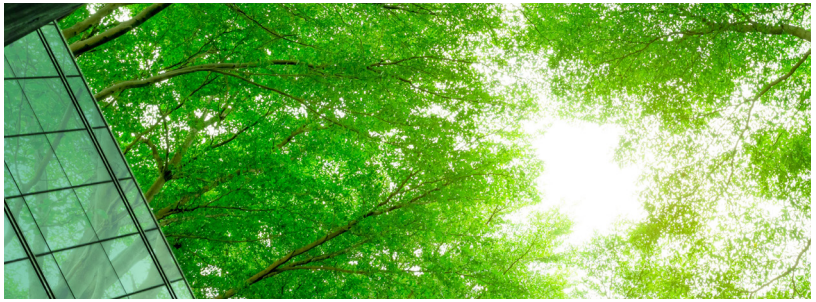
INSIGHTS

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PRIVATE EQUITY WIRE



ALIGNING ON VALUES

THE LP-GP CONVERSATION ON ESG

EXECUTIVE SUMMARY

ESG's journey from a tick-box exercise to an all-encompassing lens for investment continues – influenced by shifts in sentiment, regulatory developments, macro-economic turbulence and wider considerations of climate change and social impact. Essential for progress is an alignment of LP and GP priorities and incentives – this report aims to explore both sides of the conversation.

The good news is that LP expectations are intensifying when it comes to ESG, both in terms of transparency and monitoring frequency, but also – GPs say – when it comes to the sophistication of demands. Regulatory developments across different geographies are reflecting this shift, despite clear regional differences – as we explore in section one.

In section two, we learn how LPs have developed their own metrics and frameworks to measure ESG performance, and – to an extent – expect GPs to deliver along those lines. Beyond basic compliance, a key priorities are ESG-driven value creation and financial return. In response, leading GPs are building comprehensive value creation strategies that can be integrated across the entire investment lifecycle – from due diligence through to exit.

Underpinning all these conversations is the challenge of collecting data – historically a barrier due to the opacity of private markets. Increasingly, the conversation is shifting away from the availability of data to the quality of data, as intensifying reporting regimes expose gaps in knowledge and resources at the portfolio level. Technology will play a key role here, going forward.

As the ESG paradigm comes more sharply into focus, both LPs and GPs are developing a deeper understanding of the planning required to deliver along these metrics – open and clear communication will be crucial, going forward.

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METHODOLOGY

The data presented in this report is based on a survey of 50+ LPs – across family offices, insurance companies and institutional investors. Data was collected in Q2 2024, and the survey analysis is complemented with qualitative interviews with ESG leads at some of the world's largest GPs, as well as some LP perspectives. This is further supplemented with knowledge and insight aggregated from a range of media and news sources.

KEY FINDINGS

1

In demand

More than half of all LPs say their focus on GPs' ESG strategy has intensified over the past 12 months – 15% of these say it has done so significantly, while 28% of LPs also say a GPs' ESG profile plays a 'central' or 'integral' role in their decision to allocate. Conversations with leading GPs reveal not only a growing instance of ESG-related demands, but also a proliferation of knowledge in the space and a resultant increase in the sophistication of expectations.

2

Response to regulation

Regulatory shifts and risk management (cited by 15% each) are the biggest factors of influence on LPs' ESG strategy, followed by financial returns, wider climate change considerations and internal stakeholder pressure. Europe remains significantly ahead when it comes to both ESG prioritisation and regulation, with significant backlash in the US causing a 75% drop in the number of new ESG fund launches in 2023 as per Morningstar data.

3

Focus on value

The biggest share of LPs (34%) say their ESG strategy is best described as the intention to leverage for value creation and financial return – in contrast to the second largest pool (26%) that are looking just to comply with basic regulatory requirements Promisingly, more than a fifth (21%) of LPs say they focus purely on sustainable, future-ready businesses – leading GPs are also integrating ESG strategies earlier into their due diligence processes.

4

Data dive

The biggest barriers to ESG for LPs? Data scarcity and opacity (24%), regulatory complexity (21%), greenwashing (19%) and knowledge gaps (17%). Regulation may have brought about more stringent data collection regimes, but assuring the quality of this data remains a challenge – particularly as portfolio companies continue to adapt to new and ever-evolving reporting regimes. LPs are developing more sophisticated metrics for their use of data.

