

KEYNOTE INTERVIEW

Articulating the commercial value of ESG integration



*With ESG moving up the agenda, managers need to develop a clear long-term value narrative and embed it throughout their portfolio, say EY global private equity leader **Andres Saenz** and director, sustainable finance **Simon Abrams***

Q The need to create value in a meaningful and sustainable way is increasingly critical for private equity firms. What is driving the issue of ESG for managers?

Andres Saenz: At a basic level, there is a need to keep up with regulatory developments and there is increased regulatory action in this space. Yet probably more consequential is the way in which environmental, social and governance issues are becoming a core basis for competition. GPs compete for capital, where LPs are demanding clarity on purpose and outcomes; they compete for talent, where a growing

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number of people coming into the private equity industry want their values to align with their employer; and they compete for deals, where we are seeing more entrepreneurs wanting to work with private equity firms whose values are aligned.

Historically, businesses were looking for two things from an investor: capital and knowhow. Today, as private equity matures, businesses can access capital from a variety of firms and most funds have value creation teams, so sponsors

need to find new points of differentiation. Many of the companies that private equity is now investing in are founded by millennials that are heavily aligned with this topic and pick their private equity backers on this basis.

Simon Abrams: ESG provides a different lens on how value is going to be created and destroyed over the long term, so understanding the headwinds that ESG represents in the context of mega trends such as the need for equality, action on climate change and enhanced human rights is critical. Those issues are going to impact all industry sectors over the next 10 years. For the

companies that private equity firms own, good investment decisions will be underpinned by the identification of additional risks and new opportunities to make money.

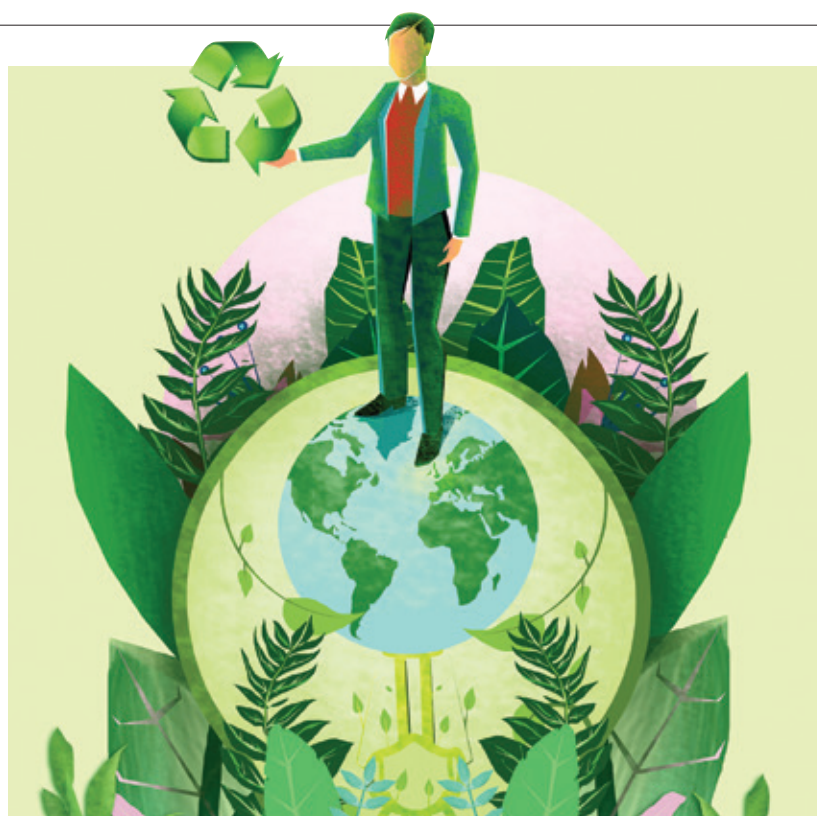
Businesses that are ethically aligned will not compromise on ethics or work with partners that do not support those messages for fear of alienating customers. Some of the fastest-growing companies going forward will be green businesses that prioritise ethical values.

Q How can firms progress their ESG focus from responding to regulatory and investor demands to a more long-term value approach?

SA: Managers need to develop a clear narrative as to why they do what they do. That starts with access to finance from LPs, then access to targets, driving operational efficiencies, attracting talent and also aligning with regulation. There will be some elements of that narrative that will drop down to immediate bottom-line profit, while others will relate to the cost of capital or the ease of doing business. A measurable values narrative that is not just about profits and returns but is also socially focused is important. That narrative should help in all decision-making and direct the allocation of capital.

AS: This is about moving along a spectrum from basic compliance to broader risk management and then flipping the switch into opportunity-seeking where you take a more direct view of impact – whether that is full impact funds or private equity funds incorporating a greater focus on long-term value. In that way, firms can achieve the transition from contributing to society because they are financially successful and then give back, to being successful because they create shared value with society.

