

PRIVATE EQUITY WIRE

INSIGHT REPORT

Creating Values:

BEHIND THE ESG REVOLUTION IN PRIVATE EQUITY

FEBRUARY 2022

SUPPORTED BY:

AssetMetrix

KEY FINDINGS



Billion-dollar-sized impact funds represent a new reality
Fundraising targets at KKR, Apollo and Apax reveal the potential to capture growing institutional LP allocations to impact funds, without comprising return targets. More specialised impact platforms based on climate, healthcare and technology are following but how GPs measure their 'impact' is being watched closely



Private equity industry is aligning on ESG measurement
Ahead of new regulations in US, the private equity industry is taking its own steps towards measuring ESG performance, with less reliance on third-party standards. With ESG heads and teams in position, GPs are also looking beyond disclosure and into bespoke investment strategies



Energy and agriculture show future of sustainable investment
Investment in electrified transportation is growing 10x faster than in renewable energy. The next leg of the energy transition will also be characterised by GPs targeting clean hydrogen and energy storage. In the food and agriculture space, sustainable investment is being super-charged by technology



Venture capital must embrace diversity
For each of the past 10 years, at least 80 per cent of the total venture capital raised in the US was invested in male-only start-ups. With diversity now a key part of the regulatory debate there, specialist VC funds and others are looking for ways to increase board representation in their investments to better align with customers and improve performance

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IMPACT FUNDS 'WILL BE THE NEW NORM'

The billion-dollar impact fund is now a reality for mainstream private equity houses. Can they stay true to the roots of impact investing and meet the expectations of LPs?

There has been an explosion in impact strategies following the launch of one of the first and largest mainstream funds, TPG Rise, in 2016.

A record 132 impact funds were launched last year, according to Preqin, with USD20 billion amassed since 2015, according to Bloomberg data.

In a survey of more than 60 private equity professionals by *Private Equity Wire* during February, around two thirds of respondents said they either have, or planned to have, an impact fund in the next 12 months.

Their fundraising targets are getting larger and strategies more specialised, say placement agents and advisers, on the back of a surge in more specific LP impact allocations and European regulations encouraging sustainable investment.

In January Nordic-based Summa Equity closed its third impact fund, and Europe's largest yet, at EUR2.3 billion. It marked Summa's entry into the 'billion-dollar impact club' – a group which includes or will soon include KKR, Bain, Apollo and Apax.

Others including JP Morgan Asset Management and Allianz Global Investors are launching or building out teams within the space too.

"It's just the tip of the iceberg, albeit a very large tip," says Stephanie Kater, co-head of impact investing at Bridgespan, which advises funds on their impact strategies. "[Impact] is becoming mainstream and even firms that weren't necessarily planning to think about an impact product or a responsible investing product are being pushed to do it by their investors."

Spinning out

Once the preserve of philanthropists and government-backed development agencies, impact investing will soon become the norm across private markets, said Nils Rode, chief investment officer at Schroders Capital during an online presentation by the investment manager in February.

A Barclays Private Bank survey of over 300 respondents, on average managing USD833 million in assets, expects the share of impact investing within portfolios to reach 54 per cent by 2027, from 41 per cent this year.

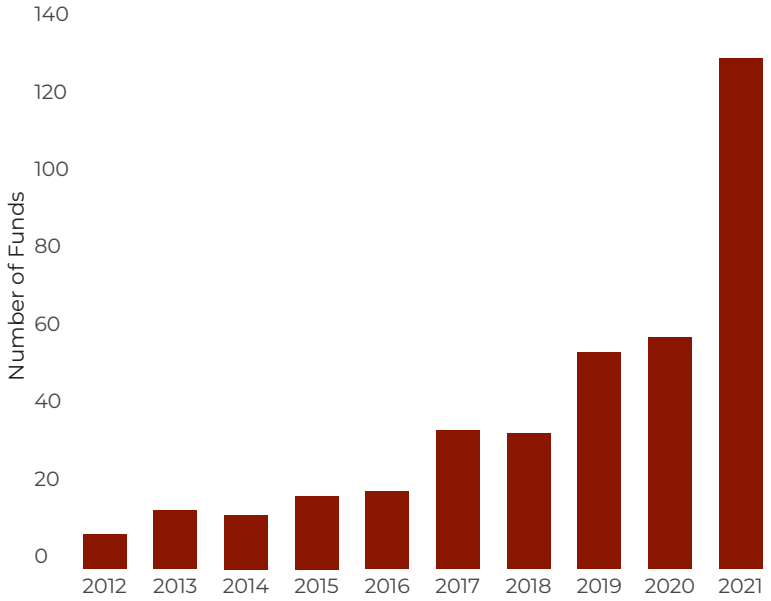
Europe is currently home to a 15 per cent higher concentration of impact and sustainable investment funds in relation to traditional private equity funds, while North America has an equal percentage of both overall (see map overleaf), according to data from Bloomberg's Private Equity Database, showing the potential for growth in the US specifically.

Although specialist managers have been active in the space for decades, much of the current growth is coming from spin-out fund products that complement existing buyout strategies says Zac Williams, managing director at fund advisory Monument Group.

These impact extensions can offer mainstream private equity funds a 'halo effect', which can help initiate or develop relationships with investors while also addressing any criticism of private equity's deepening role in society.

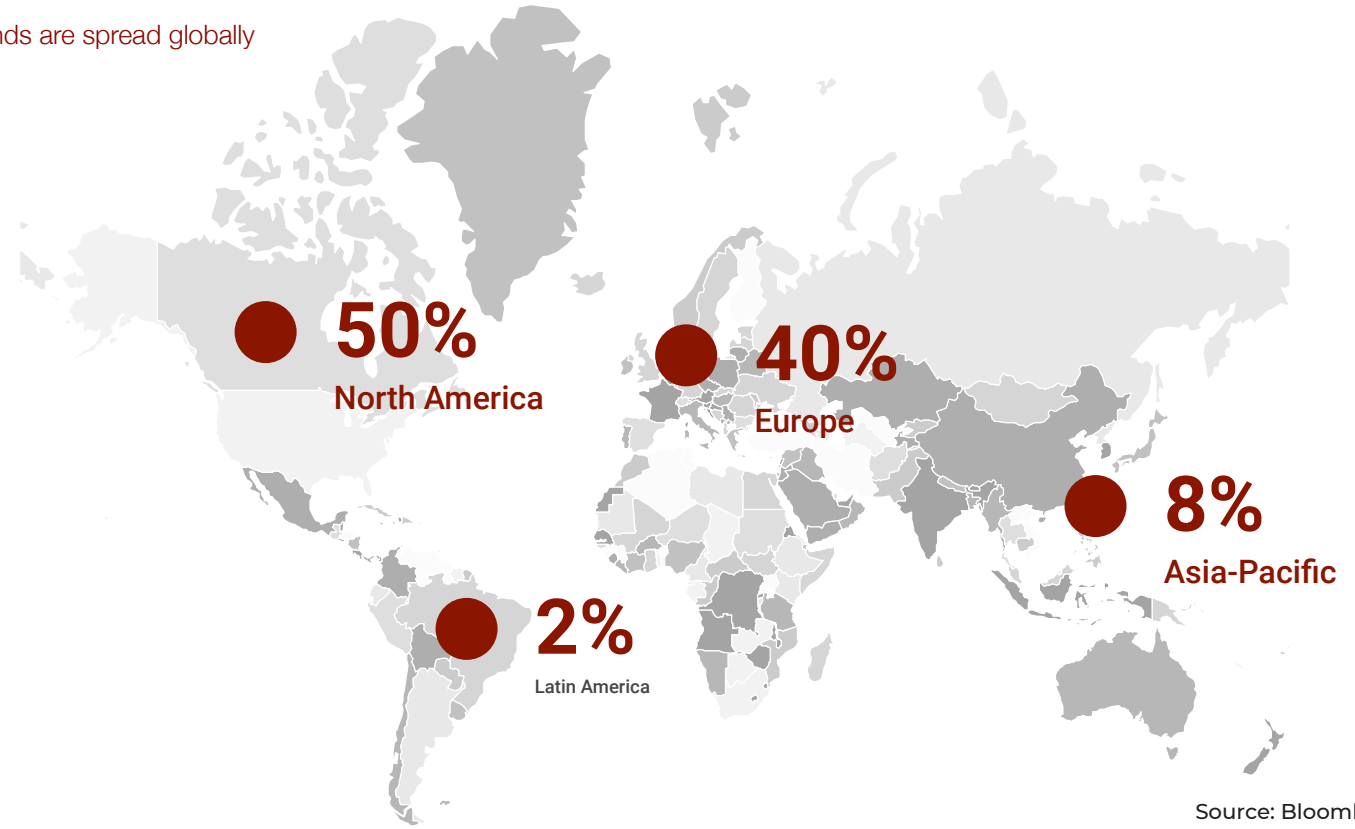
"We're seeing mainstream general

Impact funds launched by private equity firms boom



Source: Bloomberg, Preqin

How impact and sustainable funds are spread globally



Source: Bloomberg Private Equity Database

partners leading discussions with stories around their impact," says Paul Yett, director of ESG and sustainability at asset manager Hamilton Lane. "So, [the conversation might be] 'in addition to this being an investment that generated great returns, here's some of the benefits you should be aware of around environment or social or what have you'. Investors want to hear this."

But as larger players enter the space, how they measure their 'impact' is also receiving more attention from these investors.

Impact funds typically use the World Bank-owned IFC's operating principals for impact and the UN's Sustainable Development Goals but questions from LPs may still include 'what impact metrics will you report on and how will you quantify that?' or 'how will you compare this to the counterfactual of what would have happened anyway?', says Kater at Bridgespan.