MAPPING THE ENVIRONMENT

A high-level look at investor attitudes towards ESG, and how the regulatory landscape across geographies is driving change

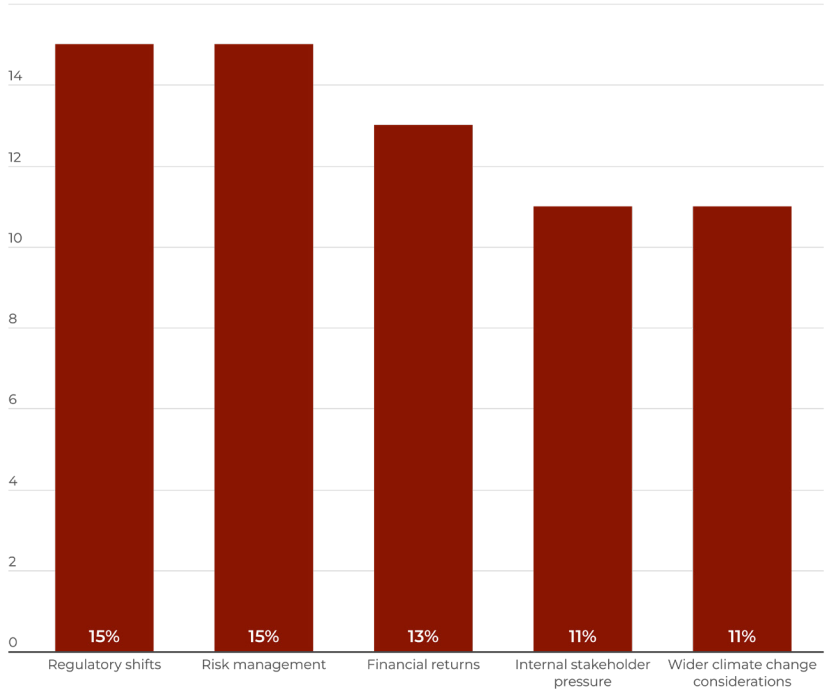
Attitudes towards ESG fluctuate in tandem with the economy. The concept – to consider environmental, social and governance factors when investing – is often subject to heated public debates that explore the 'what', the 'if' and the 'why', particularly in times of uncertainty.

Still, there are forces that maintain its position on the boardroom agenda. Private Equity Wire's Q2 2024 LP survey reveals ESG expectations have intensified for more than half of investors over the past 12 months (see Figure 1.1).

The factors most strongly influencing LP ESG strategies (see Figure 1.2) are regulation and risk (15%), followed by financial returns (13%) as well as internal stakeholder pressure and wider considerations around climate change (11% each).



Figure 1.1 Factors influencing LP sentiment on ESG



Respondents were asked, 'Which of the following factors play a central role in informing your organisation's ESG priorities? (Select all that apply)'

Source: Private Equity Wire Q2 2024 LP Survey

Yohan Hill, Principal and Director of ESG and Responsible Investing at Adams Street, breaks these factors down into internal and external driving forces. Internal drivers include the need for risk mitigation and value creation that can positively impact exit multiples, which we will explore in more detail in section two of this report.

The big external driver, Hill says, is "predominantly the proliferation of ESG regulation over the last two decades."

"There are regional differences, but this is largely happening worldwide, and directly targeting not just corporates but financial institutions, as well as economic policy more broadly.

"Linked to this, and to shifting values and investment beliefs, is the growing appetite for ESG-focused strategies. We see this anecdotally in fundraising and empirically in our global investor surveys – investors in private markets increasingly see ESG investing as not only a way of mitigating risk but also a way of capturing opportunities in a manner that aligns with their values and those of their beneficial owners."

DEGREES OF SCRUTINY

As Hill says, there are distinct regional variations in the regulatory landscape. Europe is leading the charge with such frameworks as SFDR, CSRD and CSDDD – to name a few – each pushing for a more holistic application of ESG principles across the investment lifecycle, all the way down to the supply chain.

KEY FINDINGS

Regional variations

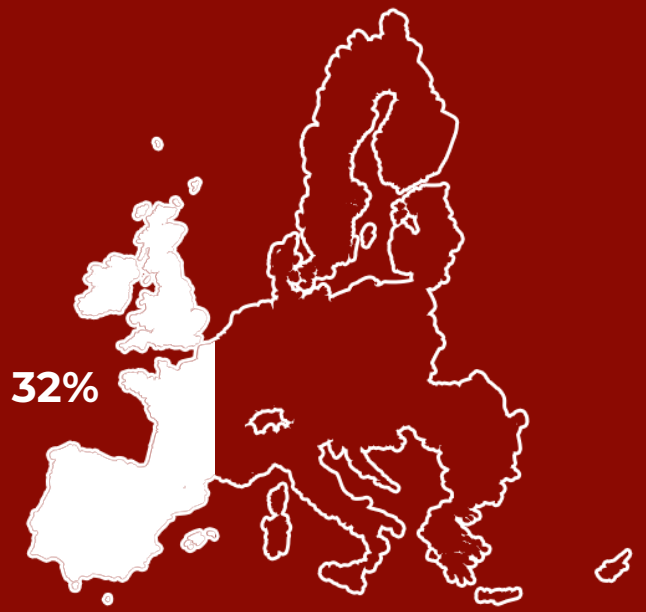
ESG is a far bigger priority for European investors than their North American counterparts

Share of LPs that consider GPs' ESG strategy 'integral' or 'central' to their allocation

North America



Europe



INSIGHTS

This will likely have a wider impact, Hill says. "It's a catalyst for and an influence on other markets beyond Europe, where regulators can learn from the experience on the continent. It also has an impact on anyone operating globally, like ourselves. If you're either fundraising or investing in the region, you do have to ensure alignment with the required standards."

