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ESG in Private Equity Funds: Insights from the Super Return Conference 2023

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The integration of environmental, social, and governance (ESG) factors has become a crucial consideration for investors across various asset classes, including private equity funds. I first encountered this development working as a funds lawyer in Paris in the early 2000's. Private equity funds receiving investment from development finance institutions (DFI's) were the first to adopt ESG principles. As the global focus on sustainability and responsible investment continues to grow, more of our fund management clients across all asset classes (including hedge funds, venture capital and pension funds) started looking to incorporate ESG principles into their fund operations and our investor clients looked to incorporate these principles into their investment policies.

A few weeks ago, I attended the Super Return Conference 2023 in Berlin, which brought together industry leaders, experts, and stakeholders in the private equity industry and sought to shed light on the latest trends and developments in the private equity sector. This article aims to delve into some of the key discussions and insights shared in relation to ESG at the conference. In short, nearly two decades down the line, we seem to be at a crossroads with some managers rejecting ESG whilst others have recommitted to the principles and moved beyond traditional implementations of ESG.

Understanding ESG in Private Equity

ESG refers to a set of criteria used to evaluate a company's performance in areas such as environmental impact, social responsibility, and corporate governance. The push to integrate ESG principles into the operation of private equity funds is motivated by various factors.

Firstly, the private equity industry, like any other, is under regulatory pressure to improve sustainability. In the early days, ESG's incursion into the private equity industry was driven largely by the climate change obligations of the governments that funded DFI's. As a result, the focus globally has for a long time been on the E in ESG and many fund managers understand ESG to be an environmental programme. Over time, governments have increased regulation around environmental issues. Increasingly, investors are subject to regulations that seek to apply ESG principles. In the United States, for example, the Securities Exchange Commission has increased climate disclosures for listed companies (many of the large private equity firms are listed). In a recent study by EY, 14% of the private equity investors polled noted that they are already required to invest in socially-responsible products and a further 29% anticipated such requirements being imposed on them in the next three years. This does, however, leave 57% of investors who do not require ESG and do not envisage this being a requirement in the next 3 years.

Secondly, the trend towards responsible investing is being driven by attitude changes in fund investors looking to make positive social impacts with their investments. This is sometimes attributed to a shift in social values within the post-baby boomer generations. Most of these investments are being channelled into either ESG-dedicated portfolios or funds that have some portion of their assets dedicated specifically to investing to address ESG issues.

Finally, some private equity firms are incorporating ESG principles into their operations because they believe that the principles mitigate risks and create long-term value.

The Business Case for ESG Integration

When ESG first rose to prominence in the private equity industry, the business case was front and centre. "Do well by doing good" was the mantra. The G in ESG is something most funds do anyway but the shift from focussing on pure returns to environmental and social impacts

was novel and controversial. With regard to the environment, it was argued that a focus on environmental sustainability and impact is not only a risk mitigator but also a generator of efficiencies – both of which enhance returns. Similarly, good social relations mitigate the risks of doing business. Of course it also feels good to do good.

The private equity industry is … well … private and it is difficult to obtain data, particularly regarding the investments fund make and the returns on those investments. Much of the data supporting the business case for ESG is therefore generated by consultants offering ESG-implementation services. It is therefore hard to say definitively whether ESG contributes to the bottom line of portfolio companies or to fund performance.

But the business case has another leg to it. The demand for ESG from investors and the requirements imposed by regulatory bodies create a business case all of their own.

According to a study, analysts and investors used to see ESG initiatives as gratuitous, but over a 15-year period starting in the early 1990s, "analysts [started to] assess these firms less pessimistically, and eventually they assessed them optimistically." In other words, analysts advising investors on where to invest, see ESG as a positive. Another study shows that "in 2021, 20% of investors decided not to invest with a manager because of inadequate ESG policies. This rose to 26% in 2022." Whether or not ESG actually contributes to the bottom line, some investors are increasingly demanding it.

