Eyes on the prize: Unlocking the ESG premium in private markets

The business of sustainability

ERM

"The summit is what drives us, but the climb itself is what matters."

Conrad Anker
World-renowned mountaineer

Foreword

Disruption from ESG trends creates significant opportunities for the astute investor

Environmental, Social, and Governance (ESG) became a discussion topic for investors long before the events of 2020. However, recent economic and social disruptions have made clear the urgency of shifting from discussion to action, as astute business leaders look to become more resilient and reimagine a better future with sustainability at the core.

Keryn James
Chief Executive Officer

While business previously understood that climate change, biodiversity losses, and societal imbalances can create upheaval and devastation for communities and businesses, COVID-19 and the global movement for racial equity cast new light on the urgency of addressing such challenges.

The value of the E and S in ESG has come into much sharper focus for people across the world and we believe this will prompt seismic shifts in behavior. I truly believe the current crises presents an enormous opportunity for governments and businesses to place sustainability at the heart of future plans and to accelerate the pace of change.

As one example of this, the pandemic has prompted the Institutional Investors Group on Climate Change (IIGCC), which represents members managing an aggregate of over €33 trillion, to urge the G20 nations to ensure that recovery plans “prioritize sustainability and equity and accelerate the transition to a net-zero emissions economy to mitigate climate risk, create new jobs and catalyze the sustainable deployment of private capital”. As hands-on investors adept at steering businesses through change, private capital funds can and should play a key role in this transition. This shift will inevitably create significant investment opportunity for discerning investors. Some estimates suggest economic opportunities will be worth at least US$12 trillion a year by 2030 and generating up to 380 million jobs. To this end, we are seeing that many Limited Partners (LPs) are already requiring fund managers and recipients of their direct investments to integrate ESG into their investment decision-making processes.

Against this backdrop of increasing urgency and greater co-ordination between financing parties, regulators and business, we surveyed over 50 Private Equity (PE) investment executives globally to provide insights into the shifting dynamics of ESG in the PE sector. The results offer a perspective into how investment professionals in PE are responding to opportunities to invest behind the sustainability megatrends and how ESG practices have evolved since our last survey looked at this in 2016.

While this year's study shows that unsurprisingly there has been marked increase in importance of ESG in PE decision-making processes, respondents highlighted that it often lacks systematic consideration as an investment opportunity or a value creation lever. And they are right. ESG can no longer be viewed as just a risk management issue, but one with significant value enhancement potential.

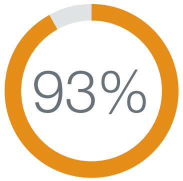
There is a mounting body of research that indicates that companies that are better at ESG are also more resilient and arguably more valuable to investors. So PE firms who are ensuring that their investment approach is ‘ESG strong’ are likely to be winners, as we all reset following the shocks of 2020.

We have already seen some investment firms make bold moves in repositioning themselves to realize the significant prize at the top of the ESG summit. We anticipate that many more will follow.

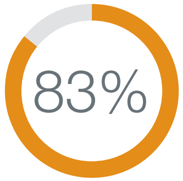
Executive summary:
Key findings

As a follow up to our survey in 2016, our engagement with over 50 Private Equity (PE) investment professionals reveals that Environmental Social and Governance (ESG) issues offer significant value creation and investment opportunities in the coming 3-5 years and that there are specific actions that PE firms can take to access the prize on their way to the ESG summit.

Considering ESG at the heart of investment theses will generate strong returns



93% of respondents overwhelmingly agree that focusing on ESG themes, i.e. companies offering solutions or services to address sustainability challenges and trends, will generate good investment opportunities **[see page 8]**.



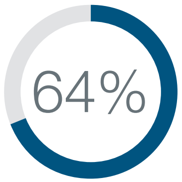
83% of respondents believe that Europe is likely to be the hot bed of ESG investment activity; other regions will soon follow **[see page 10]**.

Respondents indicated these areas and sectors offer the most significant investment opportunity in the next 3-5 years.

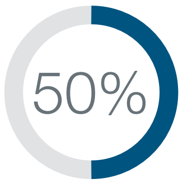
Areas
- Climate Change
- Societal well-being
- Water/Wastewater
- Circular Economy

Sectors
- Energy
- Consumer goods
- Healthcare
- Technology, Media & Telecomms

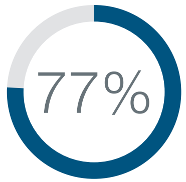
Mainstreaming of ESG in investment processes is well underway



64% of investment teams are part of their Firm's ESG committee and 86% of respondents have access to dedicated ESG Lead/Team, who provide subject matter expertise **[see page 12]**.

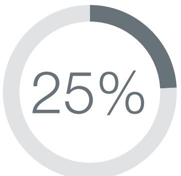


Half the respondents believe that ESG credentials are a factor in winning deals. ESG Credentials tend to matter the most to listed and family-run companies **[see page 13]**.

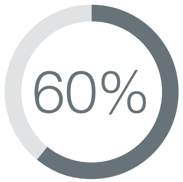


77% respondents believe ESG "sell-side" due diligence will be undertaken more in the next 3-5 years. Anticipating buyer questions is the primary reason for including ESG in vendor packs **[see page 15]**.

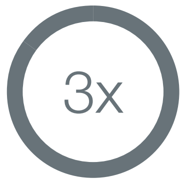
Strategic outlook and systematic approach needed to realize ESG premium at exit



25% of firms have a thematic ESG fund or strategy and actively seek out ESG-focused investments **[see page 17]**.



60% of respondents said that to maximize value, there needs to be regular and in-depth board engagement with companies to ensure that material ESG factors are systematically addressed during ownership **[see page19]**.



There has been a three-fold increase in the perception of ESG as a positive contribution to the exit multiple in sale processes which also explains the trend to have better ESG disclosures in exits **[see page19]**.

Executive summary:
Key recommendations

To truly realize the full potential of ESG we believe PE firms should consider the following:

1. **Setting a strategic vision, and fostering a culture that sees ESG as a significant value creation opportunity:** Realizing the full potential from ESG will require PE firms to shift their firm's vision of ESG, beyond the typical risk management focus, to see it as a significant investment and value creation opportunity. Such a disciplined focus on ESG themes can result in generating higher returns and improve the prospects of accessing increasing pools of committed capital from Asset Owners to tackle the biggest ESG challenges.

2. **Establishing the firm's ESG investment strategy and process for identifying ESG market trends:** Firms will need to have processes to monitor the broader ESG trends and future issues in their sectors and regions of interest. This will allow firms to evaluate the potential scale of opportunities i.e. demand for such solutions and products, sector impacts, and map-out where in the value chain may offer the most attractive ESG investment opportunities.

3. **Moving due diligence from compliance to ESG best practice to generate superior returns.** Firms should leverage the latest ESG tools, established frameworks, and Investment Committee processes to evaluate the potential for a best practice ESG program to increase the financial and brand value of their investments. Firms can derive further benefits through highlighting their own ESG credentials to differentiate and win competitive deals.