"Funds have to become more sophisticated in the way that they think and measure and track impact, because LPs are seeing through the lip service on a regular basis," she says.

Impact investment may form part of the wider debate around ESG, but it differs in that GPs typically choose the outcome they want to achieve before they invest, rather than trying to influence the investments they have already made.

TPG and Bridgespan spent two years developing a methodology to measure these outcomes in a more rigorous way. The result – known as the 'impact multiple of money' – suggests a minimum social return on investment of USD2.50 for every USD1 invested and can be used to monetise outcomes, ranging from lower greenhouse gas emissions to higher educational attainment to better health.

Social outcomes

The first impact funds tended to focus on social outcomes in impoverished communities – often much harder to measure – rather than environmental goals, but this has changed as new actors have entered the space and the energy transition has become a mainstream focus.

"The impact category is becoming harder to define but we have to be a little careful not to become fixated with labels," says James Magor, director, sustainability at investor Actis, "because, yes, climate change is an environmental problem but it's an environmental problem with profound social consequences too. By addressing a climate issue, arguably, you will be addressing some social problems as well."

Indeed, climate-based impact investment strategies are currently among the most sought-after among European LPs, with US and Canada-based investors catching up quickly, say fundraising sources.

Last year, two of the world's largest private

> Even firms that weren't necessarily planning to think about an impact product are being pushed to do it by their investors

equity funds – TPG and Brookfield – announced first closes of USD5.4 billion and USD7 billion respectively on climate-focused impact funds. Brookfield's Global Transition Fund has a hard cap of USD12.5 billion.

A third manager, General Atlantic, has a USD4 billion target for its upcoming climate fund.

Given their size, climate-based impact funds are focusing less on building wind farms or solar plants and more on decarbonising entire industries.

Established France-based private equity fund Eurazeo last year launched a 'sustainable maritime fund' with a target size of EUR350 million to invest in advanced ship technology, innovative harbour equipment, and offshore renewable energy.

According to the firm's head of ESG, Sophie Flak, the fund will use carbon accounting, and performance fees for the general partners will be based on non-financial, as well as financial targets.

She believes impact funds will become much more thematic in the years to come.

"If you are a private equity fund looking at impact and ESG you're going to go very strongly on health, you're going to go very strongly on life science. There is an appetite from LPs for thematic products."

Fundraising sources spoken to for this article say LPs are pushing their GPs for specific impact strategies in healthcare, the water sector and food and agriculture. Renewable energy, which generally falls within an infrastructure fund strategy, is now often perceived as a more crowded space with less opportunity to achieve 'impact' goals or double-digit return outcomes in developed markets.

There may also be a geographic bias among some of the new and larger impact funds which breaks with the philanthropic roots of the older specialists.

Frontier economics

Asia's favourable demographics may provide more of an opportunity for impact funds seeking traditional returns than the more impoverished parts of Africa, for example.

"There was a period of time where there was quite a lot of excitement [among impact funds] about frontier geographies – that has really dropped off," says a placement agent. "And partly, it's because of really excellent performance in the US and Europe and in many cases, very poor performance in particular in Africa, and India. The truth is that it's been really hard to make money off things like a chain of coffee shops in Namibia. Whereas climate, people believe that it has real performance potential."

Apollo's first impact fund is targeting 25 per cent IRR, linking 2 per cent of profits to impact goals and 18 per cent to financial performance, according to reports. TPG Rise achieved a net IRR of more than 20 per cent for its first impact fund as of end September last year, according to recent filings. TPG's healthcare impact fund, Evercare, which took over the hospitals and clinics previously managed by a fund of scandal-hit Abraaj in 2019 posted a lower net IRR of 3 per cent.

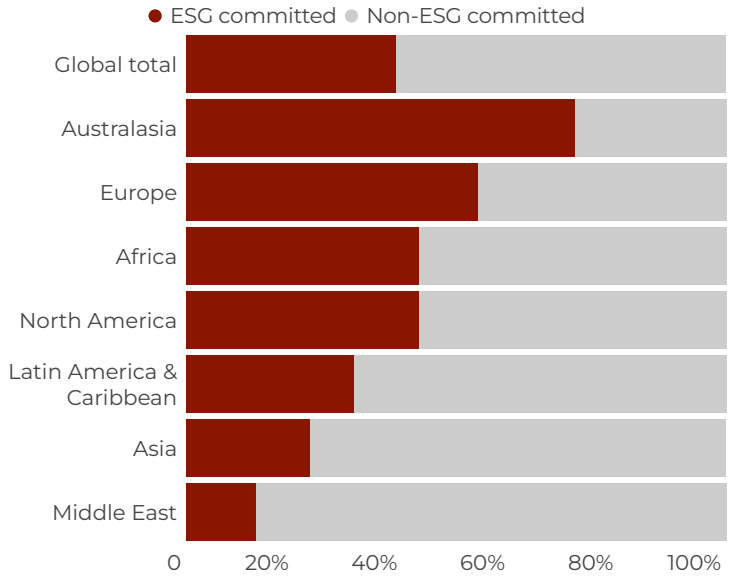
Other large funds are targeting returns for their impact platforms at a similarly high level to their existing buyout funds, say sources. But not everyone agrees that financial returns can be maintained as the size and number of impact funds grows.

According to a source at one of the largest private equity funds globally, when it looked at the opportunity to launch an impact fund above USD1 billion in size several years ago, it found that it could maximise either the size of the impact fund, or financial returns, while still having meaningful impact, but not both.

Some GPs maintain that integrating ESG across all their investments is a sounder long-term strategy.

It may be early days still, says Marc Lino, senior partner at Bain Consulting, which is encouraging clients to "experiment, test and learn" in the impact space but the paths to success will be found in four places: gaining market share early; lowering capex and opex through greater efficiency; securing a lower cost of capital through green loans; and winning the war for talent as a more impact-aligned firm.

Europe ahead on ESG-committed AUM



Source: Preqin

HOW TPG RAISED THE BAR FOR IMPACT FUNDS

TPG Rise is largest impact fund platform in the world. How much growth does it still see in the space and what challenges still remain on impact measurement and financial performance?



STEPHEN ELLIS AND MAYA CHORENGEL, CO-MANAGING PARTNERS OF THE RISE FUNDS AT TPG



TPG Rise is the largest impact fund platform in the world, with around USD13 billion AUM. Its latest fund in the climate space is due to close shortly with a hard cap of USD7 billion.

Specialist impact funds have traditionally been small-scale, below USD 1bn. What influenced TPG Rise's decision to enter the billion-dollar arena and how much further can you grow here?

Steve: One of the pillars of our theory of change was that we needed to get large institutional capital interested in the sector. But you also want to be diversified which is important for investors and important to solving the myriad of issues the world faces. Our first fund was over USD2 billion and that gave us the ability to invest across five different sectors and around the world. Also, in order to do the kind of rigorous impact underwriting that we do, it takes time, it takes resources, and it's much more difficult to do that if you're a small-scale fund.

Impact entrepreneurs also care a lot about the reach of your fund, and the depth and scale of the capabilities that you bring to bear to help grow their businesses. There is no issue with the with size of the market or getting too crowded. Frankly, we can increase the size of funds tenfold and still be massively short of the capital required.

How have you seen the approach from LPs to your strategy develop since you first launched Rise I?

Maya: Part of the Rise effort was to bring LPs along the impact journey. The persistent issue for LPs, I would say, is that there still isn't a widely accepted set of external standards in the industry on ESG or on impact, so some LPs continue to have difficulty making sense of impact assessments from one fund to another. Sometimes questions from LPs are very surface level, because they don't always have the tools to get to the depth of impact or depth of practice. There's a lot of learning that's required still, but we believe that the more impact assessment work we do, and with more impact funds coming into the space, impact measurement and data will continue to improve over time.

Steve: The market has made a lot of progress but even today, with many relatively large and sophisticated LPs, we are still having conversations that seem very similar to the ones we had five years ago.

Does your 'impact multiple of money' methodology help to guide these conversations?

Steve: When we built the IMM process, we were very focused on creating a decision tool which is different than a disclosure mechanism. The IMM has helped eliminate concerns around our authenticity.

Maya: It has been critically important. We work with a select group of our LPs to share the advancement and refinement of our approach and what we're learning about research and its application.

The IMM is also critical for the entrepreneurs, because the entrepreneurs that we engage with often do not have a very articulate way of explaining why their products and services are creating the good that they are designed to deliver.

Using research, data, and evi-

dence, we can help them understand the drivers of impact, hold them accountable for their impact results, and help to manage their impact outcomes. We believe that's a very, very powerful combination.

Following your specific climate and healthcare impact funds, what other themes do you expect to see in impact?

Maya: Within social impact, as well as within climate impact, it is important to have deep domain knowledge. Within climate investment there is so much that is new in terms of the science, the technology and the approach. There's also a spectrum of return potential in climate impact funds [across] the fixed asset return category, the infrastructure return category, the venture category and the growth equity category. Some social problems need to be addressed by philanthropy or government aid and are just not appropriate for growth equity return – you can see this across different demographic segments of financial vulnerability in the US for example.

Steve: In certain sectors and in certain demographics, it gets very, very hard [to generate market rate returns] and we need to do the hard work of determining where commercial capital is appropriate and demonstrate an ability to deliver competitive returns alongside strong business performance and quantifiable impact, otherwise we can't attract the institutional capital necessary to focus on the social and environmental issues important to the world.

How do you weigh up political risk when you invest in developing countries and emerging markets?

