

KEYNOTE INTERVIEW

Putting ESG at the heart of existing portfolios



*GPs' focus on responsible investing should not just be about targeting the right assets, but also on improving the ESG performance of businesses they already back, say **Winna Brown** and **Matthew Harold** of EY*

Q Much of the responsible investing conversation has focused on where GPs should invest going forward. Is there a more pressing conversation to be had about emission-intensive assets already in portfolios?

Winna Brown: According to PitchBook, the private equity industry has over \$4.2 trillion of AUM so there is certainly an imperative to consider private equity's current holdings when assessing the impacts of ESG and specifically emission-intensive assets.

Private equity firms have been subject to growing pressure from LPs, consumers and regulators to measure

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and report on the ESG impact of their portfolios. Private equity firms should also understand how ESG will impact their asset's equity story and ultimately the asset's ROI on exit.

These assets are unlikely to have undergone an ESG due diligence on acquisition. However, they likely will be subject to an ESG due diligence on exit, potentially impacting exit valuations. Addressing material ESG matters early will allow private equity firms to not only meet stakeholder demands,

but also provide the time needed to mitigate ESG risks or capitalise on ESG value-adding opportunities.

Private equity firms can undertake risk-based ESG materiality assessments for all their assets, which will identify opportunities across all three aspects of ESG. From an environmental perspective, there will likely be two main categories of assets, those that are obviously emission intensive, such as assets in the industrials or energy sectors, and those which may not be obviously emission intensive, but where there is still an opportunity to reduce their climate footprint.

Now is the time to move the needle

Q As the ESG discussion matures, what trends are you seeing emerge in the way private equity is approaching asset identification and the due diligence process?

Matthew Harold: We are seeing two key trends. The first is a mindset shift from risk management to value creation. From an origination perspective, as it relates to carbon emissions, EY teams help clients identify and assess targets through two lenses: targeted finance to carbon-intensive industries, to finance decarbonisation transformations rather than starve it of capital; and increasing the flow of finance to innovative, lower-carbon alternative companies that are disrupting their sectors. Both highlight companies that will outperform peers in the transition to net zero. As deal teams progress into due diligence, they are now focused less on climate risks and more focused on building a business case for realising financial growth through decarbonisation. A key outcome of this phase is a report that can be directly incorporated into the value-creation plan.

The second trend we see is general partners leaning into the ESG data challenge. Private equity firms are looking for alignment between a target and a GP's firmwide ESG strategy or commitments. GPs are increasingly signing up to industry alliances, committing



to targets and disclosures, and adopting ESG KPIs that they will report against year over year.

As such, an increasingly important consideration during target identification and due diligence is the time, capabilities and cost associated with ensuring the asset can meet GP ESG reporting requirements. This is no small undertaking. ESG measurement and reporting is well behind its financial equivalent in maturity. As ESG increasingly becomes core to the private equity value-creation narrative, ESG indicators will need to be of the same veracity as financial figures to ensure the insights they deliver are equally trustworthy and actionable.

The ultimate objective is to have ESG considerations embedded into all the core processes to give private equity firms the best chance of maximising both value protection and value creation through improved ESG performance.

from an environmental perspective. It need not be all or nothing, however it does need to be meaningful to have real impact.

Private equity is renowned for its skills in identifying and acquiring assets that are either underperforming, undercapitalised or where there is potential for innovation to disrupt and create incremental financial value. In recent years, exponential advances in technology have spurred high growth opportunities and record high valuations, disrupting the way whole sectors operate. One could similarly view ESG as the new driver of disruptive change, the main difference being that the value being created will often be measured in non-financial terms.

Private equity firms are in a unique position to leverage their proven skills in value creation to deliver ESG results, allowing them to meet the demands of their stakeholders today and ultimately result in incremental financial returns

over the long term. Doing this successfully will require private equity firms to make immediate investments in ESG initiatives, including upskilling their deal teams and operating partners and directly investing in ESG initiatives at portfolio companies. This is a fine line for private equity firms to navigate as their stakeholders are demanding an ESG focus while maintaining pressure to deliver high returns.

Good intentions and the potential for future gains alone are not going to accelerate environmental goals fast enough to meet the world's climate imperatives. While there is a compelling social argument for reducing the climate impact of assets, change is often difficult and expensive. Choosing between short-term profits and long-term benefit can be hard and, left to market forces alone, real impactful environmental change is likely to be slow.