Increasing Regulation

Businesses in South Africa are all too aware of the increasing regulations around social impacts. This is becoming a global trend. One of the themes of the Super Return conference was the massive growth in the private equity industry over the last decade. It is now twice as big as it was in 2010. The largest private equity firms – Blackstone, Carlyle and KKR – are public companies. They collectively hold in excess of $200 Billion in assets. Globally, small, privately-owned companies with fewer than 500 employees outnumber large public companies (by more than two-to-one in the United States). The environmental and social outcomes of private equity activity is significant and this increases the regulatory pressure on this sector. Governments worldwide are implementing stricter regulations and disclosure requirements related to ESG factors and this trend is likely to continue for larger players.

Tools and Frameworks for ESG Integration

At Werksmans we have developed a comprehensive suite of documents for fund formation that integrate ESG principles into the fund operations – from assessment of investment opportunities to measurement of performance, investor reporting and fund operations. Our transaction teams are well-placed to implement these principles into portfolio company due diligences, purchase and exit transactions.

Various tools and frameworks are available to private equity firms for effective ESG integration including tools to assist in evaluating ESG risks and opportunities throughout the investment lifecycle. A plethora of consultants stands ready to advice on impact measurement methodologies, ESG scorecards, PRI and Sustainability Accounting Standards.

At the investment stage, ESG principles require private equity funds to include in their due diligence processes the assessment of ESG risks and opportunities. This involves evaluating environmental impact, labour practices, supply chain sustainability, corporate governance, and other relevant factors.

Engagement with portfolio companies is a crucial aspect of successful ESG integration in private equity. Increasingly investors are looking to see active involvement of portfolio companies in ESG initiatives, such as setting clear ESG goals, monitoring progress, and providing support and resources to drive sustainable change. This results in a trickle down of ESG principles through to the portfolio companies and their suppliers.

ESG in South Africa

South Africa is somewhat ahead of the curve when it comes to corporate social responsibility. South African firms have been under pressure to address transformation for some time and have, both through voluntary initiatives and as a result of regulatory pressure, integrated social responsibility into their operations. Attending the Southern Africa Venture Capital Association conference this year, I was struck by the shift on the part of fund managers and pension fund trustees from a pure returns-based analysis to factoring in the social impact of investing. This is not a self-evident development. Pension fund trustees, for example, have fiduciary obligations to members and beneficiaries to maximise returns.

There has been a veritable explosion of ESG fund service providers over the last decade and most of them are active in South Africa. Funds and their managers have access to a myriad consultants offering advice on applying ESG principles when due diligencing portfolio companies, applying ESG principles in fund operations and reporting to investors.

Criticisms of ESG

Over the last decade, the grumblings about ESG have grown. There is now more vocal criticism of ESG and within the private equity industry. The criticism is both that ESG places too much emphasis on factors other than returns and that it does not place enough emphasis on those other factors.

Impact Funds

In our practice, we have seen a trend towards impact funds that make no bones about their focus on effecting social change through their investments. Whilst these funds still seek to deliver returns, generating measurable social and environmental impacts is equally important. These funds have moved beyond ESG in the sense that the investment strategy itself is to effect social change rather than merely taking into account environmental and social factors in order to enhance returns. We were involved in the establishment of the One Thousand and One Voice fund in 2013, a fund that blends traditional private equity and philanthropy and since then we have helped establish a host of impact funds for clients whose focus is on the impact of their investment rather than pure returns.

The Return, Stupid

The rise in impact investing is balanced by a simultaneous return on the part of some investors and managers to traditional investing. Fortune Magazine recently noted that, "Critics say ESG investments allocate money based on political agendas ... rather than on earning the best returns for savers. They say ESG is just the latest example of the world trying to get 'woke'." In South Africa, we have seen pension fund managers under pressure to allocate investment to government infrastructure projects.

These developments do raise interesting questions around the fiduciary duties of managers and trustees. If faced with a choice of investing in a company that promises a higher return but lower social impact, what does a pension fund manager do? This question recently arose in the United States when the labour department made a ruling allowing pension funds to consider ESG factors when making investment decisions. Republicans described ESG as a, "Woke scam infecting our corporations and changing our nation." The Senate promptly overturned the labour department ruling.