ESG sentiment and the regulatory environment are a reflection of each other. In the US, public backlash against ESG has potentially curbed policymaking, though it's important to consider political and social nuance from one state to another.

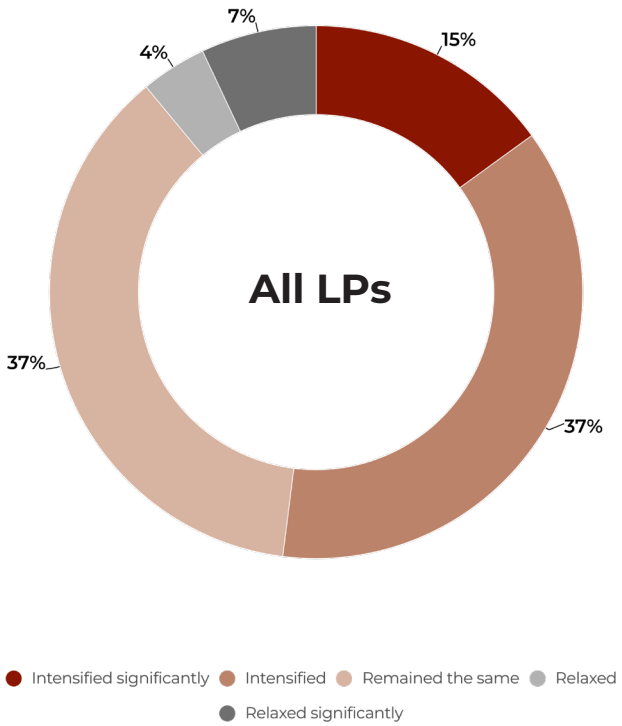
Overall, there is reason for optimism, says Angela Jhanji, Managing Director of Sustainability at EQT. "There is a debate ongoing in the US, but much of the anti-ESG rhetoric in the country stems from a handful of states. If you take a step back compare the capital flow that is tied to the sentiment, it is clear the noise is louder than the AUM amount."

"With all the regulatory advancements in Europe, and developments in the EU taxonomy around activities versus investments, for instance – it's going to be a significant challenge for LPs to avoid the reprioritisation perspectives proliferating worldwide. And this is increasingly visible – LPs are predominantly aligned with moving forward and driving sophistication."

That said, regulation may not always drive change in the right direction. Kamil Homsi, President of GRC Investment Group – a single-family office that prioritises ESG-based allocations – says Europe, Japan and the United States are at risk of "over-regulation". Homsi says: "The SFDR was passed in March of 2021 as the standard regulation for measuring and reporting sustainability in investing and finance, comprised of three articles: Article 6 addresses products without any sustainability objectives; Article 9 covers products with investment objectives; and Article 8 promotes environmental and social objectives alongside financial objectives. SFDR relies on self-assessment by financial firms, which might not always be reliable – reports might be exaggerated to appease the investor and the regulator. It was further reported that an average of 25% of the firms reporting annually have been summoned for false claims or misrepresentation, demonstrating rampant greenwashing.

"It's important to regulate the market, yes, but there is a risk of discouraging companies from participating when overregulating and rushing the process. We must consider that small businesses do not have the resources and human capital or the financial ability to collect data and prepare daily or periodical reports measuring their carbon footprint, emission or impact on the environment and, in many cases, the imperative to make changes to a workplace they do not own.

Figure 1.2 ESG trending upwards as a priority



Respondents were asked, In the past 12 months, your focus on GPs' ESG strategy has:

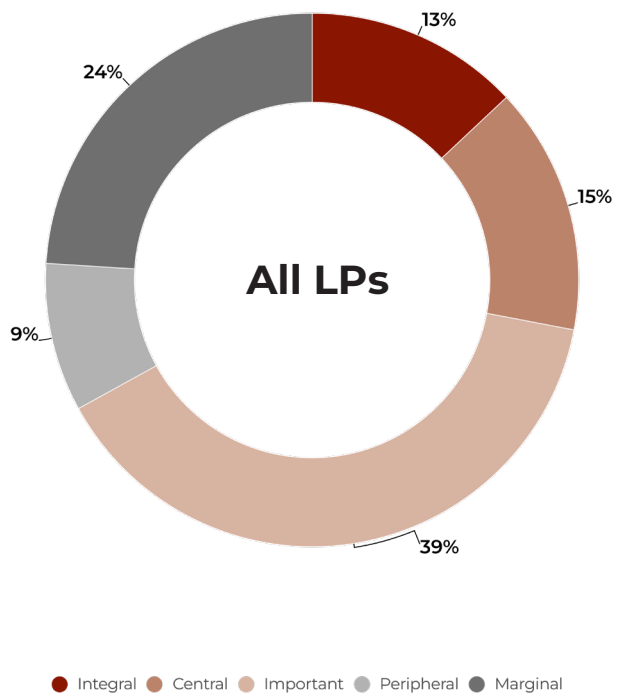
Source: Private Equity Wire Q2 2024 LP Survey