Steve: Impact-oriented businesses, particularly in developing markets, tend to be better aligned with what's important to local governments, regulators and officials so we tend to be going with the grain of what's important to those who control the geopolitical situations in those markets. It doesn't eliminate the risk by any stretch. You have to develop a deep understanding of the geopolitical context and explicitly build it into your commercial and financial underwriting. Currency is another related risk we assess very carefully. These risks are why we only invest in places where we have teams on the ground.

Maya: Our internal wiring for assessing political risk, regulatory risk, or macroeconomic risk is as significant at Rise as it is across every other TPG fund. But when you are impact-driven, you're embedded in the issues and challenges people are trying to manage in their everyday life, so it is important for us and our companies to be clear about our mission and remain very, very cognisant of reputation risks as well.



PRIVATE EQUITY LOOKS PAST THE WAR OF STANDARDS

A lack of regulatory alignment on ESG disclosure has created a noisy backdrop of third-party standards and metrics so private equity funds are attempting to lead the way instead

For much of the past 10 years, private equity firms have been swimming in an alphabet soup of ESG standards.

Recent estimates put the figure at around 200 standards globally, for reporting and assessing sustainability risks across fund portfolios. Many have little coordination between regulators, investors or across different jurisdictions.

A lack of standardisation can make it difficult to outwardly assess the impact of ESG progress on financial results and has left many GPs overwhelmed with data requests from LPs.

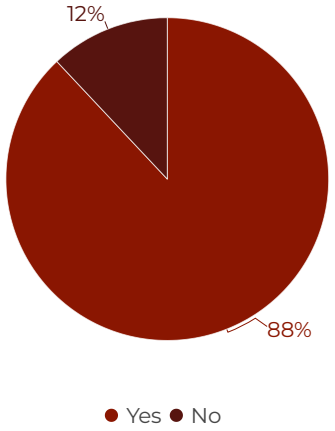
"We need to end this war of standards. We need to agree on a common methodology," says Sophie Flak, head of ESG at French private equity firm Eurazeo. "What I'm telling my LPs, and what I discuss a lot with my fellow competitors is, could we please stop being creative about the methodologies we use? Could we please agree on what's important?"

Agreement may be near, say ESG experts. Cross-industry collaboration between GPs and LPs, the development of bespoke in-house metrics and technology, and wider regulation are all accelerating the focus on a tighter set of agreed standards.

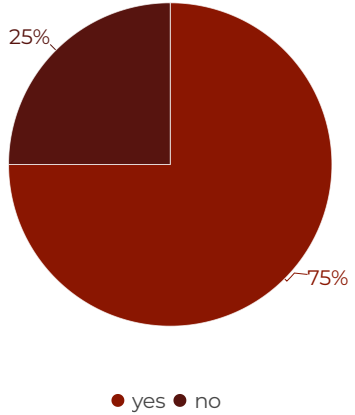
At COP26 in Glasgow towards the end of last year, the IFRS Foundation announced the formation of the International Sustainability Standards Board (ISSB) to develop a global baseline of sustainability disclosures for financial markets.

In January, the ESG Data Convergence Project announced a milestone commitment of over 100 GPs and LPs to a process which

Does your fund or firm screen companies for ESG risks before acquisition/investment?



Has your firm in the past, or would it currently, abandon such an investment due to information uncovered in that screening process?



Source: Private Equity Wire survey, February 2022

THE VALUE QUESTION

In the Private Equity Wire Impact & ESG survey, almost half of more than 60 responses said financial returns or value creation was the most important factor in their ESG monitoring and behaviour, rather than investor pressure or regulation. One respondent commented: "I think the biggest challenge facing organisations is linking ESG initiatives and strategies to financial returns. It's one thing to measure these metrics, it's another thing to accurately predict the financial gain or elimination of loss tied to these actions and metrics." Evidence of a link between improved ESG outcomes and profitability is still patchy, but it is mounting quickly. Analysis often shows often there is no downside to a greater ESG integration within a firm, but there is often an upside. These upsides can include a reduced cost of capital, higher and more resilient earnings potential, and greater talent retention. PE firms are reducing their cost of capital through ESG-linked credit facilities, which can now be as large as EUR5 billion. According to consultancy Bain last year, a PE firm it examined identified a potential 3- to 5-point EBITDA uplift tied to a series of sustainability initiatives, such as the revamping of a product line in a sustainable way. And research quoted by EY last year showed that employees at companies which rank well on ESG measure are 1.4 times more engaged, 1.7 times more satisfied, and three times more likely to stay, all potentially leading to better performance and returns.

> "Commercial benchmarks and providers are no longer the leaders on this, and it is becoming more of an industry-led and owned initiative"

will standardise ESG metrics and "streamline the industry's historically fragmented approach to collecting and reporting ESG data", according to a statement from the group.

Data will be collected in April for the first year across six categories: greenhouse gas emissions; renewable energy; board diversity; work-related injuries; net new hires; and employee engagement.

GPs in the project's steering committee have provided historical data from 2018-2020 from around 100 portfolio companies to establish a pilot data set.

"I would be surprised if what regulators come up with is remarkably different," says Lorenna Buck, senior adviser at Boston Consulting Group, which is currently aggregating the data.

Early signs are positive: in 2018, only 1 per cent of the portfolio companies in the project's pilot data set reported on their Scope 1 and Scope 2 emissions. In 2020, that number increased to 61 per cent.

Aligning such key performance indicators has been the greatest challenge among the many different benchmarks and providers to date, says Julien Krantz, research director at private equity association Invest Europe, which is separately working with the private equity industry on 10 ESG metrics of its own.

Sharing data

Krantz sees a clear shift away from commercial providers and more willingness among GPs to share their ESG performance data.

"It's a learning curve [for them]. Commercial benchmarks and providers are no longer the leaders on this, and it is becoming more of an industry-led and owned initiative," he says. "This shows that GPs are taking responsibility and it's less of a box-ticking exercise."

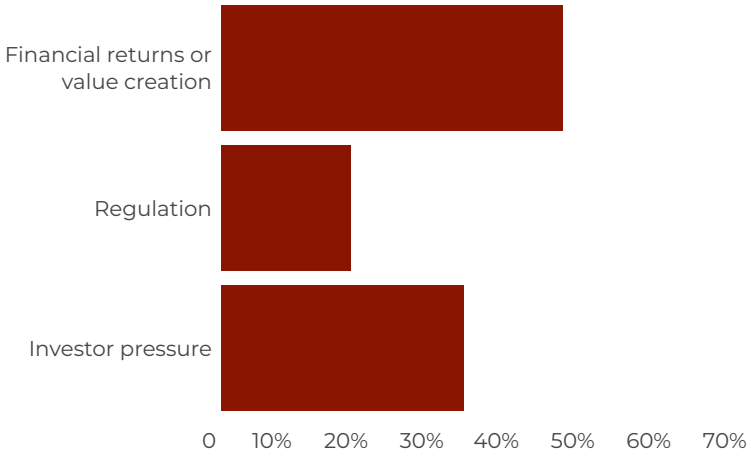
In May last year, EY found that only 34 per cent of firms it surveyed with more than USD15 billion in assets had a head of ESG, which fell to 12 per cent for firms with between USD2.5 billion and USD15 billion and to 2 per cent for firms with under USD2.5 billion in assets.

But as each month goes by, heads of ESG and chief sustainability officers are increasingly visible at large and medium-sized buyout groups, and pay is being tied to financial performance.

In a sign of how the industry is bringing ESG expertise in-house, Blackstone in November appointed the founder and former CEO of the Sustainability Accounting Standards Board (SASB) Jean Rogers as its new head of ESG, following 12 separate ESG hires across different asset classes during the year.

"The engagement that we already have with our assets in private equity means we can get the information that we need without necessarily spending years coming up with the standard," she says in an exclusive interview with *Private Equity Wire*. "Private equity just moves a lot faster. There are some universal issues – decarbonisation and

What is most influencing the development of your ESG reporting and monitoring?



Source: Private Equity Wire survey, February 2022

diversity – that's what the Convergence Project is focused on, but beyond that it really comes down to what strategy you are driving and the data, is it specific? We can't always wait five years for a framework."

Other large PE houses have acquired environmental consultancies outright.

The development of in-house ESG capabilities and greater measurement makes GPs better able to engage with their LPs, move the needle on value creation in their existing portfolio and also screen new investments for ESG risks.

"LPs know that they want good ESG but what they really want is to be able to trust the manager to do a good job managing ESG issues – that we know how to identify and manage the correct issues," says Colin Etnire, head of ESG at BC Partners. "What LPs are really investing in when they're investing in the GP is the ESG team's approach, so we provide data to justify it and validate their faith in us."

Winners and losers

"Enacting fiscal policy is not just to inform investors, but to actively drive capital into certain sectors to create winners and losers," says Rogers. "That is the opportunity companies should look to seize. If we all are too focused on disclosure and metrics, we are really going to miss what's happening in the market."

Those involved in ESG reporting for private equity firms believe there will ultimately be a wave of consolidation among commercial, third-party data platforms as industry alignment accelerates, leaving some space for the provision of industry-specific and portfolio company data, which can be more complex, particularly for smaller managers.

In a similar way to the measurement of financial performance and return benchmarks, experts expect around five or six ESG standards to emerge as reference points for private equity GPs and LPs globally, with some ability to customise metrics for regional differences, for example around diversity requirements or health and safety legislation.

"We align our approach with respect to what is happening in the regulatory space, but we see it as very important to stay flexible as regulation is only one part of what is driving the market," says Moritz Haarmann, head of product development at asset service provider AssetMetrix. "GPs have different strategies and different metrics, and approaches will make more or less sense. One thing they all have in common though are their investors who will require more ESG transparency and regulatory compliance in the coming years."

