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ESG in private equity – Doing well by doing good

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For further information on the changes below or other private equity matters, please contact one of the authors above or any member of our Private Equity and Pension Fund Investments Group.

The emergence of the COVID-19 pandemic has thrust into the spotlight certain of our private equity clients who have stepped up in a significant way. In recent weeks, private equity firms, including many with a tendency to shy away from the spotlight, have made significant contributions in an effort to support their communities and those most impacted by COVID-19. Many of the world’s leading private equity firms have committed sizeable sums to relief funds, hospitals and food banks, and taken steps to support and provide meals and accommodations to frontline healthcare workers thrust into extraordinary circumstances.

The idea that businesses can and should consider environmental, social and governance factors (ESG) in the course of investment and management decision-making – often referred to as responsible investing – is not new. However, ESG’s growing prevalence among private equity firms, both as a factor in investment decision-making and risk mitigation and as part of a strategy for generating superior long-term returns, is relatively new.

Historically, the private equity industry has often been perceived to have a singular focus on financial returns for investors. While that reputation still persists in some circles, the reality is that private equity sponsors have been buying into and adopting various forms of ESG investing policies for more than a decade. Today, there is a growing recognition among private equity funds that the long-term viability of their portfolio companies is very much tied to the welfare of their stakeholders, including employees, suppliers, customers and the communities in which they carry on business. Forward-thinking sponsors have committed to ESG as an investment philosophy. The industry recalibration we have observed with our clients over the past decade has been marked with:

* the emergence of international standards, including the UN-supported “Principles for Responsible
Investment,” which has gathered nearly 2,400 fund signatories to date, a group that controls a staggering $86 trillion in capital.\(^2\)

- A 2019 PWC study of 162 private equity funds that found 91% of respondents had or were developing a responsible investment policy and 35% had an in-house team dedicated to responsible investment initiatives;\(^3\)
- Private equity fund due diligence focusing on ESG initiatives, including business ethics, bribery and corruption, occupational health and safety, responsible supply chain, waste management and energy use;\(^3\)
- ESG increasingly being seen as a means of not only protecting, but also creating, value, and a factor considered by purchasers and public markets on exit transactions;
- Social and environmental factors increasingly bearing on consumer behaviour and business conditions – consumers are increasingly putting their buying power behind ESG issues; and
- The Institutional Limited Partners Association (ILPA) recognizing ESG investing as a means of better managing risk and generating sustainable long-term returns: the recently released ILPA Principles 3.0, one of the key themes of which is fostering transparency, governance and alignment of interests, advise general partners to consider maintaining and updating ESG policy statements.\(^4\)

Although ESG issues are more prevalent today than ever, the degree of buy-in by private equity funds can vary widely, in part depending on the pressure and expectations of the fund’s investors. Commitment to ESG can range from a traditional approach (with a focus on ROI and a respect for compliance with ESG obligations imposed by law), to a risk mitigation strategy (with a focus on managing risk through thoughtful environmental and governance policies), to opportunistic ESG investing (with a focus on investing in portfolio companies showing ESG leadership), to impact investing (with a focus on social impact alongside a financial return). In speaking with our clients, both on the sponsor and investor side, we’ve observed a number of common themes:

1. **ESG policy**: During fundraising, private equity sponsors can expect to be asked by institutional investors for a copy of their ESG policy as part of investor-side due diligence. Investors expect to see a simple and constructive policy, addressing deal sourcing, due diligence, portfolio company management and asset monitoring. ESG matters are seen by our institutional investor clients as an opportunity to generate sustainable growth as opposed to a constraint on returns.

2. **Stakeholder engagement**: Institutional investors, including pension funds, are increasingly finding vocal support for ESG initiatives among their members, beneficiaries and stakeholders. These investors want to be seen to be ahead of the curve on ESG, making it less likely they will be forced to defend their investment decisions after the fact, or to fall prey to divestment campaigns.

3. **Risk management**: Organizations that ignore ESG – whether by disregarding diversity and inclusion practices, overlooking environmental issues or acceding to unethical employee practices – present a riskier investment proposition. This is one reason why investors insist that sponsors consider ESG factors in their due diligence process. Some institutional investors have gone as far as creating ESG teams with authority to veto investments if the perceived ESG risk is too great or if the potential sponsor is not committed to ESG principles.

4. **Performance indicators**: Private equity funds seeking to differentiate themselves from others are also articulating and reporting on their compliance with clear quantifiable metrics. While third-party standards are beginning to emerge, measurable and standardized compliance indicators have yet to take hold. Private equity funds that proactively set quantifiable targets will set themselves apart from those that do not and will be rewarded on their next fundraising round.
5. **Shifting emphasis**: Environmental initiatives, and climate change in particular, have drawn the lion’s share of ESG attention in recent years. The COVID-19 pandemic has prompted a rebalancing of sorts, with sponsors and institutional investors looking more carefully at “social” factors and initiatives. At least one sponsor client has observed that it sees this as a longer-term trend towards apportioning equal attention and importance to each of the three facets of ESG.

The past decade has seen not only a growing acceptance of ESG investing in the private equity industry, but also an evolution and broadening in the way sponsors and institutional investors alike think about ESG investing. Some might attribute the rapid expansion of ESG-mindedness to a decade-long bull market – arguably the perfect environment to explore non-financial initiatives – and question whether ESG investing can stand up to being tested through a market correction. Indeed, the unprecedented and unimaginable deterioration of global economic conditions resulting from COVID-19 has presented the first such test. While it is too early to predict, we are of the view that private equity firms that adopt robust ESG governance policies and practices will fare better during the downturn than their traditionally minded peers by attracting investment, withstanding increased scrutiny by ESG-minded decision-makers and investors and delivering long-term sustainable results.

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[4] These policies are expected to provide investors sufficient information to assess the degree to which the sponsor’s investment strategy and operations align with the investor’s own ESG policies (including, in particular, how ESG is factored into due diligence and performance reporting). See *ILPA 3.0: Foster Transparency, Governance and Alignment of Interests for General and Limited Partners*. Institutional Limited Partners Association (available at: https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf).
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