements.

GM: There is certainly much more focus on value creation. Even if some companies before treated ESG as simply a red flag exercise, now, in the face of headwinds like geopolitical crises, rising interest rates, inflation, supply chain constraints, and so on, ESG is seen as an additional lever to create value. If there is a poor ESG track record going in, managers see an opportunity to fix that and make a company greener to add value.

Often a GP will ask us to support a particular portfolio company along their ESG journey. Recently, we conducted an ESG strategy review for a leading global technology provider. Key findings included identification of significant organic and inorganic growth opportunities driven by ESG-focused market trends. At the end of the engagement, the management team had a completely different perspective on the relevance of ESG to its core business.

Q Based on your work with clients, what advice do you have for private equity firms seeking to navigate the inevitable regulatory requirements and stakeholder expectations of the future?

TC: We have turned a corner on the regulatory side. ESG has been unregulated for some time and that has changed with the introduction of EU legislation and the SEC weighing in. For clients, it is about understanding the distinction between what is required and what is expected, and identifying the opportunity in that for differentiation rather than obligation.

For example, we have been helping our clients with implementation of the Sustainable Finance Disclosure Regulation, which is onerous and evolving. We are rolling up our sleeves to help clients make this as practical as possible. Beyond compliance, conversations are now shifting to how to turn the additional data collection, assessments, and other considerations into an advantage and a value-creation opportunity.

GM: There has been a good bit of scepticism around ESG but now the focus is on how we are truly making a difference, as well as starting to show successful outcomes that tangibly demonstrate firms are better investors due to their work in this area. Greenwashing is the enemy, and if the SEC issues regulatory guidance that simply codifies what people are already doing, the sceptics will win. What we need are metrics that point to real impact that is identifiable and measurable.

Q What are some of the leading and emerging ESG practices, and which will most likely develop into standard ways of doing business?

TC: As Glenn just mentioned, ESG as a value driver is a key theme defining many of our client interactions. Private equity investors realise considering ESG contributes to more than risk management.

The other key themes are focused on data – specifically data quality and integrity. There is a focus on refining the core KPIs and metrics to collect the most relevant data points. This enables more decision-useful information and advanced and consistent reporting.

GM: The industry is still trying to reach a consensus on what data is crucial. LPs and various constituents are all asking questions and identifying data points they require, but for GPs the lack of consistency from one LP to another creates a scenario of death by a thousand questions, making it hard for GPs to navigate the constantly changing landscape.

The industry has a real desire for standardisation of the data being collected, not only because of the volume of data but also to make sure the data being produced is making a difference. It sounds strange to suggest the industry wants the US Securities and Exchange Commission to come in with a standard set of rules, but that is the point we are getting to.

TC: There is a desire to come together on this as an industry, and we are seeing and supporting interesting examples of work being done to come up with that common view. The unifying perspective is that there are good existing frameworks and initiatives out there around metrics and measurement, providing a lot to work with to arrive at a common approach. Until standardisation occurs, we see the opportunity to leverage data and reporting as an advantage and as a differentiator, recognising that with all the data that is being collected the potential insights firms have access to is tremendous.

GM: It is also worth noting that gone are the days of having one person doing everything ESG-related within the business. There is a realisation that ESG requires very specific industry focus. Many of our clients have over 10 people operating across their firms, each aligned to a particular area of focus, so there is an ESG lead for real estate, private equity, credit, climate change and diversity and inclusion. That kind of focused approach will, we think, develop into the standard way of operating.

Q What are some of the key ESG challenges private equity firms are dealing with and how might they be alleviated going forward?

TC: One of the biggest pain points is the lack of consistent understanding of ESG, and how it should be incorporated and leveraged in the investment process. Huge strides have been made to the point where the majority of those in leadership positions now acknowledge the importance of ESG. Defining a firm's approach to ESG, how to practically integrate it into key activities and decisions is an enabler of success although challenging and requiring significant change management.

GM: Another challenge is inherent scepticism about ESG. We have seen fund-level ESG professionals approach portfolio companies and find board members who are just not interested and occasionally there can be resistance to initiatives.

This is why a big focus of our work with clients is to assist them in developing and implementing a rigorous and robust strategy. A key part of this is accessing quality insights to properly inform asset management. For example, to help clients address climate concerns, KPMG developed several data and analytics accelerators such as Climate IQ, EnVision and the Decarbonization Pathways Tool to help private equity clients assess the climate change risks across their portfolio, as well as benchmarking against peer activity.

> *"If there is a poor ESG track record going in, managers see an opportunity to fix that and make a company greener to add value"*
>
> **GLENN MINCEY**

> *"Funds are making significant investments in bringing high level talent into newly created, senior positions to lead their ESG agendas"*
>
> **TANIA CARNEGIE**

TC: A further challenge everyone is wrestling with is keeping up with the pace of change. This is where we are seeing an unprecedented level of desire for collaboration and shared learning. We are facilitating forums for our clients to discuss issues they feel are in their common interest to have a consistent view and approach around, or areas where diversity of approaches is important to recognise.

Finally, we see the desire from clients for a private equity-specific voice to come out around ESG and impact investing. ESG is relevant for all types of investors, companies and stakeholders and each has a slightly different perspective. It is important to recognise the unique role of private equity investors relative to other institutional or public markets investors, and therefore their unique approach and experience with ESG. KPMG is proud to contribute to several industry initiatives that support this. ■

Tania Carnegie is the global ESG lead for private equity and asset management at KPMG IMPACT and Glenn Mincey is the global and US leader of private equity at KPMG