US TO PROPOSE NEW ESG RULES

US buyout groups with European investors should already be feeling some pressure from SFDR and greater disclosure requirements, but there is an expectation that the SEC will mandate its own disclosures this year, primarily focused on environmental metrics such as GHG emissions, financial impacts of climate change, and progress towards climate-related goals. In October 2021, the US Department of Labor proposed rules that would explicitly permit retirement plan fiduciaries to consider ESG matters in their investment decision-making and voting decisions as shareholders. The SEC's semi-annual regulatory agendas, published in June 2021 and December 2021, provide some clues on next steps, with mentions of climate change, cybersecurity risk and corporate board diversity. In an article published on the topic in February, lawyers at Skadden, Arps, Slate, Meagher & Flom wrote that SEC's chair Gary Gensler has publicly indicated that proposed disclosure requirements could include metrics on workforce turnover, training, compensation and benefits, workforce demographics, and health and safety. Regarding climate change, they wrote, press reports reflect that SEC is determining whether to require companies to report on scope 3 emissions, with rule proposals in the first half of 2022.

Moritz says there is appetite from some GPs for a more standardised reporting platform and for a data exchange capability with their LPs.

Forthcoming regulation moves, particularly in the US, will determine how truly global industry-led benchmarks can become. Regulatory momentum around ESG disclosure is currently with Europe, following the introduction of the SFDR last year, but expectations are growing that other jurisdictions will follow suit.

"Although GPs might at this point still be a bit divergent in terms of how they're approaching the topics, with regulation as well as pressure from investors, it is in GPs and LPs interest that ESG disclosure and reporting becomes more aligned," says Hanne Dybesland, product development, AssetMetrix. "The regulatory requirements are still in development and so are industry initiatives, meaning that it will still take some time before a clear and useful alignment comes into place."

New world order

Indeed, the ESG Data Convergence Project may eventually incorporate some parts of this and the SFDR in Europe, says Buck at BCG.

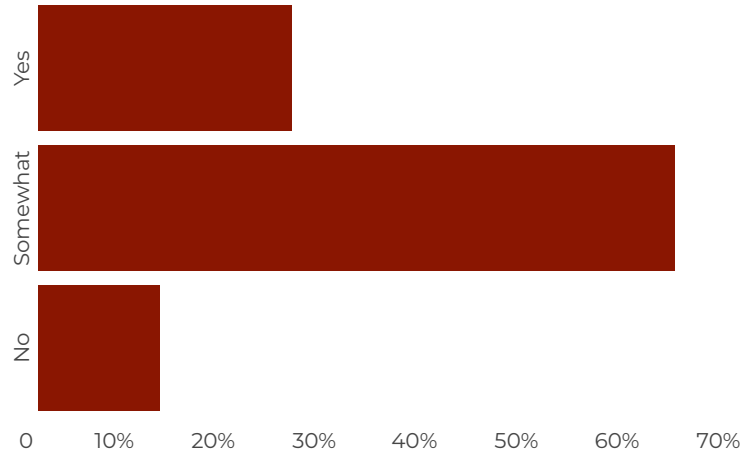
"We know that not every part of SFDR is necessarily relevant to a global audience, but the goal right now is to do something that's going to be relevant to a global audience," she says.

"The prevailing thinking is that regulatory requirements will also come to North America," says Yett at Hamilton Lane, "it'll come to Australia, it will be prevalent in other parts of the globe, in very short order. So a lot of people are focusing on getting their house in order so to speak, and I think SFDR helps drive that."

What will come from the US is still an open question, but more clarity is expected by the end of 2022 (see box). Whether it moves in line with the EU's SFDR and the global industry's own collaborative efforts to measure ESG will be watched closely by all concerned.

"I think the US will continue to be more hesitant to mandate particular types of outcomes," says Etnire at BC Partners. "And I think this probably just reflects the American regulatory culture more generally. So as an industry we want to kind of define the standards on terms that we're comfortable with. And then hopefully, the regulator's jump on that or are comfortable with that rather than the other way around."

Is your firm/fund well-prepared to meet advancing ESG regulation?



Source: Private Equity Wire survey, February 2022

FOUR PATHS OF ESG POLICY: WHAT THE LAWYERS SAY

Whilst there is a plethora of regulations which can fit under the ESG umbrella, there are a few recent developments which specifically apply to GPs in private equity, as well as their investors and portfolio companies.

ESG requirements for private equity fall into three general categories: product-level regulations; entity-level regulations; and requirements applied to third parties, such as investors and portfolio companies.

There are four key elements worthy of note.

The EU Sustainable Finance Disclosure Requirements (SFDR) comprise product-level and entity-level investor disclosure requirements applicable to financial institutions. ESG investment products may be classified as Article 8 (investments that promote ESG characteristics) and Article 9 (products that target ESG outcomes). The UK is developing parallel Sustainability Disclosure Requirements (SDR), including a 5-tier product classification system.

Secondly, there is Ecolabel: a planned 'gold standard' investment product label that indicates a high degree of portfolio alignment with environmental outcomes. National and non-regulatory labels, such as Belgium's Febelfin, also exist. The UK will create its own green investment product label.

Thirdly, there is taxonomy regulation. At an entity-level, large companies, including financial institutions, are required to disclose their activities and degree of alignment with an environmental classification system. At a product-level, the disclosures must include the proportion of an investment portfolio aligned with the Taxonomy. The UK is developing its own Taxonomy based on the EU version.

Lastly, there is the Corporate Sustainability Reporting Directive (CSRD): a forthcoming requirement that the European Commission estimates will require around 80 per cent of EU financial and non-financial companies to report at an entity-level against a range of ESG metrics. The UK's SDR will also encompass broader company ESG reporting.

It is also worth noting that the taxonomy, EU CSRD, and UK SDRs also apply to in-scope portfolio companies or might become a consideration for GPs as part of their exit strategy. Certain LPs, such as pension schemes, will be subject to all or some of the above regulations.

The G7 countries will also adopt the Taskforce on Financial Disclosures (TCFDs) across much of their economies. A global company ESG reporting standard, under the new Sustainability Standards Board (SSB), is due in Summer 2022 too, while US policymakers are also considering an integrated ESG disclosure framework.

By Alex Edmondson, head of private equity, Macfarlanes and Gavin Haran, head of policy for asset management, Macfarlanes

BLACKSTONE'S BIRD'S-EYE VIEW

The new ESG head at Blackstone will work to oversee strategy and reporting for over 250 portfolio companies. She explains why second order data is the secret sauce



JEAN ROGERS, GLOBAL HEAD OF ESG, BLACKSTONE

The sustainability veteran and founder of non-profit Sustainability Accounting Standards Board (SASB) joined Blackstone in January to take on one of the most important roles in the private markets.

Heads of ESG have been appointed at most of the large private equity houses and some smaller ones too. How much more hiring and team building do you see among GPs?

Jean: Yes, I do see it continuing. We have a hub and spoke model with a centralised team and people with specific expertise embedded into the business units such as private equity [and that works well]. The challenge is to have that central bird's-eye view, supporting initiatives within these business units, gathering intelligence and bringing it back to understand what we are seeing, hearing, and what are emerging issues.

Can you describe some of the first conversations you had with Blackstone's investors when you took on the role last year, and what you have taken on board?

Jean: The number one thing is decarbonisation – meeting net zero targets and what those transition pathways look like. We have been focused on energy efficiency and driving down emissions by 15 per cent in aggregate over the next three years for investments where we control the energy usage. We are increasingly looking at renewable energy procurement.

We also hear about greenwashing: for example, having 2050 [net zero] targets without a plan to get there. We view the antidote to this as having a very specific plan for achieving those targets and making sure that companies are accountable and measuring progress, for example through our portfolio-wide carbon footprint numbers.

As the levels of sustainable investment have increased globally, has it become difficult to deploy capital in the space?

Jean: Even with all the money that has been flowing into the public markets, we're not seeing the type of impact that we would expect and we are seeing a realisation that perhaps products [in those markets] are not doing as much as they could. We are seeing a lot of opportunity in concentrated, active decarbonisation strategies. There is not a lot of competition in this space because it often involves going into industries and assets that typically have been viewed as un-investable.

How is ESG data helping you to do this?

Jean: Data has always been a challenge in the private markets because the assets are so diverse. Where I think the ESG frameworks and data have failed us is in that

> “There’s a revolution happening now in ESG data driven by AI. It is creating structured data from unstructured data”

they are often focused on what I consider ‘first order’ metrics, for example carbon footprint or diversity metrics. What we need to assess is ‘second order’ data such as ‘what resources are you putting against this, what does your capex look like?’ That takes deep analysis and engagement with companies. Second order data is critical and you will see that this is the secret sauce.

But for smaller managers, maybe there is a challenge there, in terms of sourcing industry or asset specific data year in and year out. How do they navigate that?