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Over the past year or two, expectations have increased because knowledge has increased

Stanley Kwong
Principal, Head of Sustainable Investing, EMEA, KKR

Figure 1.3 Importance of ESG in LP due diligence



Respondents were asked, 'What role does a GPs' ESG profile play in your decision to allocate funds?'

Source: Private Equity Wire Q2 2024 LP survey

IMPLEMENTATION REALITY CHECK

Whether this drive to sophistication is being fuelled by regulation, or vice-versa, the trend is increasingly apparent to a wider pool of managers.

Stanley Kwong, Principal and Head of Sustainable Investing, EMEA at KKR, says: "Over the past year or two, expectations have increased because knowledge has increased. As regulations have intensified, with more coming down the line, LPs have developed a deeper understanding of ESG and sustainability themes. Naturally, the type of questions being asked have grown in complexity, and conversations have become more interesting."

Kwong highlights the example of decarbonisation and emission target setting. "Until a few years ago, the question was as simple as – 'does the company have emission targets, or even a climate policy, of any type?'

"Today, clients want to know if the short- or medium-term targets are appropriate, how challenging it will be to achieve them, and whether a company has the capital planning to do so."

This shift, Kwong says, is best described as an "implementation reality check" – where many of the commitments around ESG for many years now are under the microscope for their feasibility. LPs and GPs are finally starting to understand the budgeting, resourcing and planning that goes into achieving ESG targets.

SLOW AND STEADY

There is no doubt ESG investing is a key consideration for many investors. Our survey reveals 39% of LPs say a GP's ESG profile is important to their decision-making when choosing to allocate. Another 28% say it plays a central or integral role (see Figure 1.3).

On the flipside, a third of LPs consider a GPs ESG strategy to be marginal or peripheral to an allocation decision – signalling a way to go. According to Hill, a mindset shift needs to come about to drive further change.

"We shouldn't think of an ESG strategy as simply being about whether or not to invest. We should think of it as being about how we ensure that we are investing responsibly, which ranges from screening new investments for ESG risks and opportunities through to ongoing monitoring, reporting and engagement after the investment decision has been made. A big part of the success of any ESG strategy is the ability to drive change.

"That said, we also need to align with the ESG preferences of our clients and the more clarity we have upfront as to what their ESG goals and requirements are, the better we're positioned to tailor our investment approach to meet those objectives."

Objectives and priorities vary considerably. Homsi says: "In my view, ESG is a conscious investment that benefits stakeholders and stockholders alike. Because humans have been destroying our planet for centuries, we must assess the damage, develop policies, pass realistic legislations and strategies to slow the damage and eventually leading it to a permanent stop – allowing a realistic timeline and appropriating budgets to finance the reversal. We also must address the social and governance aspects of ESG immediately, since ESG is here to stay as our future lifestyle and it is not a trend that will fade with time.

"The preservation of the food we eat, the oceans, the water we drink, and the air we breathe must be our top priorities. I am a father and a grandfather – I'm concerned about the legacy I'm leaving behind for my family and the world's future generations," Homsi declares.

The next section will explore in more detail the wide range of LP priorities, and how GPs are adapting to find alignment.

KEY TAKEAWAY

Many investors still consider ESG as a marginal factor when allocating, but those who are focused on it are growing more knowledgeable and sophisticated in their demands

Divergent discourse

A Reuters report from April cited a number of data sources to demonstrate just how divergent ESG sentiment is between Europe and the US.

There is opposition to the ESG tide in both regions – European legislation has also been repeatedly pared back and diluted to accommodate more conservative voices. But investment flows show the two regions are worlds apart.

Quoting Morningstar data, the report highlights how a sustained period of backlash from US investors means they have seven times less capital deployed in sustainable fund assets than their European counterparts.

Regulations clearly reflect the divergence – Reuters quotes ESG Book to reveal there are 20 rules and 25 voluntary guidelines pertaining to ESG in Europe, compared to two rules and five voluntary guidelines in the US.

And the list goes on, whether relating to pension fund priorities, disclosure requirements or attitudes to climate change, investors and policymakers in Europe are far more committed to bringing ESG into the mainstream than in the US.