Having said this, if the pressure from investors and consumers is

coupled with strong regulation, there is a real opportunity for private equity to be at the centre of driving meaningful, positive environmental impact and delivering long-term value.

Q What should private equity firms consider when looking to exit emission-intensive assets?

MH: There are two key questions that private equity firms should be asking themselves when looking to exit emission-intensive assets. Why are we looking to exit and what improvements will help deliver a green premium on exit?

Let's start with 'the why'. Much like financial services more broadly, private equity firms are analysing the implications of exiting emission-intensive companies, and even sectors entirely, to reduce their own carbon footprint from financed emissions. These so-called exclusion policies are cause for pause and the reasoning is threefold.

First, when the private equity firm exits an emission-intensive company, those emissions come off the firm's own carbon footprint. However, if that same company is then capitalised by other means and continues or increases its emissions, the firm's exit has no meaningful environmental impact, or no emissions impact on the 'real economy'.

Second, according to the UN High-Level Climate Action Champions in a November 2021 report, "\$125 trillion of climate investment is needed by 2050 to meet net zero, with investment from now until 2025 needing to triple compared to the last five years". If we are to achieve this, the private equity industry will need to participate – and it should want to. The transition to net zero must happen at the scale of the industrial revolution and at the speed of digital innovation. Firms that help portfolio companies to effectively navigate market dynamics will position themselves to enjoy a durable competitive advantage and outsized returns.

Third, rapid defunding of emission-intensive companies will accelerate our climate objectives, but it could also have social consequences. Many emission-intensive companies also provide life-enhancing goods and services like energy or food. Without access to capital, these companies (or entire economies in some cases) will fail, and their absence could thrust millions into poverty in the name of net zero. Here, managers will need to work through broader implications to ensure investment strategies support an equitable transition.

The next question is what improvements will help deliver a green premium on exit? The answer often depends on whether the manager is looking at an IPO or a private sale.

In the case of an IPO, capital markets are making it clear that long-term net-zero targets are no longer enough. Analysts and investors want to see near-term, fully costed decarbonisation plans. They want to know how much the transformation costs, how the

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company will pay for it, and the impact on dividends and earnings forecasts. Firms that help portfolio companies develop these decarbonisation plans for inclusion in the IPO process are more likely to earn a green premium when the asset goes public.

In the case of a private sale, buyers will look to project and create value through decarbonisation. This is what our firm refers to as value-led sustainability, where companies seek to derive a competitive advantage from having a distinctive position on decarbonisation. This could mean developing new, less carbon-intensive products or services that drive top-line growth or delivering operational programmes that improve margins and reduce emissions in parallel. Private equity firms that help their emission-intensive assets develop these new strategies are more likely to return higher multiples on exit from green premiums.

Q What about the human factor around emission-intensive assets? What potential is there for impacting livelihoods and local economies that may depend on them?

WB: The private equity industry is the largest employer in the world, so

how it approaches transforming emission-intensive assets is critical as it has the potential to have a profound impact on both the people it employs and the communities they live in.

While rapid action to address negative-environmental-impacting industries is an imperative, if these sections of the economy are not addressed thoughtfully, we may improve the environment while simultaneously negatively impacting the people who depend on these industries for their livelihood, which in turn can lead to devastating consequences for whole communities.

By investing in innovation and new technologies to transform a company, there is an opportunity to retrain and upskill employees to evolve along with the sector while at the same time still benefitting from cashflows and profits in the existing business. This is especially important today because there is a war for talent and good people are hard to come by, so investing in your employees can create loyalty, build brand and be a critical retention lever.

From a community perspective, the continued employment of its people benefits local businesses and supports the lifeblood of the community so that it can continue to flourish. Additionally, for those communities that have been built around emission-intensive sectors, transforming these companies to be greener can have a positive impact on the surrounding ecosystem, giving the people in the community cleaner, healthier spaces to live and grow in.

As I mentioned earlier, technology has been both a disruptor and driver of transformation, and ESG has the potential to be an equally influential driver. By bringing the two together, there is a unique opportunity for the private equity industry to use its power and influence to effect positive change across all three aspects of ESG. ■

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