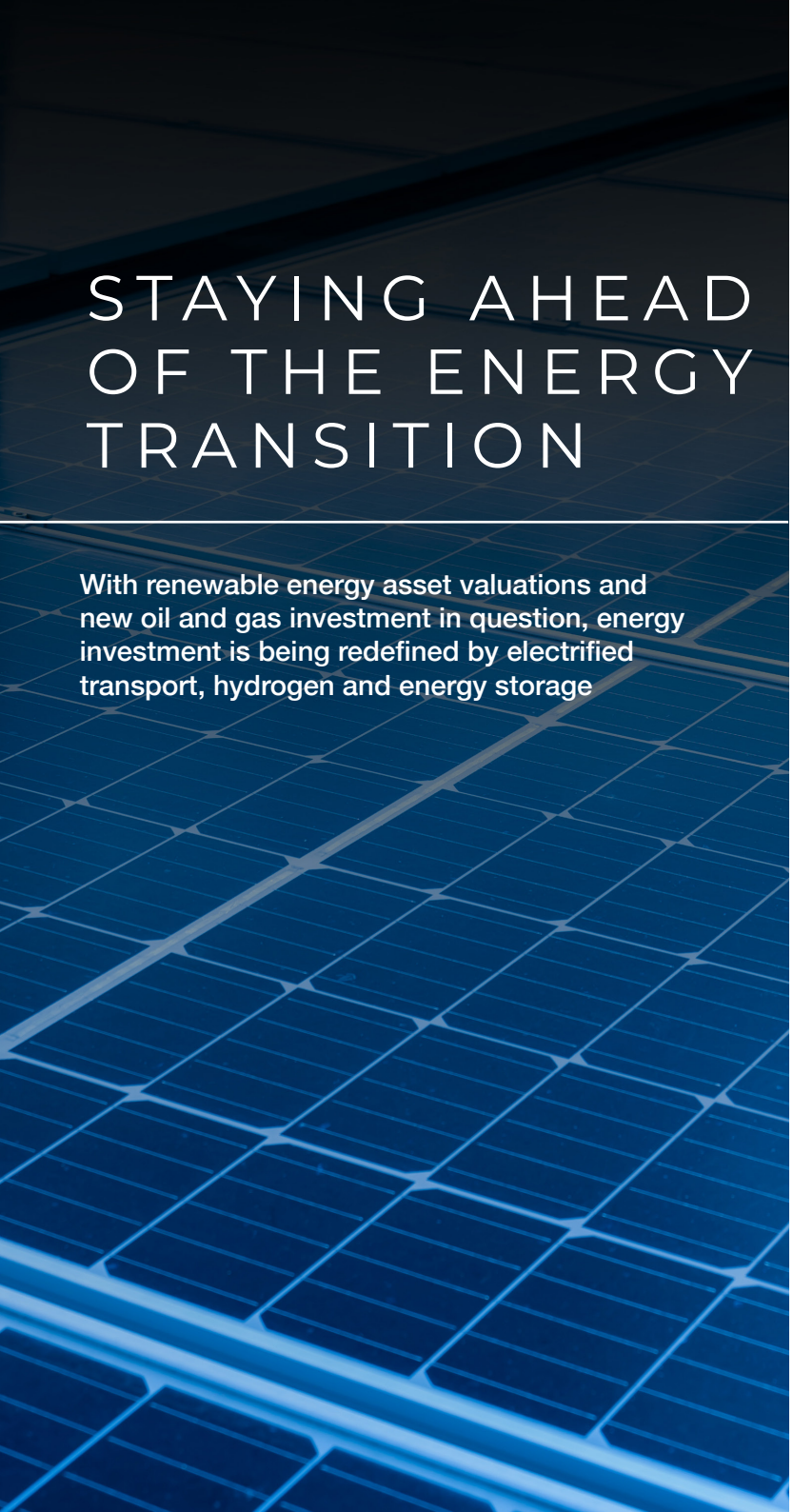
We hear this from our smaller managers, but there’s a revolution happening now in the ESG data field being driven by AI. AI is interesting and wonderful because it creates structured data from unstructured data. You don’t have to wait five years or eight years for a standard to emerge, you just have to know what you’re looking for.

Investors all have their own thesis too, so I believe this field is going to completely move into being AI-led and driven, and smaller managers with will be able to participate. That changes a lot of things because actually now you’re writing your disclosures for bots, and not for people.

What do you expect to see from US regulators in the year ahead?

They have historically taken a lighter hand on fiscal policy [than the EU] – what I think is still evolving in the US is the understanding of whether we are trying to mitigate a systemic risk [as the EU is doing] or are still focused on idiosyncratic risks, which works well company by company. The fact that they’re beginning to write comment letters on climate change is positive.





STAYING AHEAD OF THE ENERGY TRANSITION

With renewable energy asset valuations and new oil and gas investment in question, energy investment is being redefined by electrified transport, hydrogen and energy storage

Though many institutional investors in private equity have taken a hard line on new oil and gas investment in recent years, the idea of a longer, more rational energy transition that does not marginalise populations in the developing world is becoming more widely accepted.

But although hundreds of billions of dollars still need to be invested in oil and gas production to meet global demand, it is the number of investment opportunities related to low carbon power generation that looks set to grow at a faster rate in the next decade.

In Europe, energy M&A deal volumes are at their highest level for 15 years, according to a report by law firm CMS in February.

"With the regulatory clock running down, businesses are looking to offload carbon-intensive assets when opportunities for optimisation have been exhausted," according to the firm's head of energy and climate change, Munir Hassan. Power and transmission – including renewable energy – generated the most M&A in Europe last year, with a total of 442 transactions in 2021, putting the sector far ahead of oil and gas (73 deals) and utilities (69 deals), according to the report.

Positioning for these opportunities, the number of energy-transition-oriented funds has grown by over 12x in the last 15 years, according to Hamilton Lane, with the bulk of that coming in the last three years. The energy transition attracted USD755 billion investment last year, a 25 per cent increase over 2020 and a more than 20-fold increase since 2004, according to figures published by BNEF.

Valuation anxiety

Renewable energy in particular is now an established sub-asset class of its own, and cuts across energy M&A, private equity, infrastructure/real assets and impact investment strategies, making it fiercely competitive and driving anxiety recently over asset valuations.

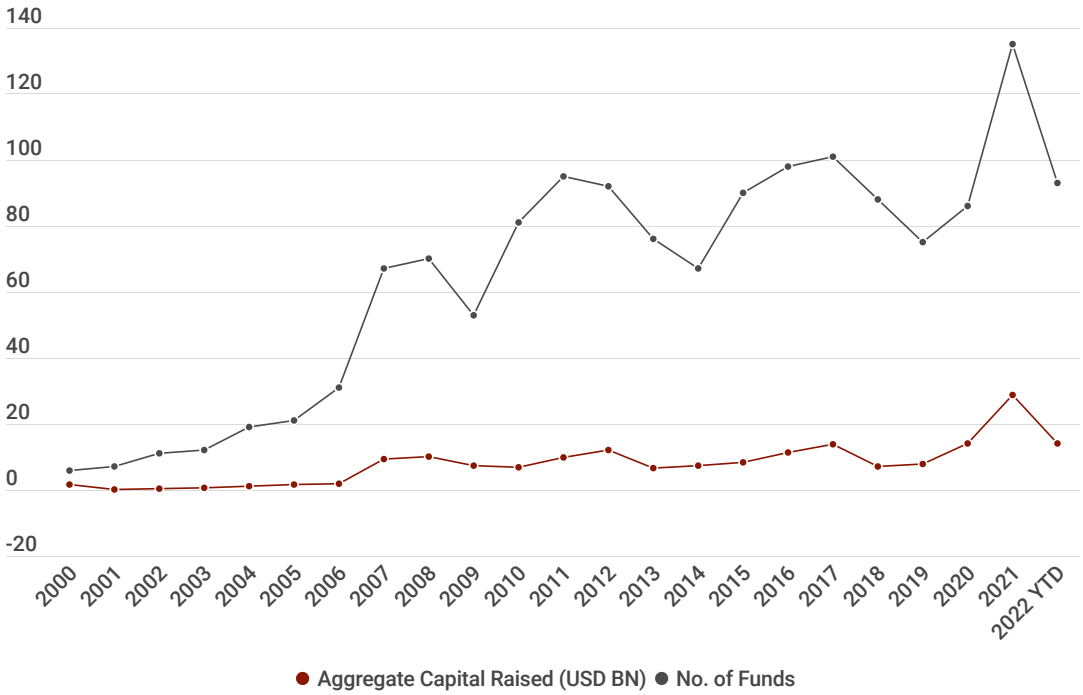
"Renewable energy is very competitive," says James Magor at Actis. "It doesn't matter the strategy everyone wants to invest in renewable power. But it's an enormous pie so there's enough for everyone to have a slice."

Private equity firms are accessing the growth in renewable energy through early-stage development risk, buy and build strategies and green lending, as with Blackstone's new sustainable credit platform for renewable energy companies.

But while renewable energy represents around half of all investment in energy transition and climate technology, investment in electrified transport, which exceeded USD270 billion last year, is growing 10 times faster, according to BNEF. Of course, only a small propotion of this was made by private equity funds. VC and PE climate tech investment hit almost USD54 billion last year and was fairly consistent throughout the year even as public market activity shrunk to near-zero in April and again in October 2021.

Private equity and VC investment in the space will grow year-on-year. Fund managers such as UK-based Zouk Capital, which manages around EUR1 billion, and France-based Meridiam have identified and raised private equity or infrastructure fuds specifically targeting electric vehicle

VC cleantech fundraising doubled in 2021



Source: Preqin

charging infrastructure and sustainable urban mobility.

Energy storage, hydrogen and carbon capture and storage (CCS) are other areas where private equity investors are building strategies and deploying capital.

Lapis Energy, a Texas-based carbon capture and storage company, said in January that private equity player Cresta Fund Management will fund the company's origination, development, and implementation of CCS and clean hydrogen projects. It is worth noting that Lapis Energy was formed in 2021 under the leadership of former Kosmos Energy chief executive Brian Maxted and Glen Cayley, former vice president of Shell UK.