4. **Ensuring companies become "ESG Strong" during ownership to benefit from a higher exit multiple.** Firms should adopt a systematic approach to integrate material ESG factors in the full potential plan for their companies, including board engagement on the execution of such plans and consideration of the benefits of linking management incentives to achieve desired goals. Finally, PE firms will need to ensure that ESG disclosures at exit from investee companies provide a credible and complete picture of the company's strong ESG program to demonstrate resiliency and to attract valuation premiums from ESG sensitive buyers.

Based on this survey, firms should feel galvanized to take bold steps toward the significant opportunities presented by the transition to a sustainable, low carbon and equitable economy. **While value protection is important, future-facing firms will generate higher returns by incorporating an ESG approach that systematically targets value creation and proactively invests behind the sustainability megatrends.**

Context and objectives: **What we explored**

Embracing the resilience premium

Integrating ESG is no longer a "nice to have"; it is integral to strong corporate governance and business performance. The evidence is building: a report this year by HSBC[1] (one of several pointing to similar conclusions) concluded that the stocks of companies with stronger ESG credentials and more robust climate strategies have outperformed those of their peers this year. Also, according to the Institute of International Finance (IIF)[2], "the relative performance of sustainable and ESG-focused assets in 2020 has been remarkable… 85% of ESG equity indices outperformed non-ESG peers in Q1 2020, as have 80% of ESG fixed income indices in Q2 2020."

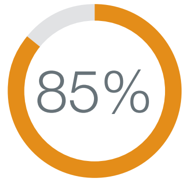
Our work on producing a brief[3] with the World Business Council for Sustainable Development (WBCSD), through the new ERM SustainAbility Institute, shows how companies can build long-term resilience through addressing three key areas: developing risk-management capabilities; investing in human and social capital; and fully integrating ESG matters into decision-making.

We have seen that robust ESG management has helped build resilience in companies, but the pandemic has really brought this to the fore. Going forward, it is clear that business resilience will be highly valued over the coming years, with investors and buyers willing to pay a premium for companies that can demonstrate strong ESG credentials and a resilient business strategy.

A groundswell of investment appetite behind ESG

The amount of assets under management (AUM) among ESG funds as of March 2020 was more than US$1 trillion. These funds have grown by more than 35% over 3 years and European funds account for ~75% of this AUM. This is the growing market.[4]

In October 2019, 30 of the world's largest asset owners (including Allianz, Aviva, APG, CDPQ, CalPERS and GPIF) committed to mobilize significant sums of private capital toward the Sustainable Development Goals under a two-year UN-led initiative, the Global Investors for Sustainable Development. It is clear that an increasing number of the world's most influential Limited Partners (LPs) are focusing on ESG and targeting their capital towards sustainable and equitable outcomes and are likely to look for Asset Managers who can help them meet these objectives, while delivering PE style returns. This trend inevitably creates opportunities for PE firms who ensure that their investments apply a mature ESG approach and who actively pursue ESG investment opportunities. Firms who do not fit into these categories will need to double down on their ESG programs to take advantage of these large pools of capital.



85% of ESG equity indices outperformed non-ESG peers in Q1 2020, as have 80% of ESG fixed income indices in Q2 2020.

US$ 1 trillion assets under management of ESG funds as of March 2020.

1. https://www.greenbiz.com/article/hsbc-companies-focused-climate-change-outperformed-virus-spread
2. IIF Green Weekly Insight, "ESG Funds Deliver," June 2020. Q2 2020 data as of June 18, 2020.
3. https://www.wbcsd.org/eng/Overview/About-us/Vision-2050-Refresh/News/Building-long-term-business-resilience-Learning-lessons-from-COVID-19
4. Morningstar and Morgan Stanley Research, May 2020

Objectives and approach for the 2020 survey

Against this context of increasing appetite for ESG in the investment community and the growing recognition that strong ESG companies are more resilient and can attract higher valuations, our key objectives for the 2020 survey were to:

- Uncover and share perspectives of private equity investment professionals towards ESG and investing behind sustainability mega trends.
- Provide insights regarding the value creation opportunity (both tangible and intangible) from embedding ESG considerations in PE transaction and ownership processes.
- Identify priority actions for PE firms to realize this significant ESG opportunity.

In 2016, against a backdrop of the Paris Agreement of COP21 and an increasing interest in the ESG agenda in private equity markets, ERM produced a report based on research targeted at General Partners (GPs) and Limited Partners (LPs) to explore the impact of ESG issues on investments and the state of ESG integration in investment and ownership processes.[5] Roll forward to 2020 and for many, ESG is now a key part of investment discussions in the private capital markets. Many PE firms also realize that we have only just begun the climb up the mountain where ESG is a key value creation driver.

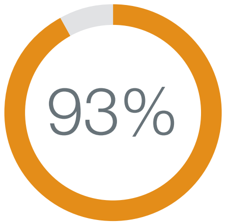
We carried out an in-depth survey with 54 private market investment professionals to cover our stated goals. These investment professionals represented firms spanning five regions across the globe and a selection of Large Cap, Mid Cap and Small Cap funds. Please refer to the overview of survey respondents on **page 22** for further detail.

5. https://www.erm.com/insights/erm-survey-report-esg-the-multiplier-effect/

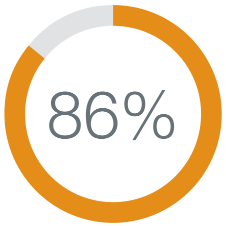
Identifying the mountain of opportunities: **The shift in ESG thinking**

Overwhelming recognition of investment opportunities behind ESG themes

The PE industry's approach to ESG is still evolving, with many firms placing a greater emphasis on risk mitigation than identification of value creation opportunities through ESG. However, as evidenced by the growth of impact funds, including large buy-outs who have impact strategies or separate impact funds, there is a strong appetite in Private Capital markets to explore opportunities behind sustainability megatrends.



93% of respondents overwhelmingly agree that focusing on ESG themes, i.e. companies offering solutions or services to address sustainability challenges and trends, will generate good investment opportunities.



86% expect the pipeline of ESG investment opportunities to increase over the next three-five years than currently, including **21%** who say there will be significantly more.

Our survey shows that now there is clearly a high recognition among PE of the opportunities ESG presents, both now and in the future. Driving this belief are an increased awareness and understanding of investment opportunities from ESG themes, greater clarity of the investment case and/or proven track record of opportunities relating to ESG themes, and more interest from LPs, all of which were cited almost equally by respondents.

Many firms are now recognizing the lucrative opportunities behind ESG themes but the leaders will be those that have a systematic process to identify these prospects and take decisive measures to create competitive advantage.

"For two businesses with [the] same profitability, we would be willing to pay a premium on the one that is a sustainability leader in its segment… because when we sell it in 4-6 years, we will get an even higher premium if we can maintain and grow this position."

Managing Director
(Investment Team)
European Firm

ESG at the heart of investment areas

As context, of the top 10 global risks by impact identified by the World Economic Forum in 2020 (published before the pandemic), all but one is ESG-related. Tackling these ESG risks is not just about mitigation, it also offers significant investment opportunity as policy makers, asset owners, and asset managers mount coordinated responses and action plans.