Sceptical Investors

The controversy around ESG has also created opportunities for managers looking to service sceptical investors.

Some investors see ESG as another money-making scheme and the scepticism seems to be growing as the business data continues to be unconvincing. It has been noted, for example, that BlackRock's ESG Aware fund charges fees five times higher than those of its Core S&P 500 fund.

When Tesla lost its place on the S&P 500 ESG Index, Elon Musk described ESG as a "scam" that "has been weaponized by phony social justice warriors." Noting that six oil companies were listed on the index, Musk criticised business for complying with a political agenda. Many fund managers have also noted that the preoccupation with ESG has created opportunities for managers running anti-ESG strategies. It is noted, for example, that during a global energy crisis, Exxon, which is owned 21% by private equity firms, has decided to shift away from fossil fuels to renewables, which will necessarily reduce its energy output. At the same time, the new chief executive officer of Shell, Wael Sawan, has promised to be "ruthless" in his pursuit of higher returns for shareholders. "Ultimately what we need to do is to be able to generate long-term value for our shareholders," Sawan told the FT. "The answer cannot be, 'I am going to invest [in clean energy projects] and have poor returns and that's going to vindicate my conscience'. That's wrong."

Greenwashing and Lack of Accountability

On the other side of the spectrum, some critics of ESG raise concerns about "greenwashing," where companies or funds overstate their ESG commitments without meaningful action. These critics counter that the problem with ESG is that it is not being properly implemented, properly monitored and properly regulated.

One of the central challenges private equity funds seeking to implement ESG face is the lack of any universal accounting or reporting standard. Private equity funds have a unique mandate to produce substantial returns quickly and any cost that threatens to reduce those returns is treated with scepticism. Some fund managers who have implemented ESG into current vintage funds point out that there is no consistent data establishing a positive link between ESG investing and financial returns.

Advances in technology, such as data analytics and machine learning are being touted as facilitating ESG data collection, analysis, and reporting. Most of the exhibitors at the Super Return conference, for example, were service providers touting the artificial intelligence they utilise in providing reporting and administration services to funds.

Certainly, without proper verification and standard accountability mechanisms, there is a risk of ESG integration being used as a marketing tool rather than driving substantial change. Those who have sought to look beyond firms' marketing collateral, have found that the majority of private equity ESG efforts are superficial with firms frequently putting new labels on cost or efficiency initiatives that they would have implemented anyway. Of the roughly 9,000 private equity firms operating globally, around 700 have signed up to the United Nations Principles for Responsible Investment ("**PRI**"). Less than 16 of these firms disclose ESG impacts on financial returns and only half use ESG principles in monitoring the bulk of their portfolio. This translates to less than $0.5 trillion in a $3.4 trillion industry.

Conclusion

As sustainable and responsible investing continues to gain traction, large private equity firms will be under increasing pressure to integrate ESG into their operations. Given the controversy around the contribution of ESG principles to the returns that drive this industry, the trend is likely to also result in opportunities for smaller firms that eschew these principles and seek to benefit from the reduction in price of assets seen as "unclean".

The march towards incorporating these principles will continue to be driven by investor and regulatory demands. Fund managers will need to carefully assess the market to ensure that they remain competitive – avoiding being taken in by the feel-good factors and overspending on ESG, whilst at the same time committing sufficiently to ESG to remain regulation-compliant and attractive as an investment.

Some valid concerns have been raised about certain managers losing focus on returns and in light of fiduciary concerns and financial services regulations, caution must be exercised by managers seeking to take into account other factors when making investment decisions – particularly where investors have not given the manager a specific mandate to take these factors into account.

Particular attention must therefore be applied to the wording of the fund documentation to ensure that the ESG obligations the fund takes on are discharged and that the fund does not apply principles that it does not have a mandate to apply.

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