UK-based company Storegga, which is building one of the largest CCS facilities in Europe, counts GIC, Singapore's sovereign wealth fund and Mitsui & Co and Macquarie as investors and received over GBP30 million in government funding for the project last year.

The International Energy Agency reported in October 2021 that governments have committed at least USD37 billion to the development and deployment of hydrogen. In the same way that subsidies and policy support provided revenue certainty for wind and solar power investors, the same is expected for green hydrogen and electric vehicle charging infrastructure too.

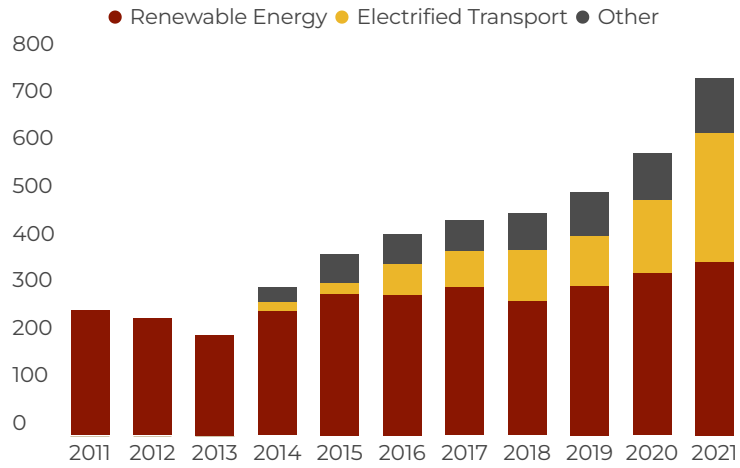
Green and greenest

French private equity player Ardian and H2-focused asset manager FiveT Hydrogen launched a joint venture last year called Hy24 that is targeting EUR1.5 billion for its first hydrogen fund, making it the largest to date. Insurer Axa has pledged to join French and Asian industrial groups as an anchor investor. Other hydrogen funds are expected to follow, targeting specific markets globally where policy and projects are being developed. In February, the Biden Administration in the US announced a series of initiatives worth USD9.5 billion to support the development, production and transportation of clean hydrogen around the country.

Energy transition technologies will need investments of around USD131 trillion by 2050., according to the International Renewable Energy Agency (IRENA). Around 80 per cent of this is expected to come from the private sector, with debt financing growing to a 60 per cent share within that, says IRENA.

Some of this investment will be in renewable energy, but investments in gas infrastructure

Energy transition investment shifts gear



Source: Bloomberg New Energy Finance

> We're seeing the emergence of different kinds of transition strategies and it's something that we're thinking deeply about

in developing countries, in Asia for example, and in the deeper decarbonisation of more complex sectors and companies will also feature.

"We're seeing the emergence of different kinds of transition strategies and it's something that we're thinking deeply about," says Magor at Actis. "The easiest thing in the world is just to say, well, we're going to stick to the greenest of the green. But actually, that's not what society in the world needs to transition. The hard fact is that the energy transition from coal to gas in Asia is probably as fundamental as the rest of the world transitioning."

The ability of buyout funds to take controlling stakes in carbon-heavy companies and use active management to drive outcomes gives private equity a unique role in the energy transition – for example in buying up firms that might be under managed from an ESG perspective.

"I think that there's a lot of additionality there because not every manager is going to bother doing that," says Colin Etinere at BC Partners. "I think that that's perhaps the difference between the broader ESG sector and what private markets can do for ESG. Our asset class has this advantage."

GREEN LOANS GROW UP

Sustainability-linked loans, which incur a premium or reduction on interest payments based on ESG performance, are an increasingly common way for private equity funds to reduce their cost of capital. They are increasing in size, structure and setting. In 2020, EQT launched the largest of its kind, up to EUR 5bn, and the first ESG-linked bridge facility. A year later Carlyle secured the largest ESG-linked private equity credit facility in the US for USD4.1 billion – also the industry's first facility to focus exclusively on advancing board diversity. In January, Helios Investment Partners secured Africa's first ESG-linked capital call facility. In February, Actis signed an USD1.2 billion 'impact-linked' revolver for its latest energy fund. It is the first to combine project eligibility criteria with a margin adjustment mechanism that incentivises verified impact outcomes. Infrastructure fund InfraRed Capital Partners has also applied the concept to other risk and treasury management solutions. Last year, when the renewables investment trust TRIG (managed by InfraRed) entered into long-term inflation swaps linked to both RPI and CPI it also signed several foreign exchange hedging counterparties up to ESG agreements to capture foreign exchange derivatives under an ESG framework with tangible metrics. The growth in sustainable credit lines is only starting. Speaking on Blackstone's recently launched credit platform which will lend to renewable energy companies and those involved in the energy transition, Jean Rogers, head of ESG at Blackstone says: "I believe credit is one of the most efficient forms of capital. Companies are always managing their weighted average cost of capital, but now what we're seeing is they're managing their weighted average cost of carbon."

WHY AGTECH BOOM IS RIPE FOR IMPACT

Venture capital is pouring into sustainable farming and biotech, as supply chains and food sovereignty enter political debate. The potential for impact-linked outcomes here is growing too

Much like the surge of venture capital (VC) in renewable energy and cleantech in the mid-2000s, food and agriculture investment is going through a transformation, powered by changing consumer habits, climate change and new technology.

Traditionally, VC investment into food and agriculture flows downstream – to retail products, restaurant delivery, and e-grocery. But last year, upstream took the majority of investment with 52 per cent going to start-ups in agtech, food science and vertical farming.

A record USD5 billion was invested in agtech in 440 funding deals to VC-backed start-ups last year, according to Crunchbase data – a leap from USD3.3 billion in 2020.

For impact funds, the agriculture sector offers measureable outcomes at the cross-section between rural poverty, climate change and social justice.

"Agtech is definitely becoming more 'impact'-based as it lends itself well to the E, S and G," says Zac Williams at Monument Group. "It is a massive industry with a large environmental footprint so there are lots of levers to pull and this resonates quite nicely with ESG goals."

Critical capital

Covid-19 has highlighted the role for impact funds in natural capital (which includes forestry and biodiversity) but also in supply chains and cold storage to bring food closer to consumers and reduce food miles.

Speaking on a *Private Equity Wire* panel in January on the opportunities for private equity and climate impact-based investment, the head of climate impact at Unigestion, Joana Castro, said that agtech is a broad sector which will be "critical" to sustain population growth in the coming decades.

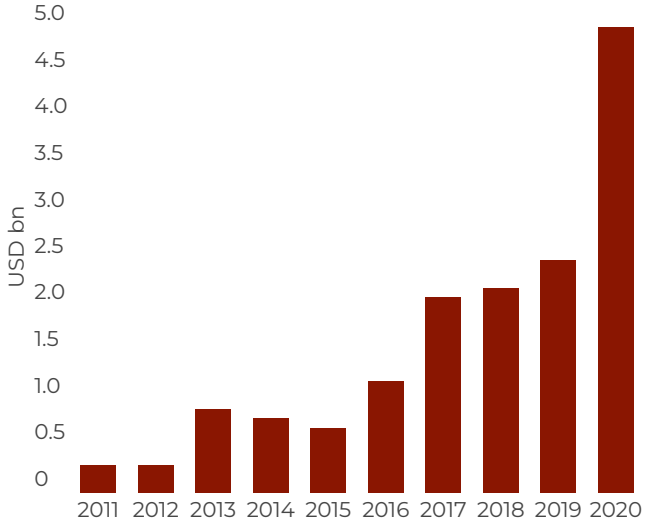
By 2050, feeding a planet of more than nine billion people will require an estimated 50 per cent increase in agricultural production, according to the World Bank. As well as a growing preference for plant-based and organic foods in the West, rising wealth in parts of the developing world means people there are consuming more protein and fresh fruit and vegetables.

How these demand trends intersect with climate change will become a major investment thesis of private equity funds in the coming years, says Sophie Flak, head of ESG at Eurazeo.

"We know that food resilience and agriculture's adaptation to climate change is going to become a huge topic," she says. "Humanity will face damage first from a biodiversity crisis, which comes as a direct consequence of climate crisis. The pressure to secure our food supplies has started and food sovereignty is becoming a huge geopolitical topic."

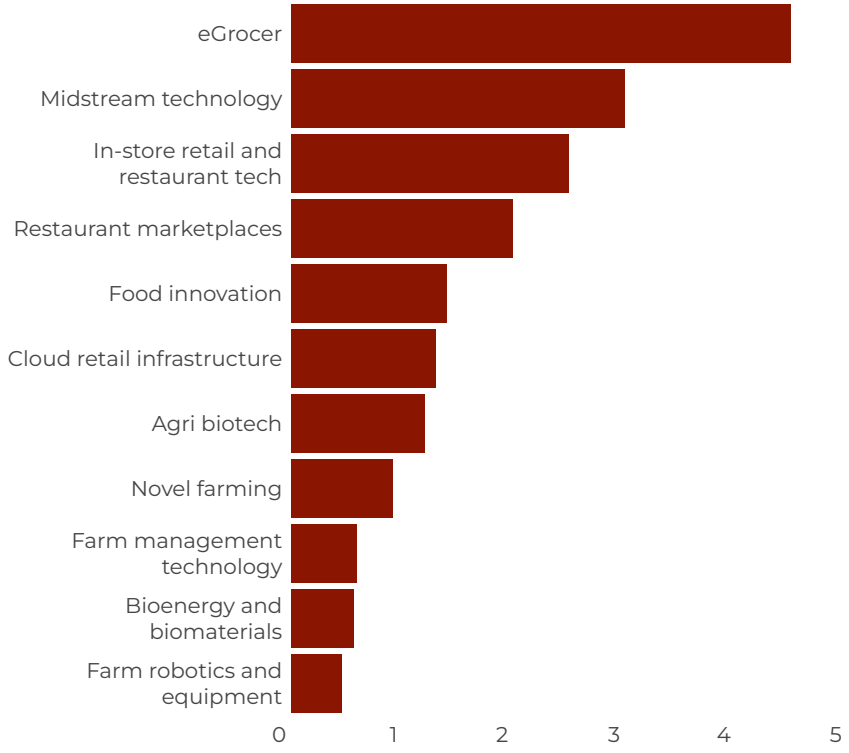
Given its traditionally heavy dependence on pesticides, fertilisers and genetically modified crops, agriculture has not always been easily associated with ESG. But sustainable

Global VC investment in agtech, by year



Source: Pitchbook

Agriculture and food investment in H1 2021



Source: AgFunder, data not including China

agriculture is increasingly being understood as more than just small, organic farming, say sources in the sector.