Taking this as context, respondents similarly see the top four themes for PE Investment as (at least 55% of respondents marked these four areas as presenting large or very large opportunities in the next 3-5 years):

1. Climate change impacts
2. Societal wellbeing
3. Water/Wastewater
4. Circular economy

Given the scale of the issue and the opportunities that the transition to a low carbon economy presents, climate change is unsurprisingly the leading theme. Societal wellbeing, which includes topics such as affordable healthcare, education, housing and food security & nutrition, was the second most popular investment theme followed by investment opportunities in the water/wastewater sector. The second and third themes, are both closely linked to our ability to manage climate impacts.

Close behind the top three ESG themes targeted by PE is circular economy, which came in fourth. This area offers significant opportunity as societies and businesses increasingly recognize the need to reuse and recycle resources to prevent waste and pollution and ensure the earth's growing population has enough resources. According to the World Economic Forum, circular economy, which promotes the elimination of waste and the continual safe use of natural resources, offers an alternative that can yield up to $4.5 trillion in economic benefits by 2030.[6]

Themes like biodiversity did not yet make it to the top four investment areas. However, WEF research shows that $44 trillion of economic value generation – over half the world's total GDP – is moderately or highly dependent on nature and its services.[7] Noting that we are losing species at a rate 1000 times greater than any other time recorded in human history and the dependency of various business value chains on such ecosystems (e.g. pharmaceutical, food, apparel, nature-based alternatives in a number of industries), it will not be long before such issues start to feature prominently in investment discussions.

Interestingly, the respondents felt that ESG themes would almost equally impact opportunities to invest with companies that solely provide sustainable products, to expand sustainable product segments of a target company, or to transform a mainstream company to have a more sustainable profile. This finding should give further assurance to PE investment professionals that ESG issues provide a significant value creation opportunity for a range of companies and situations and not just for companies offering niche "sustainable" products and services.

From the survey findings it is clear that climate change, social wellbeing, water and circular economy are 'hot' investment areas - others like biodiversity and nature-based solutions will come. **It is about PE firms having a systematic and holistic process for identifying such trends and the future issues, so they can successfully create value from these ESG investments.**

Top four ESG themes for PE investments

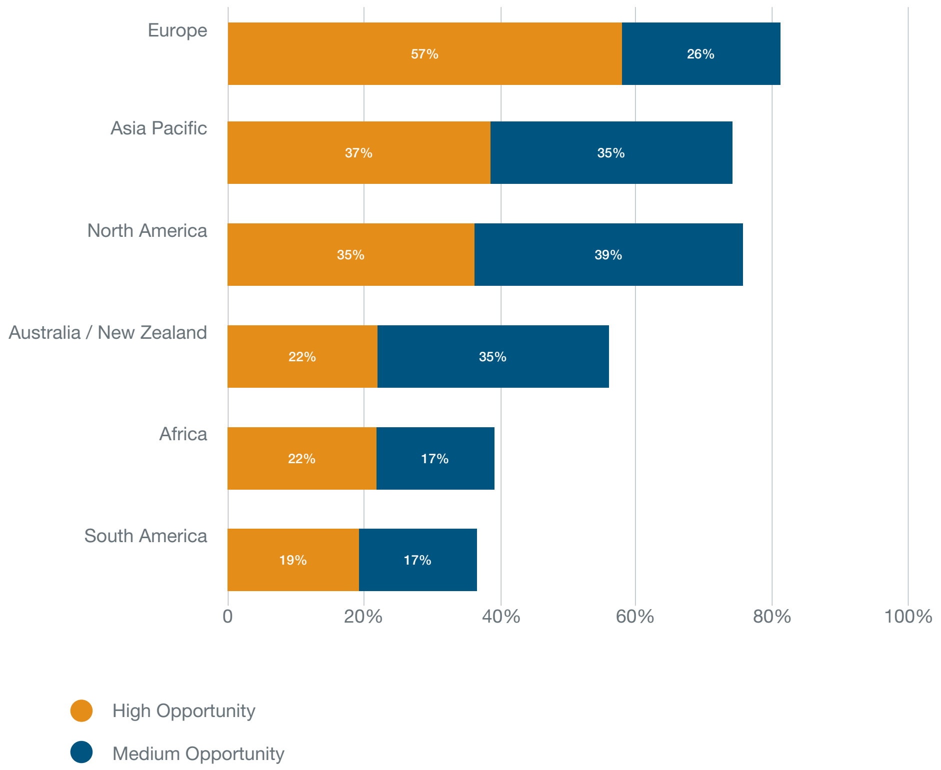
6. https://www.weforum.org/projects/circular-economy/
7. https://www.weforum.org/reports/nature-risk-rising-why-the-crisis-engulfing-nature-matters-for-business-and-the-economy

The regional differences affecting ESG investment opportunities

With clear intent among Europe's policymakers for the EU to become the world's first climate-neutral region by 2050 and plans to target a 55% cut in greenhouse gas emissions by 2030, it is easy to see why respondents consider Europe as having the greatest opportunity for ESG-related investment over the next three-to-five years, with Asia-Pacific and North America following closely behind.

In 2019, Europe experienced a landmark year in finding consensus for legislative proposals, creating a sustainability taxonomy, and increasing disclosure of sustainability considerations for corporates and investors from 2021. These include the European Green Deal, which provides a road map to transition to a clean, circular economy, restore biodiversity, and cut pollution, and the Sustainable Europe Investment Plan, which aims to mobilize at least €1 trillion of sustainable investment over the next decade. The regulatory environment provides a framework for PE firms to act. In contrast, North America arguably presents a larger latent ESG market but is likely to need a more conducive federal policy and operating environment for these investment opportunities to come to the fore.

Regions with greatest opportunity from ESG in the next 3–5 years



> "The combination of client expectations and enhanced regulation make Europe the geographic area of strongest focus for the present expansion of our ESG offerings."
>
> **Large Cap Firm, Europe**

