ESG Program Development: A Few Strategic Questions

February 2020

Bridge House Advisors wrapped up 2019 with over 100 clients, a 2nd year anniversary, and an exciting pipeline of new opportunities and ideas for the future. During the year, we delivered 27 ESG and Impact programs and diligenced over 150 new investments. As the ESG and Impact field continues to evolve, and in the course of our work, we have witnessed some recurring questions from our clients and other market stakeholders. To address these key challenges, we've compiled a guide for professionals of any ESG-proficiency level, including what questions to ask and how to start arriving at answers through practical approaches.

Decision-Making on the Key Elements of an ESG Program

1) ESG Policy Development – Who Is the Audience?

ESG policies can be designed for different audiences and purposes, evolving with changing levels of maturity of a firm's ESG program over time.

I. Internal Audience: For the purpose of informing an internal process or establishing overarching themes, a 1-2 page policy is often considered comprehensive.

II. External Audience: When sharing an ESG policy with LPs and other external stakeholders, most investment firms are moving towards more comprehensive policies that allow management to include differentiating details about their perspective and how they are managing ESG factors throughout the entire investment lifecycle.

Try this: Conduct a comparative benchmarking analysis of your ESG policy versus those of your primary peers/competitors in the market. This activity will reveal the key program components that are disclosed by your competitors and enable you to calibrate your level of disclosure. In addition, the benchmarking exercise will likely reveal ESG program components that have been adopted by your competitors that you might want to consider adding into your program.

2) ESG Due Diligence – Insource or Outsource?

Private equity firms who are implementing ESG due diligence as a part of their standard pre-investment due diligence efforts (often a separate workstream from traditional environmental liability due diligence) must determine the most effective and efficient way to conduct this analysis. In order to integrate ESG diligence into existing processes, investment professionals are trained and then expected to add this incremental work to their responsibilities. Many PE firms have opted to retain specialist consultants to help with part or all of this process.

I. Insource: Do we want to educate and build capabilities on our investment team on ESG risks and opportunities and ask them to integrate this analysis into their standard due diligence process?

II. Outsource: Do we want to outsource ESG diligence work to experts in the field, similar to other third-party advisors that we hire, to support due diligence efforts?

III. Combination: Do we want to hire experts to train our team as well as provide confirmatory due diligence support as we approach exclusivity on the deal?

Try this: Pilot one or more of these approaches on live deals. The pilot(s) will not only enable you to test drive the process, but the findings of the ESG due diligence assessments will enable you to adjust both the process and the work product, both of which will inform the best approach for your firm.

3) ESG Metrics & KPIs – Should We Set and Track Portfolio-Wide Metrics?

Portfolio-wide ESG metrics are often desired by internal ESG program managers, but there are numerous challenges in creating comparable and meaningful portfolio-wide ESG data sets. Metrics can be reported in a range of methods from a small selection of key performance indicators across the entire portfolio, to sector-specific ESG factors aligned with the investment strategy, to specialized ESG factors tailored to each individual investment. A combination of these options is also possible. Portfolio-wide metrics should be considered in cases where the consolidated data at the fund level can relay an important message about the ESG performance of the portfolio. Some of the more common portfolio-wide ESG metrics are carbon emissions, climate risk, energy consumption, diversity & inclusion, employee health & safety, and cyber security.

I. Portfolio-Wide Metrics: Is there performance-related ESG data that we are trying to showcase for the full portfolio? Is this data obtainable, comparable, and meaningful across investments?

II. Sector/Investment Specific Metrics: Is our investment strategy focused on specific industry sectors? Do our companies in these sectors have reasonable and comparable data? Do some portfolio companies have specific data that could demonstrate their performance more acutely?

Try this: Assemble a quorum of stakeholders within the firm to determine which of the above methods aligns best with the firm's existing investment strategy, reporting process, and ESG program objectives. Consider which metrics may overlap across the portfolio or across industry sectors within the portfolio and if the consolidation of that data would provide meaningful insights into the investments' ESG considerations.

4) ESG Reporting – Is an Internal Report Enough, Or Would External Communication Be Beneficial?

ESG expectations are evolving quickly, and so too are the ways in which firms seek to keep investors updated on ESG performance. Some firms may experience investors or other external stakeholders pushing for GPs to become UN PRI signatories or participate in other third-party reporting frameworks. As ESG policies are often value-aligned with a firm's investment philosophy and mission, some ESG programs don't meet all the guidelines defined or developed by external entities. Reporting sophistication often varies based on the maturity of the ESG program, with most firms starting small and then growing based on both management and investor steer.

I. Internal Audience: Who are the internal stakeholders that would benefit the most from ESG reporting? To what level of detail do we need to gather data at the portfolio company level for our internal reporting effort?

II. External Audience: Could third-party reporting bolster the firm's ESG performance and reputation? If so, evaluate potential third-parties to align with based on your firm's existing ESG strategy and investment philosophy. Are LPs or other stakeholders pushing for specific third-party participation? If so, evaluate these specific programs to determine if their ESG objectives align with the firm's own goals, while also considering current and possible future requirements for participation.

Try this: Resist the temptation to sign up for a third-party reporting framework before your ESG strategy and management program is fully formed. Becoming a "member" of an external ESG or sustainability framework often requires some level of formal disclosure or reporting. Better to define your strategy first, and then evaluate the benefits of what these third-party frameworks can do for you, as opposed to the other way around.

Jeffrey M. Gibbons

(484) 319-8699
JGibbons@bridgehouseadvisors.com

Daniel A. Mistler

(609) 513-8607
DMistler@bridgehouseadvisors.com

Molly Smith

(260) 403-2001
MSmith@bridgehouseadvisors.com

BRIDGE HOUSE ADVISORS
125 South Clark Street
17th Floor
Chicago, IL 60603

info@bridgehouseadvisors.com
www.bridgehouseadvisors.com