"The ESG angle around food and agriculture has started to draw people's attention," says Darren Rabenou, head of food and agriculture and ESG investment strategies at UBS Asset Management, which is the second largest institutional owner of farmland in the US.

"Investors want to understand how to make scalable investments in organic-oriented strategies that have a clear ESG angle. While organic farming has a number of ESG attributes, it is also important to understand the challenges."

Technology risk

On the point, greenhouse agriculture may use significantly less water than traditional farming but it typically relies on enormous power needs to heat and cool facilities. As a result, investors are asking follow-up questions on how sustainable energy can be incorporated into regenerative agriculture like greenhouses, says Rabenou.

"Investing in agtech can have a significant impact on helping traditional farming be more sustainable, but venture and growth equity firms that back agtech need to figure out how to access traditional farmers in order to validate new technologies that address sustainability."

Many agtech opportunities may remain firmly in the high-risk VC space until this question can be answered and the transformational levels of investment required make more financial sense to traditional buy-out funds.

"There is always a complexity in our line of business around when is value going to crystallise," says Flak. "We know [sustainable agriculture] is a mega trend, but when is going to be the right window? We're working on that. If you arrive too soon, it's not good."

Flak cites the example of household cleaning products eight years ago, when the wall of investment needed to transform the industry did not yet match consumer demand patterns. "It really depends, industry by industry, where is the switch point," she adds.

The food and agriculture sector may align well with impact and ESG-based strategies in some places but there are also number of negative externalities and a higher risk of 'impact-washing'.

"Oftentimes there is something you need to 'net out' when you invest in the sector," says Kater at Bridgespan. "So maybe you are you are taking unused food and finding ways to innovate and avoid landfill or there's transportation of all of that from point A to point B, or it could be excessive water use for farming."

She cites the example in the downstream food sector of impact fund-backed healthy snack products, which often end up being sold to the type of consumer who already buys healthy food.

One unintended social consequence of increased organic farming in less developed countries can be higher food costs for consumers, says Rabenou.

Sector-specific ESG metrics might therefore include water use, energy use and carbon emissions or considering food security issues in countries that are disproportionately reliant on food imports. Questions of 'impact' and ESG outcomes have never been more relevant.

VC FUNDS HAVE A DIVERSITY PROBLEM

The past decade has supported the venture capital market generally, but there has been a disproportionate impact on female-founded companies seeking funding



Venture capital fundraising in the US reached an all-time high of USD330 billion in 2021. But through one lens, things look very much the same as they did 10 years ago. The capital is still not finding its way into female-led start-ups.

Though they received an additional USD3 billion in venture capital in 2021, compared to 2020, this was still only 2 per cent of the total raised that year, according to PitchBook. In the US, women-led start-ups have not received more than 3 per cent of the total venture capital raised at any point in the past 10 years.

The data is important because research shows that start-ups in the US with at least one female founder will employ 2.5 times more women than start-ups with all-male founders, according to industry association Kauffman Fellows, compounding diversity through the wider economy and supporting financial performance.

Companies in the top quartile for gender diversity (30 per cent minimum women) on executive teams are 25 per cent more likely to have above-average profitability, and ethnically diverse organisations are 36 per cent more likely to outperform their peers, according to McKinsey's most recent diversity study, in 2020.

A study from employment service provider, Monster in 2020 showed that, for 83 per cent of Gen Z candidates, inclusivity is a significant factor when choosing an employer.

"When I speak to GPs who are doing ESG well, have a diversified board, company, they tend to also be the ones making good returns and having higher valued funds," says Rhonda Ryan, head of EU private equity, Mercer.

Simon Hopkins, co-founder and COO of UK-based investor Angel Acadame, says: "It seems really obvious, but if you want your product to appeal to a diverse group of consumers, it's probably helpful to have a diverse management base."

Seeking a partner

The under-representation of female-led start-ups is of course a reflection of the VC industry itself.

More than one third of Europe's top VC firms are yet to hire a female partner, despite the pressure on the industry to improve on diversity and the commitments it has made, according to data platform Sifted.

In 2021, only 15 per cent of US GPs in venture (VC firms with more than USD50 million) were women, according to PitchBook.

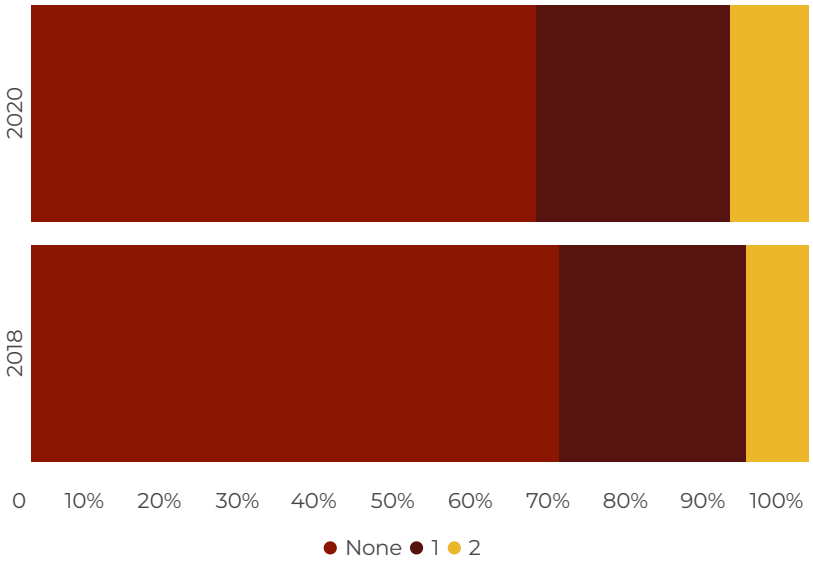
"I think the alts space has a long, long way to go in terms of diversity – they're very much trying to catch up," says Ryan. "Even only three years ago, I don't think GPs had much awareness of the lack of diversity."

According to data from Morgan Stanley, traditional male-led VC funds are currently doing the least work towards improving diversity issues, with only 41 per cent appointing more women, more racially diverse (African American, Hispanic, Latino, Asian and all other non-white) LPs, GPs, partners or board members, compared to 63 per cent of racially diverse VCs and 64 per cent of female VCs doing so.

"The bigger funds who aren't diverse risk 'groupthink'," says Ryan, "if you've been to the same university, you look the same, you often think the same and you're likely to miss things that you would otherwise pick up on with a more diverse team. You can't know what your consumer wants if you don't

> Companies who do not pay attention to the importance of diversity and who don't diversify their teams will no longer exist in 10 years' time

Number of female investment partners in US VC funds



Source: VC Human Capital Survey, powered by NVCA, Venture Forward, and Deloitte

relate to them in any way."

In Europe, one barrier blocking more female partner representation is the fact that Europe's top VC funds tend to hire from a pool of existing investors, narrowing the talent pool. "There seem to not be enough potential female candidates for senior roles that tick all the boxes – ie, having started at McKinsey or Goldman, then done a Harvard MBA, then two years at a startup before joining VC," said Julia Dous, founder and CEO of Grow Diverse (talent advisory firm) in an article recently published by Sifted.

Next generation

Perhaps in response to this, there is now a growing number of female-led or more diverse VC funds with mandates for changes. According to the Inclusive PE & VC Index Score 2021, published last year by the Equality Group, the three highest scoring VC firms were Sweden's Kinnevik, UK-based Bethnal Green Ventures and UK-based Atomico Partners. According to their websites, all three still have male CEOs.

Revaia is a women-founded growth equity firm, based in France, that invests in a diverse range of tech start-ups with an ESG angle, and looks to grow these companies' ESG practices further. It places emphasis on the fact that it leads by example, rather than highlighting the fact that it's Europe's largest women-led VC and growth equity investor, as it believes that this is the way to instigate real change throughout the industry.

Bettina Denis, Revaia's COO and head of sustainability, predicts that companies who do not pay attention to the importance of diversity and who don't diversify their teams will no longer exist in 10 years' time.

"Five years ago, it was just the beginning, but it's become very clear in recent years that clients are increasingly prioritising sustainability and diversity when investing in a firm. There's currently a real acceleration on this point, and the next generation values this even more," she says.

"There's a sense of urgency for GPs to actually change," says Ryan, "and it's up to us – LPs, GPs, investment consultants – to mentor and support women and ethnic minorities and change the current landscape. It's going to take time, and it's going to take big money to stop committing to those who aren't changing."

The opportunity to back women and minority-owned firms "has never been greater", claims investment advisory Fairview Capital's latest Market Review. The investment

DIVERSITY IN THE BOARDROOM

Diversity disclosure requirements in the UK are due to launch early this year, according to proposals in a report released by the Financial Conduct Authority (FCA) last year.