The sector differences affecting ESG investment opportunities

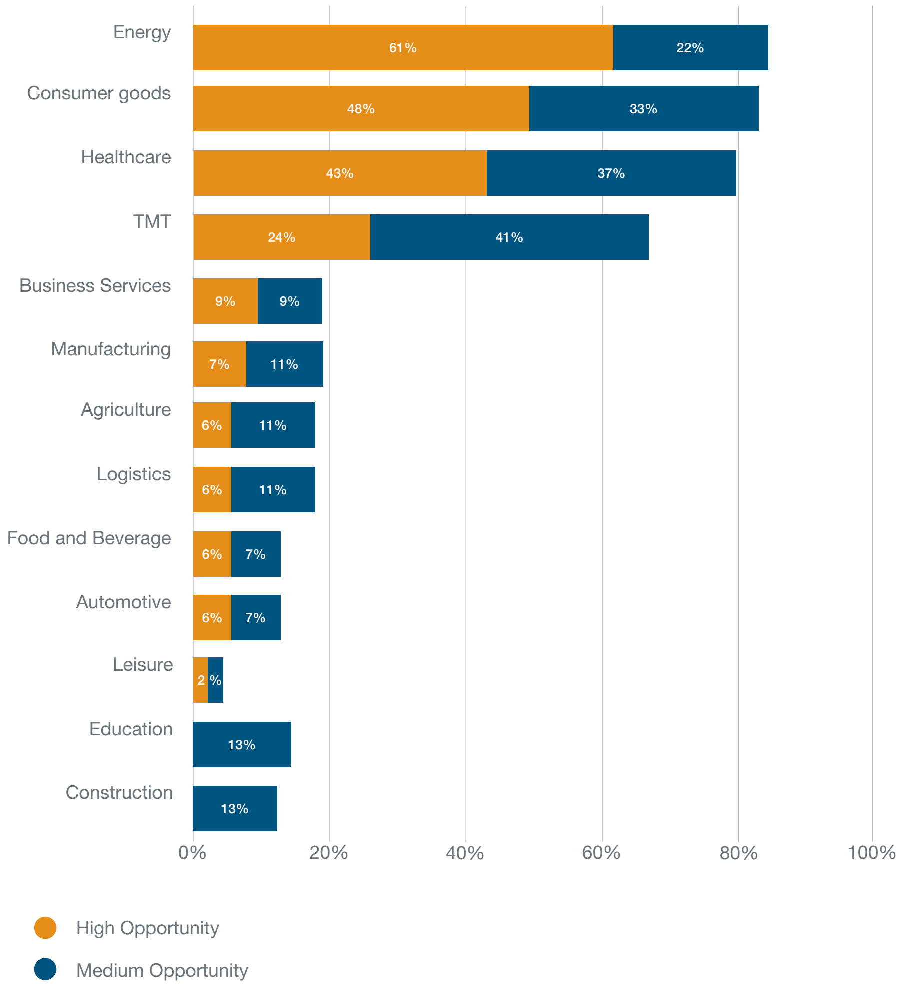
In terms of sectors presenting the greatest investment opportunity (deemed by respondents to be high/medium) from ESG in the next 3-5 years, the survey identified the top five sectors in descending order:

1. Energy
2. Consumer goods
3. Healthcare
4. Technology, Media and Telecommunications (TMT)
5. Business Services

Over the last 18 months, there has been a notable increase in the number of mainstream PE firms (i.e. not just Impact funds) that are making investments in companies that provide solutions that address ESG challenges, and in ESG consultancies and data providers, who help companies improve their underlying ESG performance. These findings offer a pathway for where and how firms can focus their efforts on the road ahead.

By honing in on material issues within and across sectors, firms can identify attractive new investment opportunities and support their existing companies to embark on ESG value creation initiatives.

Sectors with greatest opportunity from ESG in the next 3–5 years



Ascending the ESG maturity curve: **Current status and progress of ESG integration**

Integration journey in firms well underway

PE investors have made significant progress when it comes to their approach to - and understanding of - the opportunities and risks from ESG factors in investment.

Whilst firms are using tailored ESG approaches to suit their firm's culture and operating models, integration of ESG mostly includes these four key elements:

- ESG policy;
- Dedicated ESG teams and committees;
- Pre-investment ESG due diligence and engagement with companies during ownership; and
- Alignment with Responsible Investment initiatives (e.g. PRI) and disclosures.

67%

67% are signatory to PRI, which continues to be the main platform for PE firms to align with a global responsible investment initiative.

64%

64% say their ESG committees include investment team members.

86%

Most have access to a dedicated ESG Lead/Team (**86%**), who are bringing in subject matter expertise and maturity to ESG enhancement programs in their firms.

5yrs

5 is the average number of years that firms have had an ESG policy in place, which indicates that firms have now had the time to implement these policies, obtain feedback and benchmark against sector best practice.

We believe while policies and committees are a good starting point, a mature approach is one that fully integrates ESG factors into the investment process. **To that end, it was encouraging to see that 64% say their ESG committees include investment team members.** Investment teams are on the front line and perfectly placed to identify areas for improvement in portfolio companies as well as incorporate ESG factors into identifying new investment opportunities.

> "ESG has become a standard expectation for our industry. We receive enquiries about our commitment and we understand the need to demonstrate our integration of ESG considerations in our investment processes. People are making decisions based on ESG criteria more than ever."
>
> **Large PE Firm, North America**

Recognition of a tangible value of firm's ESG credentials in winning deals

It was interesting to note that a significant number of respondents (**50%**) believe that their firm's ESG credentials are a factor in winning deals in competitive situations. ESG credentials tend to matter the most to listed (**37%**) and family-run companies (**33%**).

When it comes to showing the evidence behind the claimed ESG credentials, the highest value for respondents was ESG track record and case studies involving portfolio companies, cited by **44%** of respondents to this question.

Furthermore, a proactive, structured ESG program could have as much as—or even more—value for dealmakers when seeking a preference.

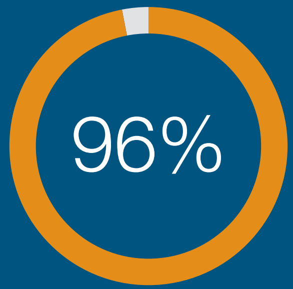
Other factors that matter are the firm's senior management commitment to ESG (**31%**) and how PE firms support and incentivize their companies to enhance their ESG performance and programs.

> "Our team has experienced direct situations in which, all else being equal, our ability to demonstrate experience and integration in ESG has been the factor in our selection. As a result, we continue to find ways of using ESG to set ourselves apart from competitors."

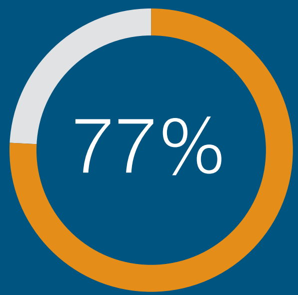
Mid Cap Firm, Europe

Consideration of ESG in pre-investment due diligence and ownership plans is evolving

We found respondents conduct due diligence around a whole range of ESG issues, with the majority examining topics such as governance, health and safety, labor and working conditions, as well as environmental compliance for every investment they make.



96% of firms conduct ESG due diligence for risk management



77% of firms conduct ESG due diligence to comply with firm policy

Most firms typically conduct ESG Due Diligence to manage risks (96%) or to comply with firm policy (77%) and some are starting to identify opportunities (64%). Albeit the opportunity assessment is, in majority of the cases, not as extensive as the risk element of the diligence.

An overarching point is the survey highlights a focus on risk management and firm policy—these rank above opportunity identification and competitive advantage for PE firms when it comes to the purpose of ESG due diligence. This suggests a need for the further development of internal processes and incorporation of frameworks to ensure ESG opportunities as well as risks are identified at the due diligence phase of an investment where possible, although the time constraints of a transaction process can make this challenging.

For many firms, ESG due diligence is now an important part of communication to the portfolio company during the post-investment phase and engagement with management teams (as evidenced by 75% of respondents who share their ESG due diligence findings), with many also using diligence findings to inform their value creation plans. We believe this alone is unlikely to uncover all ESG opportunities for improvement and investment required, given the aggressive timelines common to most deals and the complexity of ESG issues. **64% of respondents stated that they use material diligence findings as part of their post-investment engagement with management teams** but also acknowledged that more effort is needed to ensure investee companies are systematically addressing and following up on both opportunities and risks during the hold period.