Perhaps the most telling stat from Morningstar – new ESG fund launches in the US fell by a staggering 75% in 2023, compared to a 10% drop in Europe. Our own data tells a similar story.



SOPHISTICATED EXPECTATIONS

Mapping the range of LP priorities in the ESG space, and how the world's leading GPs are building value-driven strategies

There remains a degree of polarisation amongst the investor base when it comes to ESG. The top two priorities that emerged in our LP survey are: On the more sophisticated end of the spectrum, 34% that expect to leverage ESG for value creation and financial returns; and on the other, 26% that hope just to comply with basic regulatory requirements (see Figure 2.1). A healthy 21% are particularly advanced – focusing purely on sustainable, future-ready businesses.

Angela Jhanji of EQT says: "We look at sustainability from a future-proofing perspective because it drives good performance. LPs looking for outsized returns and a solid risk-return adjustment should also be looking for sustainability as that long term valuation lever."

Kamil Homsi of GRC Investment Group says: "ESG and measurable impact are paired – to implement the collected ESG data is to produce a material benefit. These themes are discussed with every GP and fund manager when allocating investment capital – to ensure our partners have a policy in place, and conduct serious ODD when selecting partners and or portfolio companies. Due diligence should cover all aspects of sustainability, including gender equality, meritorious advancement, pay parity, training, workplace culture and more."

And while LP perspectives on ESG are growing more sophisticated, the ongoing challenge for GPs is to meet a wide range of evolving expectations – in a space that is relatively young

and still establishing its foundational definitions. Our survey reveals three-quarters of all LPs now have their own ESG policy – and 49% of these expect to find alignment with GP frameworks (see Figure 2.2).

VALUE IN COMMON

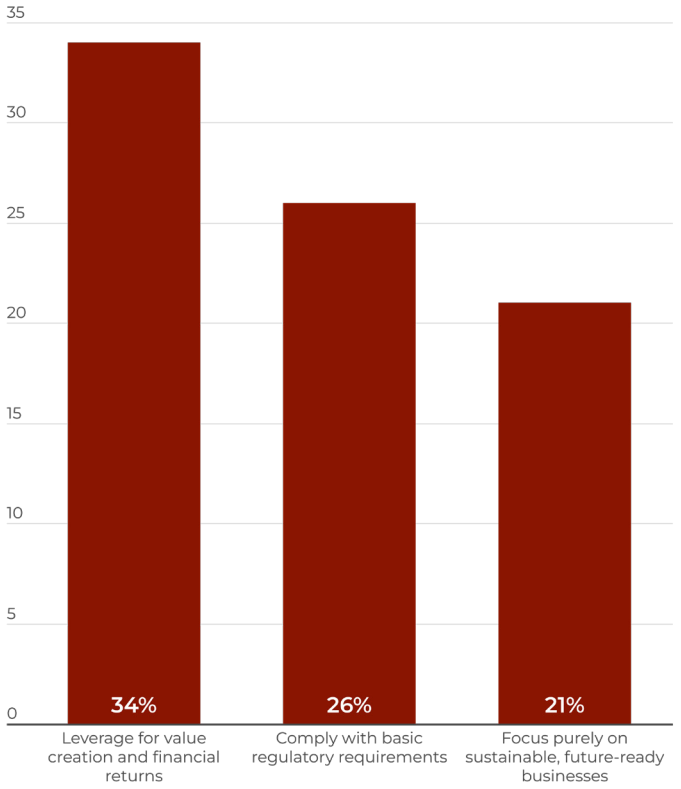
A question underpinning many ESG conversations in recent years has been to do with its financial value-add. In a period where exits are historically low and the importance of value creation in long-hold situations has come to the forefront, many have been keen to explore the transformational potential of ESG strategies. LPs have grown more interested, and GPs have evolved their response.

Jhanji says: "Value creation means many things for our strategy. For one, we focus on downside risk protection, which includes the regulatory landscape – but by driving value during our hold period, we can really improve returns at exit.

"We find value throughout the investment lifecycle, which starts at the due diligence phase. Traditional diligence tends to be just a snapshot in time of a company. What we do is align sustainability objectives with the commercial due diligence process, giving us not only an idea of the baseline, but also of the delta required and implications of that delta if the company grows. Private markets assets are held for extended periods, and evolve as they grow both from a risk perspective and from a valuation perspective."

She presents an example exit strategy: If a company has the potential to become even more

Figure 2.1 ESG priorities



Respondents were asked, 'Which of the following best describes your ESG strategy?'

