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KEYNOTE INTERVIEW

ESG as a value driver


PE firms are doubling down on ESG to boost portfolio companies' resiliency and their appeal to buyers, customers and talent, say Tania Carnegie and Glenn Mincey at KPMG

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Q How is today's challenging deal environment impacting the attention PE firms are paying to ESG?

Glenn Mincey: There is no doubt the deal environment is currently challenging, which is leading sponsors to put a lot more focus on driving value creation in existing assets. The headwinds are well understood at this stage: gone are the decades of free credit, but valuations are still high, interest rates are high and access to credit is difficult.

In that context, there are limited value-creation levers that sponsors can push. Some of those relate to innovation, which is often PE's sweet spot, but others relate directly to ESG. As a result, we see much more attention being paid to ESG as a value-creation tool.

The deal environment will turn up again, and sponsors will need to be able to react quickly to opportunities. As part of this preparation, ESG considerations are being taken into account much earlier in dealmaking processes, with a clear eye to value creation from the outset. Making a 'brown' company 'green' makes it more valuable on exit and increases the return on investment.

While deal volume is low, a lot of clients are revisiting their approaches to ESG due diligence, especially where they have previously taken a more compliance or risk-based approach. They are coming to the realisation that if they lean into this a little more, they can identify the opportunity to drive value through ESG earlier in the process and tee up companies for success from the beginning.

Tania Carnegie: There are a few themes we are observing in this market. First, many firms are reviewing their current ESG approach. GPs are evaluating the progress they've made over the past two years, lessons learned and anticipated regulatory changes to inform further refinement of their strategy and external advisers.

For example, we are assisting firms to evolve their ESG diligence approach. Initially, many were focused on identifying ESG risks and mitigating potential downside. Now we are helping them expand the ESG diligence scope to also assess opportunities for ESG to create value for the business, and to evaluate and rapidly quantify climate-related risks and decarbonisation pathways. Some PE firms are also reviewing their current ESG diligence providers, and we're excited about the global ESG diligence mandates we've recently been awarded.

Regulation is also enhancing the focus of PE firms on ESG and creating additional complexity that we are helping firms navigate. Regulatory changes have shifted ESG and climate from being voluntary to now being required in many cases, especially for private equity firms with investors and investments in Europe. In the US, we are waiting on the US Securities and Exchange Commission to finalise its climate disclosure rules, which are expected to be consistent with the Task Force on Climate-related Financial Disclosures.

Q How do you see managers leaning into ESG as a value lever in the context of exit readiness ahead of a deal market recovery?

TC: With deal volume down, our clients are focused on supporting their existing portfolio companies. ESG is a key area operating partners see as an opportunity to enhance their value. Increasingly, we're being asked to help portfolio companies prepare for the sale process by assessing their current ESG practices with the scrutiny of potential investors.

The ESG value story today is more than whether the right policies and procedures are in place, it's about how ESG is embedded in the way the company does business and communicating the way it adds to or preserves the value of the business. A common area for enhancement is improving the alignment of ESG with, and as an enabler of, their broader business strategy. Many companies are still thinking about ESG in a siloed manner, and we assist them to realise quick wins and develop a longer-term plan to enhance integration of ESG.

The goal is to create more sustainable, resilient and attractive companies for investors, customers and employees going forward, not ESG for the sake of ESG.

In addition to evaluating climate plans and performance, several companies we've been working with believe their human capital, compensation and benefits practices are a differentiator and an area of focus as they prepare for exit. Investors are interested in what makes a company an attractive place to work, as attracting and retaining top talent is a critical enabler of a company's success.

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>
> **GLENN MINCEY**

Q Are there any industries where you see ESG considerations really moving up the agenda right now? Why is that?

GM: Two industries that we see as particularly attractive in an ESG context are the energy sector (specifically related to the energy transition) and healthcare. Healthcare-focused ESG opportunities are a burgeoning area right now, and that is something we first started to see during covid.

If you think about access to affordable healthcare as a key criteria for ESG, healthtech has a compelling part to play. During covid, healthtech gave people in underserved communities much better access, and that has continued beyond the height of the pandemic.

While efficiencies are also important, the power of applying an impact lens to increasing access to healthcare in underserved and underrepresented communities is compelling.

When it comes to the energy transition, there are several areas within that where private equity is now actively investing, such as renewable energy, energy storage, energy transmission and electric vehicles. Forecasts have put the price tag for the transition to a green energy landscape at over $100 trillion over the next 30 years, and that money cannot come from governments alone. A large proportion of it must come from private investors, including private equity.

TC: A lot of our clients are prioritising the highest emitting companies in their portfolios. Factors driving this include investor expectations, regulation and climate commitments made by the PE firm. Helping these companies to decarbonise is an important part of their competitiveness going forward. As they identify these businesses, we are assisting them to determine and prioritise different decarbonisation options, the associated costs and the implications to the business.

Our clients are starting to seek an understanding of climate risk and associated financial implications to a target early in the deal process. As mentioned earlier, we've been co-developing and delivering climate risk diligence with clients, including analysis of what the material climate risks are, potential decarbonisation levers, what the estimated costs are and implementation considerations.

Q What do you think ESG best practice in PE might look like five years from now?

GM: There will come a time when we do not think of ESG in isolation, but instead it will permeate everything we do. It will become standard operating practice to consider ESG at every stage of the life cycle of an investment.

TC: Best practices will continue to focus on the value provided by ESG and climate considerations. This includes quantitative as well as qualitative assessment of the contribution of ESG to the value of a company. This is the ultimate exam question asked by investors.

However, in five years I anticipate that ESG will firmly be part of a company's equity story. The ESG and climate equity story will be so embedded as a critical part of a company's competitiveness and value proposition that it will no longer be a separate ask. Instead, companies will be asked what the underlying issue is if they aren't proactively integrating ESG into their strategy and narrative, to enable both short- and long-term growth and resilience.

Q How are PE firms responding to the latest regulatory developments in relation to ESG?

GM: The focus of governments has been on relatively narrow criteria when it comes to ESG, whereas private equity as an industry has increasingly applied a much broader lens.

Regulatory attention has impelled the industry to focus more on this, but private equity firms have generally gravitated away from net zero as a goal because they are focused on much more than just reducing carbon emissions. Rather, they are trying to look at the tangible benefits they can bring by making more significant changes. The driver is not reducing carbon emissions but making companies greener overall and driving a broad positive impact.

TC: The regulatory and standards landscape is evolving at a fast and furious pace. Many of our clients are trying to keep up with requirements they need to comply with as a firm, and the different regulatory requirements their portfolio companies are subject to. This is very complex for firms that invest globally in companies that operate in multiple jurisdictions.

Each regulation comes with its own set of data, reporting and disclosure requirements. We are assisting our clients with implementation including rationalising the various requirements, and establishing the appropriate policies, methodologies, processes and controls. Fundamental to many of the regulations is greenhouse gas reporting, and we are assisting with establishing GHG inventories and reporting readiness. Our goal is to help our clients realise benefits beyond compliance – how to leverage the data to inform asset management decisions in addition to disclosure. ■

Tania Carnegie is global and US ESG lead, private equity and asset management, and Glenn Mincey is global and US head of private equity at KPMG