Securing premiums at exits: ESG vendor due diligence (VDD) on the rise

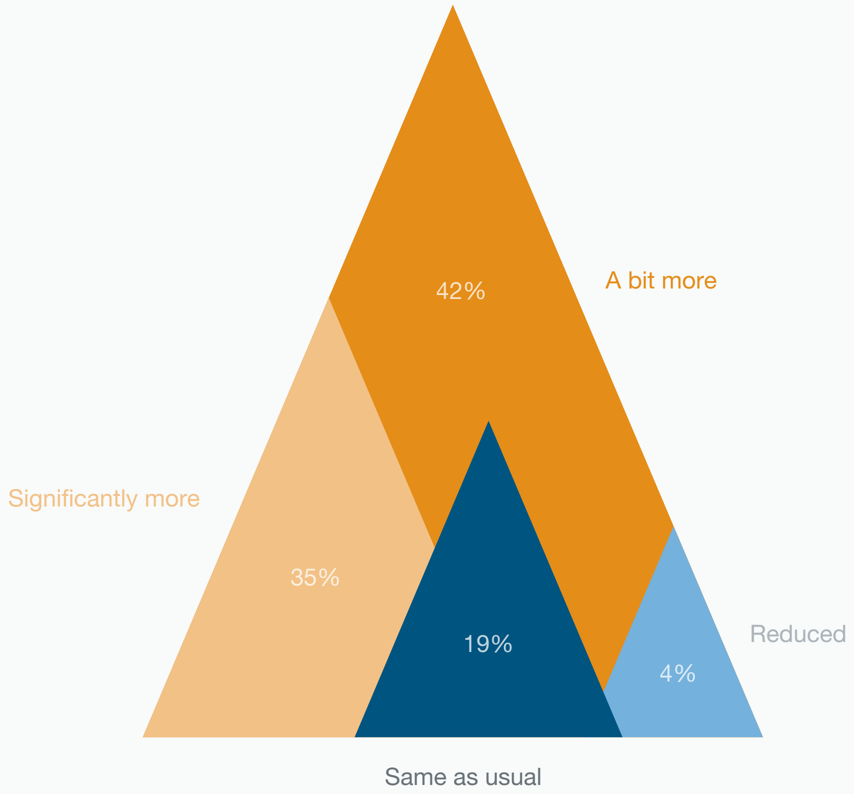
In line with an increased focus and recognition of ESG as a driver for increased exit multiples, 79% of executives currently include some ESG disclosure in their sell-side packs, largely to anticipate buyer questions.

ESG sell-side diligence is set to become even more widely used. **Over three-quarters of respondents (77%) believe that ESG sell-side diligence will be undertaken more over the next three-to-five years**, including 35% who believe it will be conducted significantly more.

What this means for PE firms is that failing to address ESG robustly when preparing for exit could mean failing to maximize value of their underlying investment.

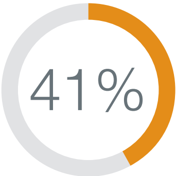
It is clear that PE now no longer views ESG management as pre-investment risk screen. Instead, the industry has moved towards a view that there is intrinsic value in ESG themes and recognizes the potential for a "sustainability premium" at exit.

Degree to which ESG VDD will be conducted in the next 3–5 years?

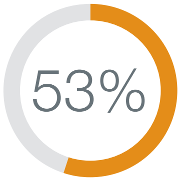


What is needed to reach the summit

Navigating the variety of sustainability frameworks and standards in the market



41% of respondents say they use the UN's SDGs to identify investment themes and opportunities.



53% of respondents are not using any ESG framework to identify opportunities at a tactical level.

One of the challenges facing investment firms is the plethora of frameworks in the market currently all having distinct purpose, all doing slightly different things and all being used by various parts of the market. This ranges from the broad Sustainable Development Goals (SDGs) - originally created for entire countries to use and now core to many company strategies, through the accounting frameworks such as Sustainability Accounting Standards Board (SASB) to the thematic frameworks, most notably the Task Force on Climate-related Financial Disclosures (TCFD).

In exploring this with respondents we found 41% say they use the UN's SDGs to identify investment themes and opportunities, while 53% are not using any ESG framework to identify opportunities. While on one level it is encouraging in terms of adoption, it might also suggest that many firms are working in the dark when it comes to identifying ESG investment opportunities.

Some of the SDGs, such as affordable and clean energy, climate action, responsible consumption and production, good health and wellbeing, and quality education, offer a clear path for directing capital toward new investments in areas related to healthcare, education, renewable energy and the circular economy. Others lean more toward operational issues and productivity, such as gender equality and decent work and economic growth.

There is clearly a distinction between leveraging the SDGs for direct investment, indirect impact, and operational contribution, and this requires careful consideration. Further understanding of these distinctions and deeper knowledge of the underpinning details of the SDGs is likely to result in better investment decision making.

While applying frameworks is still a work in progress, our experience shows that leading PE firms are able to use ESG themes during the origination phase to good effect and to cover a spectrum of ESG-related opportunities. Where used, firms report that ESG themes help them invest in companies that are currently sustainable, materially expand the positive social and environmental impact of a company or transform a mainstream company to a more sustainable proposition, and create significant value in the process of doing so.

One framework in particular that has added a directive approach to the issue is The Task Force on Climate-related Financial Disclosures (TCFD). This was established under instruction of the Financial Stability Board, with its aim "to promote more informed investment, credit and insurance underwriting decisions" on the basis that "investors need better information on how companies… have prepared for, or are preparing for, a lower-carbon economy; and those companies that meet this need may have a competitive advantage over others".[8] As of February 2020, support for the TCFD has grown to over 1,027 organizations, representing a market capitalization of over $12 trillion.

Our survey indicates that relatively few firms are using mature, sophisticated frameworks to identify investment opportunities behind sustainability mega trends but that doing so materially adds value. Firms are encouraged, therefore, to adopt one that is best aligned with their culture and overall investment themes.

8. https://www.fsb-tcfd.org/publications/tcfd-2019-status-report/

ESG leadership needs to move from reactive opportunism to proactive value realization

Getting the right information, understanding what to do with it, ensuring ESG is discussed and risks and opportunities are acted on through the life of an investment—all these actions more than at any time in the past are crucial. However, our survey points to a more fundamental issue when it comes to ESG: **only 25% of firms have a thematic ESG fund or strategy and actively seek out ESG-focused investments and the majority of respondents take a reactive, opportunistic approach to ESG investment**.

This largely opportunistic approach may well explain the patchy use of reference sustainability frameworks both at a strategic and tactical level. It may also be behind many of the issues around board discussions and the view that the purpose of ESG due diligence is for risk management more than identifying opportunity.

It is clear from the results of our 2020 survey that PE firms recognize the opportunity in investing through an ESG lens and understand both the positive impact on exit multiples and the differentiating power of ESG reputation. The problem can be in tying all this together and defining clear ESG goals for individual firms.