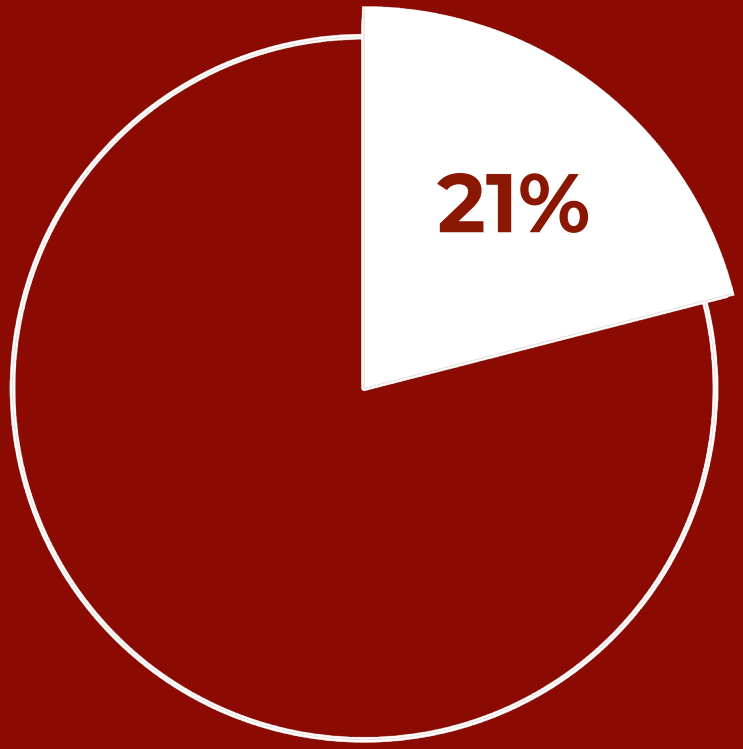
Source: Private Equity Wire Q2 2024 LP survey

KEY FINDINGS

Future fit

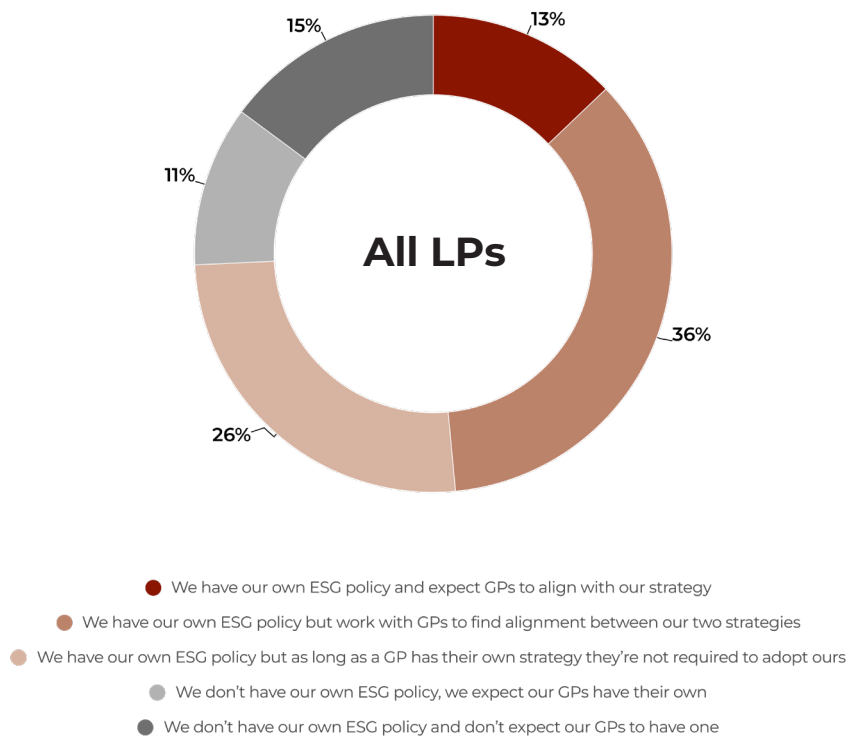
Sustainability is central to the investment thesis for many

Share of LPs that 'focus purely on sustainable, future-ready businesses'



INSIGHTS

Figure 2.2 Alignment of ESG frameworks



Respondents were asked, 'Which of the following best describes your approach to GPs' ESG strategy?'

Source: Private Equity Wire Q2 2024 LP Survey

sustainable, there may be a multiplier opportunity if there is a change impact funds will be interested further down the line. In the case of a product: there may be the upside potential of obtaining a green premium that will drive revenues; or the downside consideration of a material, plastics for instance, that may be subject to more regulation in the near future.

"ESG can be leveraged across the top or bottom line, to drive efficiencies, to optimise the balance sheet, or add real value to the end product and thereby the income statement," says Jhanji.

Comprehensive planning that starts from the due diligence phase is similarly the strategy at KKR, according to Stanley Kwong. "We have a set of themes that we think apply across portfolios, and are deemed critical as basic hygiene for value creation. These are: climate, human capital, data, security and management governance.