Achieving that requires the attention of those at the most senior levels, which many private equity firms have come around to; it needs to be directed from the top to embed those practices across



“Environmental, social and governance issues are becoming a core basis for competition”

ANDRES SAENZ

the deal life cycle, from sourcing professionals through to operating teams.

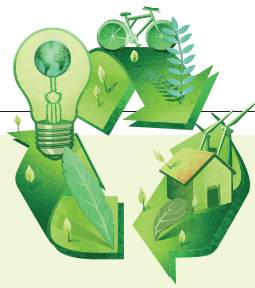
Q How can ESG principles and metrics be integrated across the investment life cycle?

SA: Defining ESG principles and metrics is important because the material issues will be different for each

business. Some issues are clearly relevant on a sector-by-sector basis, and some are relevant almost on a principles level. For example, whatever sector you are in, you need to demonstrate you are doing something on climate risk, even if your sector has a relatively low-level impact, and also on diversity.

Beyond those, investors need to hone in on the relevant issues for a particular sector and business, and how it makes sense for that business to start addressing those issues to create or protect value. They need to think that through, agreeing those material issues at the diligence phase, developing an action plan when the deal closes and then being able to demonstrate at exit that they have either created value or protected value.

AS: Starting from origination, we can see private equity firms either adding an ESG lens to the types of companies they are looking for, or more specifically having entire theses devoted to areas that are ESG-positive, whether those



Q What evidence is there that superior ESG leads to superior returns?

AS: Some of the research we have seen shows that companies that rank well on ESG measures are outperforming the market by roughly 3 percent per annum, which is meaningful. Also, their employees are 1.4 times more engaged, 1.7 times more satisfied, and three times more likely to stay, all of which leads to better performance and returns.

SA: We published a report last year with Royal London based on independent research that we collated looking at ESG performance, covering more than 500 studies. We found that if you integrate ESG there is no detriment and you do not lose anything, while a significant number of studies say you outperform. The evidence shows there is no downside, but there is often an upside.

AS: I suspect there is still an element of scepticism among certain investors. However, the conversation is moving towards understanding there is more value to be created by being attentive to these issues, because there are potentially opportunities to unlock value that were not previously considered. The broader ecosystem supports this, consumers are becoming greener and are demanding more ethically aligned goods and services, so ultimately this is accretive, including financially.

SA: Where more work is needed is on the quantitative side. We know that qualitatively it makes sense, but we need to do more work to demonstrate that so people can focus on the figures with greater confidence.

are companies that are pioneers in the space or are transformative in one way or another. On diligence, the same importance that one gives to financial, tax and commercial considerations needs to be attached to the ESG metrics that should be considered when evaluating a company.

In the ownership phase, one of the first things a private equity firm does is identify the elements that will create differential value during their hold period, and they need to ensure ESG initiatives sit on that list. For some companies they might be at the top of the list, for others further down, but they need to be there. Then, once an exit is achieved, managers need to measure and communicate the return on what has been done from an ESG perspective, both for internal tracking of the impact on returns and to external shareholders.

SA: A good example would be a flower business that a private equity firm invested in based in the Great Rift Valley in Kenya. The strategy was to double the number of flowers grown, but the question of climate impact meant the likelihood of threats to the water supply, or that the government might put a cost on water in the event of water scarcity, had the potential to have a significant impact on margins. The investors had to think about that over a 10-year horizon, because even though their hold period was only going to be five years, the threat had the potential to impact the exit at the end of that period.

Q What is EY doing to support the private equity industry in establishing a long-term value framework?

AS: We are trying to help firms move

through that spectrum from basic compliance to opportunity-seeking. We have been supporting managers getting to the more interesting stage of evolution and developing their long-term value frameworks, thinking about not just the financial but also the human, customer and social implications of what they are doing. That requires starting at the top and then embedding it through the organisation, determining stakeholder outcomes and widening understanding of what drives value creation and preservation.

We have been focusing on ‘the power of positive equity’, which is about taking action and innovating around portfolio companies, whether that is digital value creation or specifically around ESG. There is also a huge talent angle around stewardship of the workforce, both at the private equity firm level and in portfolio companies, which includes training, reskilling, and the recruitment and retention of diverse candidates.

SA: We are doing a lot to help companies think about the short and long-term impacts of climate change, including the regulatory, financial stakeholder and customer impacts, and on diversity and inclusion. At the start of 2020 these issues were on the radar, but with everything that happened last year they have moved up the agenda even further. We saw a lot of new commitments on climate change come to light despite the cancellation of the UN Climate Change conference last year, and I expect this year’s COP is really going to focus minds.

The events with George Floyd in America raised visibility and commitment towards ethnic diversity across the corporate world and challenged people to do even more. The corporate world has really stepped up to the plate in light of the pandemic, but it has brought some of the social issues of ESG into the spotlight. These, plus many other issues, are helping to embed ESG across the business world. ■