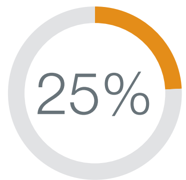
This is why firms need to have a well-defined, strategic vision of how they will capitalize on the increased focus on ESG. This needs to be a message that comes from the top of the organization and cascades through the firm at all levels. Firms armed with a clear view of how they will unlock ESG value for investors can then work through, in a highly systematic way, how they implement and incorporate ESG through the entire investment life cycle as well as within their own organizations.

Infusing ESG into the DNA of the firm will be critical to sustain success

As ESG is now coming to prominence in investment houses and the capital markets, we do believe there will be a war for talent for the best people, as value creation by ESG factors becomes more prevalent. In parallel, we also see the need for training, education and comprehension of ESG factors from junior executives right through to the entire board as of paramount importance. Failure to do so will hamper the speed of integration of ESG into the DNA of the firm and a potential loss of competitive advantage.

With an ESG vision in place and strong organizational culture to support it, PE firms can start to implement the tools, systems, and frameworks they need to generate strong returns well into the future.

Our teams have worked closely with leading PE funds and witnessed first-hand the significant value the PE funds have gained from such a systematic and strategic approach to addressing ESG holistically across the investment lifecycle. **Firms that seize this ESG opportunity will be the private equity market leaders of the future.**



25% of firms have a thematic ESG fund or strategy and actively seek out ESG-focused investments.

Enhancing ESG due diligence to identify value protection and creation opportunities

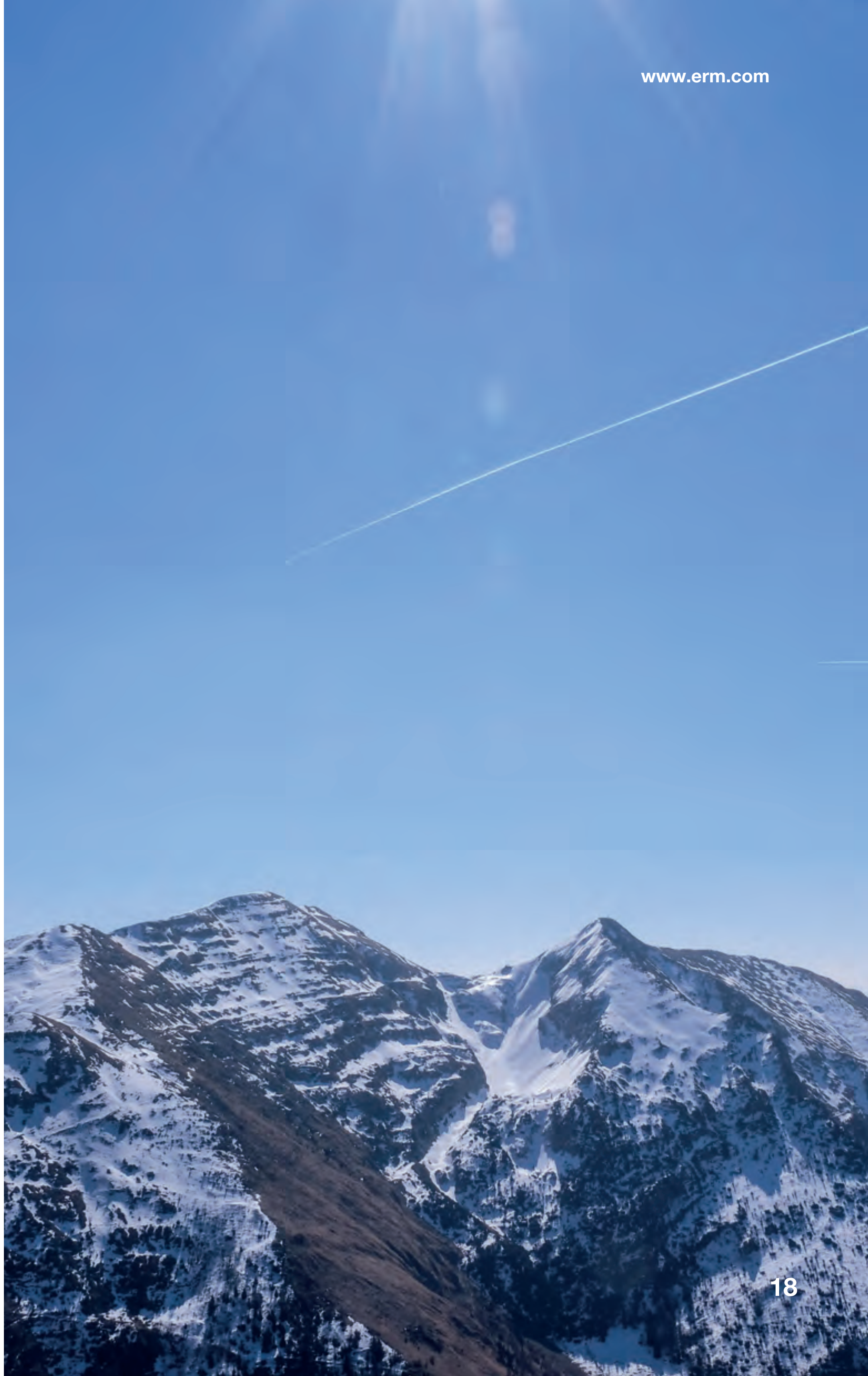
Despite the challenges associated with collecting complex information in short timeframes, the majority of firms believe that their ESG performance could be enhanced through improvements to their due diligence process.

Respondents cited a range of areas that would improve the ESG diligence process. These include:

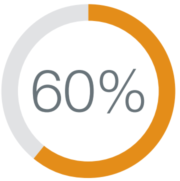
- deal team training on commercial consequences of ESG factors and earlier consideration of material ESG factors when assessing deals;
- more in-depth discussions in investment committee to review opportunities and risks;
- a better focus on the business case for companies to achieve leadership through implementing best practices (not just compliance) in addressing material ESG factors.

While ESG due diligence is an important tool in helping PE gain an informed (if incomplete) view, it is probably best considered as a useful starting point for discussion and identifying areas on which to focus, with further work carried out in phases through the ownership period. We see making ESG opportunities part of due diligence, then quickly moving into post-investment with ESG as an operational imperative would bring this point to fruition.

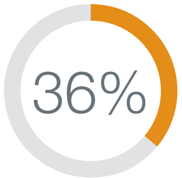
Due diligence cannot be simply a compliance checklist item, nor an afterthought. Firms needs to consider germane ESG trends and investment opportunities and how to target companies that may be positively impacted from such trends and derive benefit from being best in class on ESG.



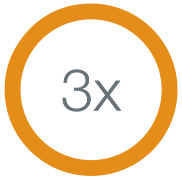
Building strong ESG companies to demonstrate resilience and to realise valuation premium at exit



60% said that to maximize value, there needs to be regular and in-depth board engagement with companies on systematically addressing material ESG factors during ownership.



36% say they would like to see management incentives aligned with ESG metrics.



A three-fold increase now see ESG as making a positive contribution to exit multiples since our previous study.

