KEYNOTE INTERVIEW

# Harnessing the ESG premium

*Private equity firms need to focus on data to be able to tell a convincing story on ESG, say Will Rhode and Winna Brown at EY*

It's clear that ESG has emerged as a strategic business imperative for private equity firms, not least because a significant majority of investors incorporate ESG-related indicators as part of their investment decision process. The emphasis on greater transparency and a standardised adoption process could play a significant role in accelerating the transition to a more sustainable future.

The key to success – say Will Rhode, Global Private Equity ESG Leader at EY, and Winna Brown, the firm's Americas Private Equity ESG Leader – is for private equity firms to get their priorities in order from the beginning. To benefit from an ESG premium on exit, they believe it is vital to work with portfolio companies to develop a systematic approach to managing ESG, such as collecting reliable, relevant data from the onset of a hold period.

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**Q Why is it important for PE firms to make commitments around net zero and other aspects of ESG?**

**Will Rhode:** Climate-related risks are a focal point for the majority of investors, consumers, lenders, management and employees. This trend is growing. Over the longer term, the adoption of a systematic approach to ESG will prove to be a competitive advantage by virtue of the value that's created. Firms that are ahead of the curve will benefit in contrast to those that remain less committed.

At present, the pressure on climate comes from the LPs, who may have made their own net-zero commitments. They are looking for private equity funds to show they are aligned to their climate agenda. But beyond climate, ESG is important because PE firms, by virtue of the vast size of their capital holdings and their ability to steward their portfolio companies, represent an incredibly powerful lever for positive change. PE firms have an advantage and flexibility in how they approach ESG. They have the ability

to be rigorous in how they execute on their strategy, because they have the opportunity to think flexibly about what they want to do before they make any explicit commitments.

## Q What are the key trends around ESG due diligence?

**Winna Brown:** Just two to three years ago, most PE firms looked at ESG and sustainability-related issues largely from a risk management perspective. There's been a key paradigm shift, wherein PE investors are now looking at ESG as a key value driver – and that process begins in the diligence phase. ESG is becoming a key focal point for deal teams in addressing the growing mandate from investment committees, certainly in Europe, and we are also starting to see that in the US. Deal teams are looking for an integrated approach, where ESG diligence zeroes in on the financial implications of an ESG dimension on the performance of a company.

As ESG impacts are specific to sectors, it is essential for firms to have that sector expertise. There is so much change right now, in terms of decarbonisation, transition pathways and the technology that is enabling ESG, so teams need to have a perspective on the sector-specific transition pathway.

Finally, there are groups that are developing models that integrate the cost of carbon into EBITDA, or consider the positive correlation between improved ESG scores on deal multiples. Others look at how ESG risks connect to broader strategic issues, such as the cost of energy, and ability to access lower cost renewable energy sources. That means thinking about ESG, not just in terms of it being an opportunity or cost, but also in the context of deal underwriting. It will be amazing to observe how this evolves over time.

## Q How can PE firms ensure success with ESG value creation?

> *"The adoption of a systematic approach to ESG will prove to be a competitive advantage by virtue of the value that's created"*
>
> **WILL RHODE**

**WB:** The first 100 days are crucial, as with any value-creation process. It is important for PE firms to focus on some key ESG themes such as operating model mobilisation, decarbonisation strategies, supply chain challenges and – especially in the US – DE&I and pay equity. Establishing a process needs to be front of mind. ESG capabilities within the portfolio company should be formalised and the right governance structures need to be in place to ensure the company will collect, monitor and report on their ESG data.

PE firms also need to consider that portfolio companies have different levels of maturity when it comes to ESG and therefore be prepared to help the portfolio company understand these ESG requirements – which may be quite new to them. What we have found in speaking with both PE firms and management teams, is that it helps to take the time to walk the company through why ESG is a priority and how it can help to create value. If the companies don't understand why ESG matters, then they are never going to be fully onboard. Working alongside them and bringing them on the journey goes a long way.