"For every company that we target, our due diligence covers these themes, and we develop a value creation plan on the back of it. On top of that, a crucial part of our investment thesis is to identify the material ESG topics from which we can derive the most value – either on the downside or the upside. This goes into a value creation plan that is embedded in the onboarding process, and we walk the companies through each of the levers – the expected timelines, estimated budgets, resourcing required and – most importantly – the outcome."

Kwong uses the example of a decarbonisation roadmap – where emission targets can be set based on industry benchmarks and best practices.



JOSH GREEN
COO, Novata

TRANSFORMING ESG DATA MANAGEMENT WITH TECH

In private markets, the growing demand for environmental, social, and governance (ESG) data continues to signal investor interest in the impact of sustainability factors on business performance. According to Private Equity Wire's survey of limited partners (LPs), 58% say their focus on the ESG strategies of their general partners (GPs) has intensified over the past 12 months. Notably, macro-economic forces and the need for risk management are among the top drivers influencing their priorities. The shifting regulatory landscape, climate change considerations, financial returns, and internal stakeholder pressure also play a role in how they set priorities.

With the focus likely to continue, particularly with regulatory requirements evolving quickly, the pressure is on GPs to not only disclose data but also demonstrate how they are using this information to manage risks and opportunities across the portfolio. Accurate and comprehensive data is foundational to developing effective ESG strategies — in addition to ensuring that firms and companies are able to comply with regulations, the data is critical to investors 'ability to identify tangible, short and long-term risks, determine opportunities to mitigate those risks and create value, and generate more accurate valuations as a result.

Despite this, challenges persist. Per the survey, 25% of LPs say that data scarcity and opacity presented the most significant challenge when it comes to ESG in the private markets. Knowledge gaps (21%), greenwashing (19%), and regulatory complexity (18%) were also cited as concerns for LPs. Solving the issue of data availability and transparency can take time; however, having tools and resources in place to simplify data collection and analysis processes can help improve the quality of data and ease the burden on reporting companies trying to navigate a complex landscape. At Novata, we believe in the value of technology in making ESG and sustainability data measurement more accessible. Technology is becoming increasingly sophisticated to meet the changing needs of the market, making it easier for investors to collect data and benchmark and analyze it, thereby increasing transparency. In turn, the higher the quality of data, the stronger the insights to inform GP strategies (see Figure 2.4).

LP demand for ESG reporting by GPs isn't going away; in fact, it's intensifying. By investing in the solutions best designed to meet their needs, GPs can get the most out of the data, improving outcomes and meeting LP expectations along the way.

> "LP demand for ESG reporting by GPs isn't going away; in fact, it's intensifying

SCIENCE OF SOCIAL

Indeed, many examples of ESG-driven value creation tend to revolve around themes of environmental sustainability – many being of the opinion that social impact is harder to track and measure. There is work being done in this space.

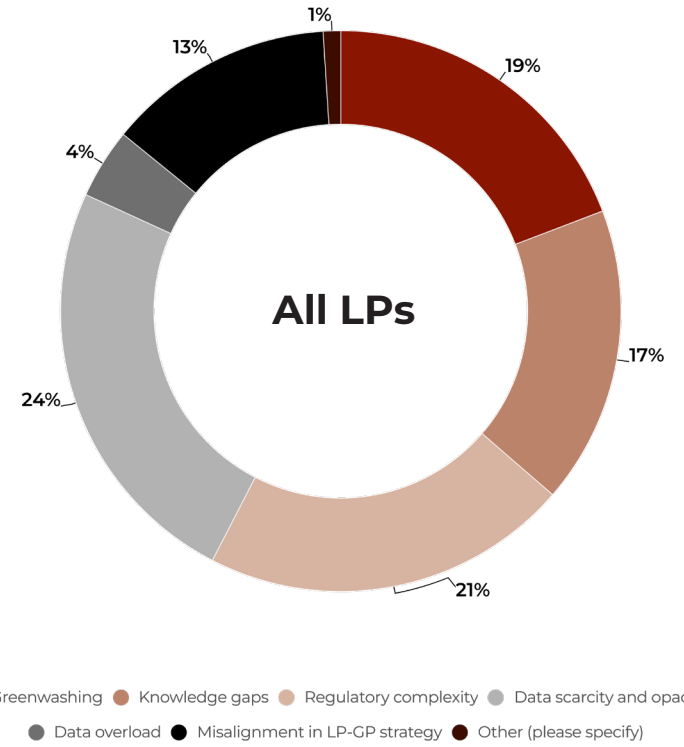
Kwong says: "It's a less developed area than environment when it comes to metrics. That said, for businesses where it is material – a business where people are at the core – there are metrics available. Most companies will have diversity, equity and inclusion (DEI) initiatives or employee engagement and satisfaction scores, for instance. The real challenge comes in implementing an improvement plan, which could have significant growth potential.