Our research points to the notion that if the industry is to truly capitalize on the disruption potential in the shift to sustainability issues, there needs to be a more systematic approach through the investment lifecycle, in particular during ownership and exit, guided by the firm's strategic vision on ESG.

Whilst there is a growing number of boards that do discuss ESG issues at a high level, 60% of our respondents felt that to fully capitalize on opportunities, the ownership phase would benefit from regular and in-depth board conversations on ESG issues and opportunities. The board and the company management team need to have better clarity on strategic alignment of ESG issues in improving the financial and reputational value of the company and to ensure timely execution on the priority ESG improvement initiatives.

Over half (57%) the respondents say there should be a more systematic review of both opportunities and risks during development of the value creation plan, while 36% say they would like to see management incentives aligned with ESG metrics, both of which, if done well would drive better ESG performance. Importantly, these changes do not need to take a significant amount of time or effort, yet they can generate a significant payback.

Having strong ESG performance on material aspects, will be of added interest in the post-COVID world, where recent research from institutions like Morningstar and BlackRock shows that companies with strong ESG characteristics are more resilient to shocks.[9] The PRI and ERM ESG monitoring and reporting guidance also provides PE firms with examples and suggestions of effective portfolio engagement approaches that focus on material ESG aspects as well as address wider stakeholder (i.e. Limited Partners) interest areas.[10]

Given such market data, perhaps it is not surprising to see in this survey the almost **tripling of the proportion of PE investment professionals that now see ESG as making a positive contribution to exit multiples since our previous study**. In 2016, just 10% said this; while in 2020, this had risen to 28%.

Finally, PE firms will need to ensure that ESG disclosures at exit from investee companies provide a credible and complete picture of the company's strong ESG program to demonstrate resiliency and attract valuation premiums from ESG sensitive buyers. In our experience, the best vendor disclosures systematically cover both risk and opportunities and are undertaken well in advance of any eventual exit, allowing adequate time to address any improvement opportunities that may be identified.

There is an opportunity for leadership— while many see the prize, few have been able to execute on the promise.

"Our board members frequently seek more detail about ESG performance, but there is sometimes an inability to track management in a systematic way in parallel with financial performance."

Mid Cap Firm, Asia Pacific

9. https://www.hedgeweek.com/2020/05/19/285741/new-blackrock-research-points-esg-resilience-during-coronavirus-downturn
10. https://www.unpri.org/pri-and-erm-launch-guidance-on-esg-monitoring-reporting-and-dialogue-in-private-equity/3296.article

Conclusion
A summit worth climbing: Maximize value and deliver positive impact

While value protection is important, future-facing firms will generate higher returns by systematically targeting ESG value creation and proactively investing behind the sustainability megatrends.

The world is changing, with the pace of change only accelerated by COVID-19. Forces from all directions are pushing governments, regulators, businesses, NGOs and investors to build a more sustainable future—and fast. This sustainability shift and resulting disruption is creating significant investment and value creation opportunities for the astute investor.

As Jean Boivin, Head of the BlackRock Investment Institute wrote recently, "it's not only about managing risk of climate change that might affect your portfolio. It's also about riding a wave that should be a source of return in itself."

We agree. Indeed, the megatrends underpinning the transition to sustainable economies – from the groundswell of younger generations, who care much more deeply than their predecessors about the social and environmental impact of their careers as well as their purchasing and investment decisions, to the notably greater coordination emerging between investors, regulators and businesses designed to address rising inequality and climate change — create genuine opportunities to outperform while also creating a positive legacy for society and the environment.

Our survey shows that PE firms are well underway with integration of ESG in investment processes, but have yet to capitalize on the full value of a mature approach and leveraging sophisticated frameworks and tools that are available. To realize the full potential of ESG we believe PE firms should consider the following:

1. **Setting a strategic vision, and fostering a culture that sees ESG as a significant value creation opportunity.** Realizing the full potential from ESG will require PE firms to shift their firm’s vision of ESG, beyond the typical risk management focus, to see it as a significant investment and value creation opportunity. Such a disciplined focus on ESG themes can result in generating higher returns and improve the prospects of accessing increasing pools of committed capital from Asset Owners to tackle the biggest ESG challenges.
2. **Establishing the firm’s ESG investment strategy and process for identifying ESG market trends.** Firms will need to have processes to monitor the broader ESG trends and future issues in their sectors and regions of interest. This will allow firms to evaluate the potential scale of opportunities i.e. demand for such solutions and products, sector impacts, and map-out where in the value chain may offer the most attractive ESG investment opportunities.
3. **Moving due diligence from compliance to ESG best practice to generate superior returns.** Firms should leverage the latest ESG tools, established frameworks, and Investment Committee processes to evaluate the potential for a best practice ESG program to increase (and protect) the revenue, margin and brand value of the target investment. Firms can derive further benefits through highlighting their own ESG credentials to differentiate and win competitive deals especially where sellers are listed companies or family-run businesses.
4. **Ensuring companies become “ESG Strong” during ownership to benefit from a higher exit multiple.** Firms should adopt a systematic approach to integrate material ESG factors in the full potential plan for their companies, including board engagement on the execution of such plans and consideration of linking management incentives to achieve desired goals. At exit, PE firms will need to ensure that investee companies provide credible disclosures of their strong ESG program to demonstrate resiliency and to attract valuation premiums from ESG sensitive buyers.

Addressing this opportunity does not need to be resource intensive; in fact, there is evidence that structured approaches are more, not less, efficient than reactive ones. PE firms can, and should be, the pioneers of better and more profitable ESG investment—we believe they will be.

The scale and pace of change means that ESG can no longer be considered a small corner of the specialist investment world, a tick-box exercise or simply a risk management framework. ESG and sustainability themes need to be at the core of investment strategies, decisions, and processes if PE firms are to continue raising capital from increasingly ESG-focused LPs and to capitalize on the biggest investment opportunity of the decade and beyond.