## Q In terms of ESG reporting, what are the key considerations for GPs?

**WR:** Reporting is a key aspect of how a PE firm engages with its stakeholders. LPs want to know what PE firms stand for when it comes to ESG. They may want to split their investments to cover different elements of ESG, so it's important for them to be able to understand what a PE firm is driving at from a value-creation point of view.

LPs also want to see clear frameworks and policies to protect against greenwashing and reputational risk. When it comes to demonstrating performance, there is a move towards reporting sector-specific ESG key performance indicators. That means, instead of looking at overall ESG scores or ratings, the PE firm helps companies within a specific sector to work towards KPIs that are most materially relevant.

Reliable data is key to help a PE firm ensure it has good provenance on the metrics that are being monitored and measured. As ESG increasingly becomes core to the value-creation narrative, ESG indicators will have to be of the same veracity as financial figures if they're going to deliver on their promised value. GPs therefore need to make sure of the quality of the data that is being gathered for ongoing reporting purposes.

Also, standards are evolving and becoming more detailed over time, so it makes sense to have a scalable approach on reporting against the most important ESG themes. There are multiple standards that require, for example,

carbon performance data. You don't want to have to reinvent the wheel on every report, so the focus needs to be on operationalising reporting capacity according to theme.

### Q What are the main challenges in collecting ESG data?

**WB:** Understanding the type of data that needs to be collected is critical. Are you focused on absolute data, like absolute emissions data or hazardous waste generated? Or is comparable data, like emissions intensity, for peer comparisons more relevant? Maybe specialised data, with forecasts and adherence to industry standards, is the most important lens. Broadly, what are the metrics and KPIs that you are going to report on and what is the equity story that you are looking to tell? These are the baseline considerations.

A portfolio company also needs to have people that are trained and understand what they are looking for, so they can get the data in a timely and consistent manner and guarantee its quality and integrity. That can be a challenge when there is a lack of experience and bandwidth in the portfolio companies. So, to operationalise good data collection, the PE firm should assess whether the portfolio companies have the scale, people, processes and necessary technology solutions in place.

### Q Given that ESG is becoming more widely practised, is it still possible for firms to differentiate themselves with their approach?

**WR:** PE is on a journey when it comes to ESG; and while it's not yet fully integrated into the investment process for many firms, we think PE is differentiated as a financial services actor compared to other financial services firms.

PE firms are in a position to influence and steward the transition to a sustainable future and they have a broad range of options when it comes to deploying capital. This gives them an advantage versus other types of financial services firms that are more limited in the types of financing they provide and for what purpose. PE is able to direct capital in a focused way towards a specific ESG objective and with more control over the outcomes.

From a product perspective, PE firms can establish a reputation for managing thematic and impact funds that can create lasting change. Especially around impact, they have the ability to grow companies that will meet the needs of a sustainable future, such as those that enable the 'brown-to-green' journey.

It's an exciting time in PE, where firms are embracing the opportunity to create shared value with society. But, in order to achieve that vision, transparent frameworks and policies have to be in place. Firms must be able to demonstrate that they have the ability to systematically collect reliable data, so that everyone is confident in how the firm is investing, and that the value-creation potential of ESG – in all its forms – is fully realised. ■

### Q To what extent is it possible to benefit from an ESG premium on exit?

**WB:** EY did a PE divestment study and found that nearly three-quarters of PE firms expect to capture an ESG premium in the businesses they are selling. The big question is where that ESG value uplift is going to come from and how it is going to be measured. You can do great things on ESG, but if you are not measuring it, reporting it and talking about it, you are not going to get the credit for it. Firms need to be smart about how they crystallise the premium and ultimately increase shareholder value.

Because the hold periods are short, it is especially important for PE firms to get up and running quickly and to be clear on how they present their ESG value-creation strategy. Firms need to be able to capture both the tangible and the intangible benefits of their approach to ESG. If they have focused on climate change, for example, they need to be able to explain how helping emission-intensive assets to adopt a path towards decarbonisation is going to return higher multiples.

Data is also going to be key – when you are on the receiving end of ESG due diligence at exit, you want to be able to make sure you can demonstrate your achievements.