Jhanji highlights the value of improvements in this space. "There's a prevailing misconception around what DEI actually entails. If you boil it down, DEI can be a powerful HR tool that enables analysis of NPS Scores, turnover and retention and other factors that represent millions in costs for businesses each year."

DEEP DATA

A comprehensive value creation strategy across multiple levers is important, but the most critical component of an ESG strategy remains data. The scarcity and opacity of data has been a challenge for years, and it remains the top pain point in 2024 per our survey – cited by 24% of LPs. Regulatory complexity (21%), greenwashing (19%) and knowledge gaps (17%) all follow (see Figure 1.3).

Figure 2.3 Biggest ESG challenges



Respondents were asked, 'The biggest challenge when it comes to ESG in private markets is (Select all that apply):'

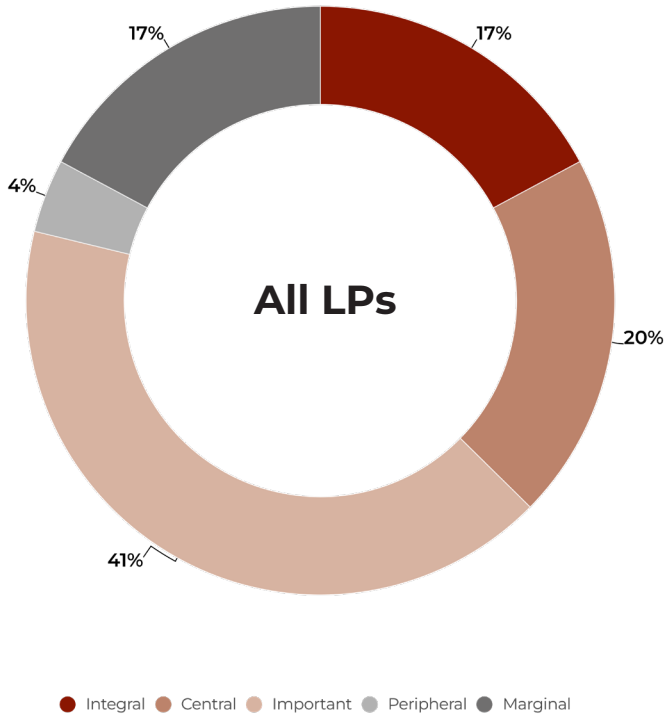
Source: Private Equity Wire Q2 2024 LP Survey

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Due diligence should cover all aspects of sustainability, including gender equality, meritorious advancement, pay parity, training, workplace culture and more

Kamil Homsi
President, GRC Investment Group

Figure 2.4 The role of tech in ESG



Respondents were asked, 'How important is a GP's use of technology for ESG data collection and management?':

Source: Private Equity Wire Q2 2024 LP Survey

As LP ESG strategies evolve, so do their data demands. Jhanji says: "LPs are doubling down on transparency and sustainability reporting. They consistently want clear, comparable data, and they're moving beyond collecting this data to gleaning real insight on what it means how it compares with recognised frameworks."

"Some are even developing their own internal ratings systems for GPs, where they've defined what maturity looks like. For now, this is focused on actions rather than outcomes – checking in on whether we have processes in place, but it is growing more sophisticated. There's always a flavour of the month in ESG, and this year it's biodiversity – so many are pushing and asking about frameworks we have in that space."

Meeting these expectations is increasingly challenging, and while Kwong agrees data collection is an ongoing theme in private markets, the biggest obstacle at the moment relates to data quality which many GPs are focusing on, and something that CSRD will help align. "In many cases, companies are doing disclosures for the first time, so providing a level of quality assurance towards that data is a significant challenge. We want to provide LPs with as much data from our portfolio companies as possible.

"This challenge is only going to intensify as more knowledge and resource gaps emerge. The CSRD, for instance, is a disclosure regime that will transform the data reporting mechanisms within companies – as it asks for metrics from a wide range of areas within the business. How can a company upskill and build its knowledge here? It's a big task, which may have a commercial outlay involved."

According to him, LPs are starting to realise and understand the scale of this challenge, which again speaks to the implementation reality check ongoing in the ESG space.

KEY TAKEAWAY

Value is the biggest driver of ESG strategies, and a growth plan needs to be integrated across the investment lifecycle

PRIVATE EQUITY WIRE

CONTRIBUTORS:

Aftab Bose
Head of Private Markets Content
aftab.bose@globalfundmedia.com

Johnathan Glenn
Head of Design
johnathan.glenn@globalfundmedia.com

FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:

Enrique Schindelheim
Business Development Manager
enrique.schindelheim@globalfundmedia.com

Published by: Global Fund Media, Fox Court, 14 Gray's Inn Rd, London, WC1X 8HN

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