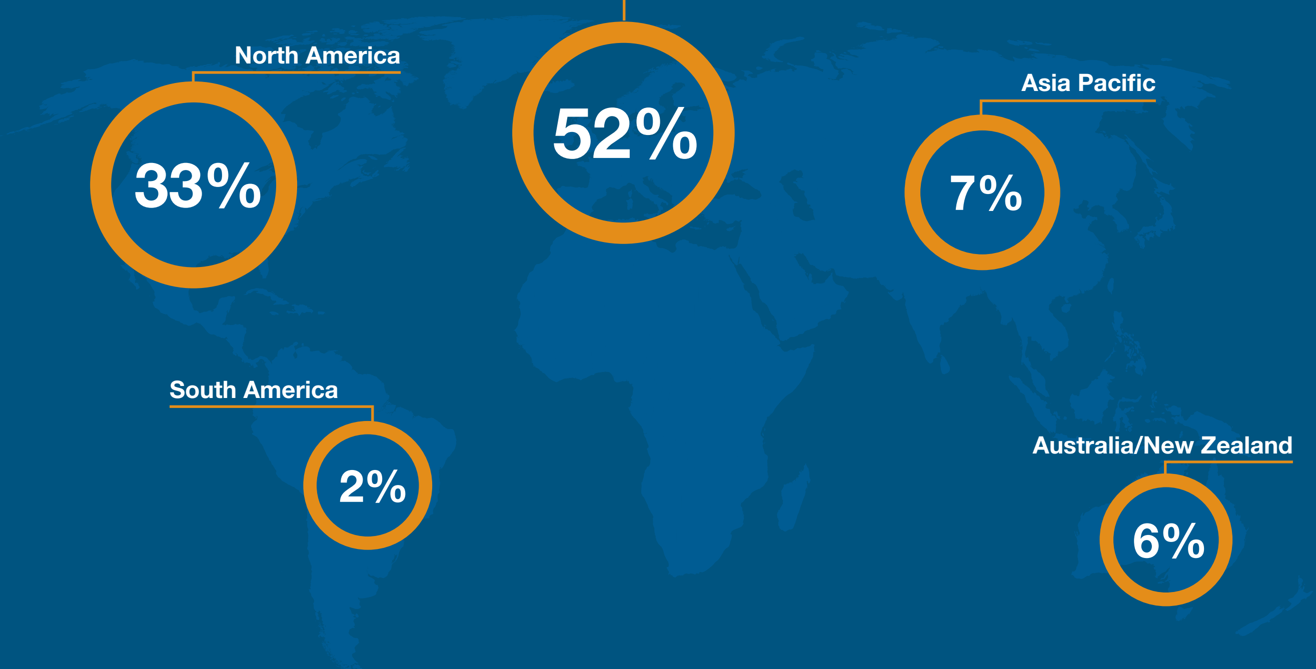
It is clear that there is an urgent need to take decisive actions to address our pressing sustainability challenges. There is a need for significant investment to address these challenges and a clear role for investors to play in the transition to a sustainable, low carbon and equitable economy.

Overview
of Survey Respondents

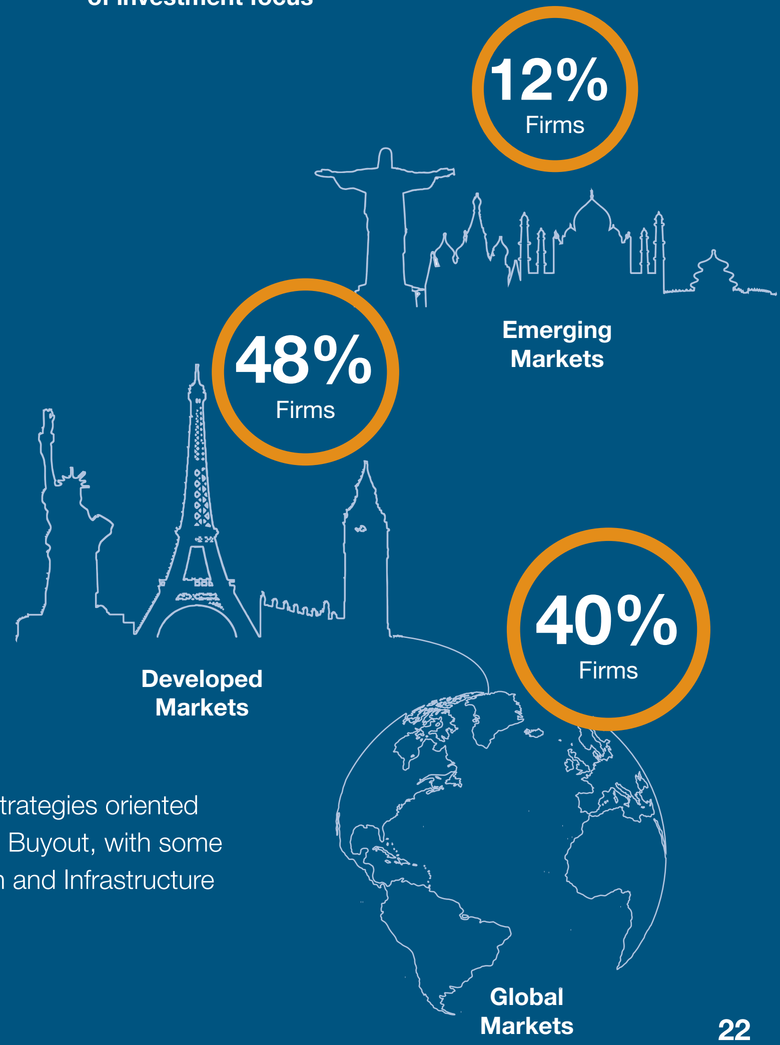
54 Survey respondents worldwide from investment, operations, and ESG teams

47 Survey respondent firms participated

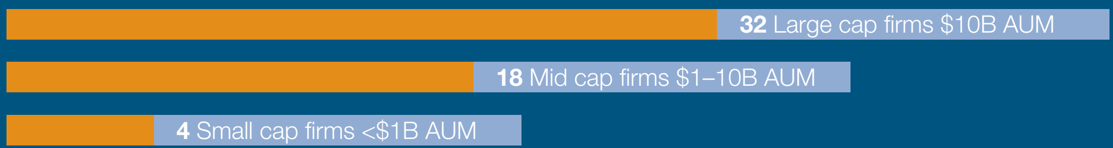
Location of survey respondents' headquarters



Survey respondents' geographical area of investment focus



Survey respondents' Assets Under Management (AUM)



Fund strategies oriented toward Buyout, with some Growth and Infrastructure

Throughout the majority of this report we refer to the respondents' findings but where a question relates specifically to a firm's position (e.g. ESG policy), the percentage or figures relate to "firms" (given that a few firms had multiple respondents, covering different geographies). Also, not all figures add up to 100% as a result of rounding percentages and excluding non-responses from survey participants.

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+ DIF Capital Partners
+ EQT
+ Eurazeo
+ GED Capital
+ IK Investment Partners
+ InfraRed Capital Partners
+ KKR
+ Magnum Capital Industrial Partners
+ MCH Private Equity
+ OMERS
+ Pacific Equity Partners
+ Paine Schwartz Partners
+ Palisade Investment Partners
+ Patria
+ Permira
+ ProA Capital
+ T Capital Partners
+ Triton
+ Tsing Capital
+ Waterland Private Equity Investments
+ Anonymous Asian Mid Cap Firm
+ Anonymous Asian Mid Cap Firm
+ Anonymous European Mid Cap Firm
+ Anonymous European Mid Cap Firm
+ Anonymous European Large Cap Firm
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ERM is the global market leader in the provision of ESG-related support to a client base of over 150 Asset Managers and Asset Owners on a consistent and regular basis.

We understand the Private Markets business model and value drivers, significance of fund raising, and return on investment driven by earnings growth and enhancing the multiple. Our team members have a unique blend of technical sustainability, in-house Private Markets and Banking expertise, accounting and management consulting backgrounds. ERM's holistic service offering covers the full breadth of PE ESG needs across the investment life cycle, including GP level policies, procedures and reporting, transaction evaluation (acquisition and vendor), portfolio company value protection and creation strategies, compliance, and risk management requirements.

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We have more than 160 offices in over 40 countries, employing more than 5,500 people who work on ESG projects around the world.

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