One of the proposed goals is that 40 per cent of a company board should be women. However, with recent research from Deloitte showing the UK lagging behind its European counterparts with regards to gender diversity, there remains a long way to go.

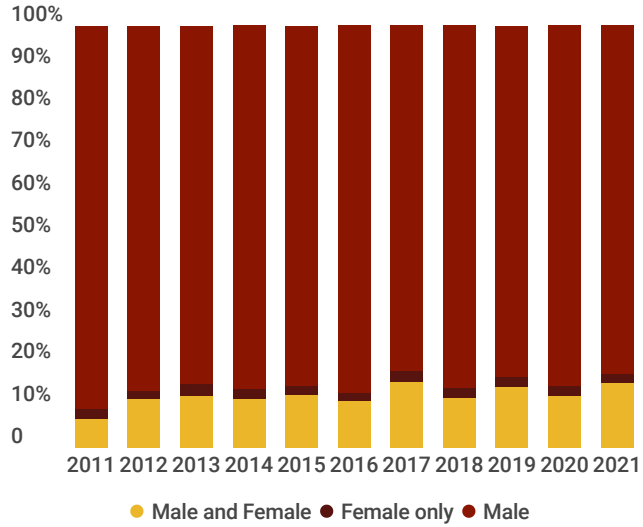
Deloitte's 2021 'Women in the boardroom' report, shows that only 30.1 per cent of board seats are held by women in the UK, falling over 10 per cent short of France who has 43.2 per cent of seats held by women.

The US falls even further behind, with as few as 23.9 per cent of company seats being held by women, an explanation for diversity being at the forefront of several US firms' agendas.

Globally, only 5 per cent of CEOs are women, a tiny 1.1 per cent increase from 2016.

The underlying problem which follows on from this is that companies with women CEOs have significantly more balanced boards (14.1 per cent more women) than those run by men.

Female-led companies receive less US venture capital



Source: PitchBook

advisory found that the number of woman- and minority-owned venture capital and private equity firms grew by 25 per cent between 2020 and 2021, and that 280 woman- and minority-owned firms raised capital during the year, up from 234 firms in 2020.

"There are a lot of great early-stage companies out there with women founders, and I suspect that ten years ago that wasn't the case," Hopkins notes.

Can female-led start-ups capture more than 3 per cent of the venture capital raised this year, or next?

According to Morgan Stanley data, two thirds (68 per cent) of VCs surveyed in 2020 said they were more likely to invest in racially diverse founded companies in the coming year. The same figure could not be found for female-led companies.

Ultimately C-suite leaders must address barriers to diversity in their companies too.

People spoken to for this article cite examples of companies and managers they have worked with who previously used the description 'diverse' because the managers came from a different region or industry, or an example of other companies simply not being aware of their reputation as a non-diverse and predominantly male-led company.

While this article mainly focuses on diversity from the perspective of gender, this is not to say that the inclusion issues concerning non-white and LGBTQIA+ peoples are not just as important or prevalent in the industry.

"What I genuinely hope is that, in ten years' time, we're not even talking about this," says Hopkins, "it would be great if our organisation was redundant. I think that there will still be all-male founded companies, but I think it will be quite unusual. This needs to be a non-conversation."

LPS WEIGH NEXT PRIORITY IN RACE FOR NET ZERO

LPs are becoming increasingly ambitious on their ESG priorities, with all of those not currently invested in ESG funds looking to invest within the next 24 months according to recent figures

European ESG assets will rise to as high as EUR1.2 trillion by 2025, according to PwC, with private equity responsible for almost a third of this and appetite from investors still growing.

When asked about their principal motivations for investing in ESG-linked assets, LPs cited risk management (41 per cent), corporate values (41 per cent) and risk adjusted returns (35 per cent) as their main reasons for doing so.

European mandate-led institutions, particularly Nordic and Dutch pension funds, have generally led on zero carbon goals and ESG policy, but the goal pool of ESG-minded LPs is expanding rapidly.

According to a recent survey by the Official Monetary and Financial Institutions Forum, pension funds are leading on ESG and deploying the greatest variety of strategies at scale.

"It's fair to say European investors, both LPs and GPs, have been ahead of US and Asian investors in terms of integrating ESG," says Joshua Featherby, managing director at investment firm Cambridge Associates. "European GPs have been better at discussing ESG than their US counterparts."

This may be changing, however. UK law firm Dechert says that 49 per cent of GPs expect a 'significant increase' in EMEA LPs' 'ESG scrutiny' and reporting, but 60 per cent of GPs expect the same from North American LPs.

Foundation for change

Jay Ripley, co-head of investments, Global Endowment Management (GEM) cites US foundations, including Ford Foundation, Heron Foundation, MacArthur Foundation, and Kellog Foundation, as all leading in the ESG space.

"I've spoken to other endowments and foundations in the space, and even the ones who I thought would be the furthest away from discussing or integrating ESG are approaching GEM for advice on how to bring in new policies to accommodate it," he says.

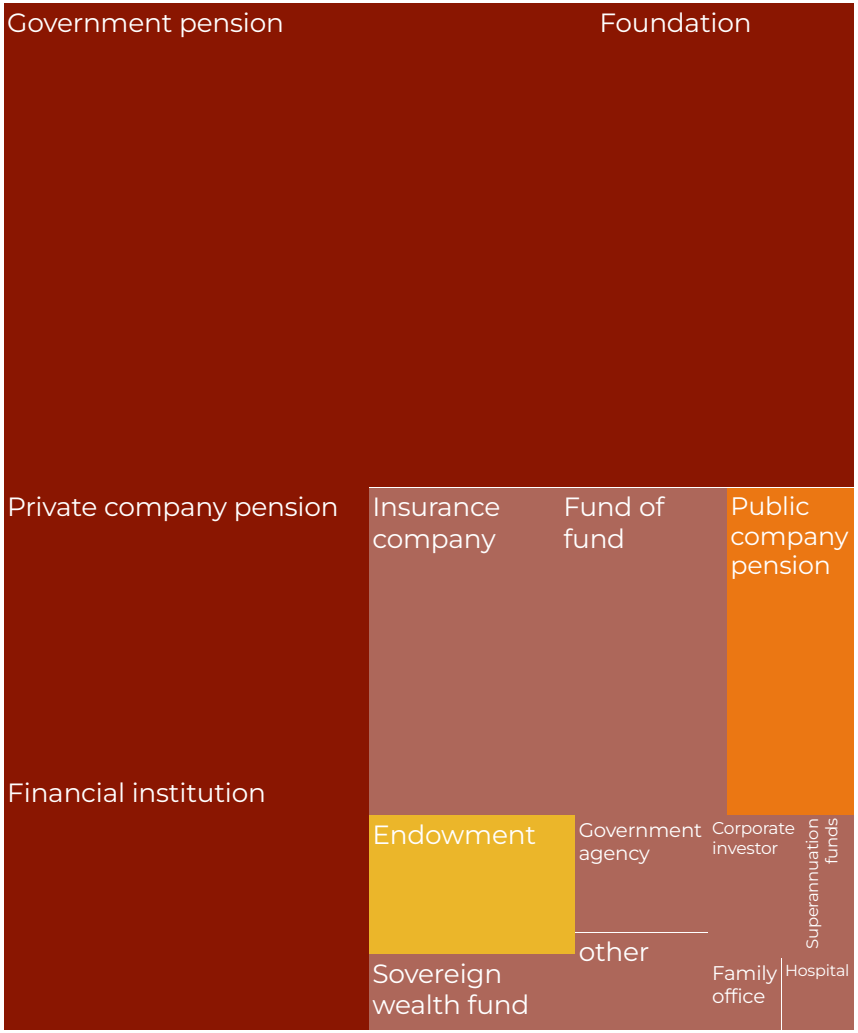
While European LPs can be more focused on climate, North American LPs often have their own ESG agenda to implement.

"In the US however, endowments and foundations tend to focus on racial and social justice," says Ripley. "At GEM, for example, our private investment team went to the Race Equity Institute course to identify and reduce our inherent biases when making decisions on who we work with."

US-based TPG Rise Climate, one of the largest impact funds in the market currently with a hard cap target of USD7 billion, includes some of the world's largest institutional investors: AXA, Ontario Teachers' Pension

> "It's fair to say European investors have been ahead of US and Asian investors in terms of integrating ESG"

Government pensions comprise a third of all ESG LPs



Source: Bloomberg Private Equity Database

Plan Board, Silk Road Fund, State of Michigan Retirement System and Washington State Investment Board. But it also holds an investor base of the world's leading multinational companies too – Apple, Nike, FedEx, Dow, Boeing and General Motors.

This was made possible, in part, by the appointment of former US Treasury Secretary Hank Paulson as executive chairman of the fund. In an interview with Fortune magazine last year, Paulson said: "Every one of these began with a call from me and [TPG co-founder] Jim Coulter to the CEO."

Net carbon zero targets are now a priority among institutional investors globally.

Ground zero

Not surprisingly given its mission, the UK's National Trust endowment has a publicly stated 2030 net-zero commitment. Cambridge University Endowment Fund was also described as "very progressive, almost to the point of concessionary" by Stan Miranda, founder and chairman of advisory firm Partners Capital, due to the endowment's 2030 net-zero commitment.

A 2022 survey from ILPA-Bain reveals that 31 per cent of LPs have set net-zero commitments, and more than half of those LPs are based in Europe have already done so.

Net-zero in 2050 is a more common commitment for LPs, as 2030 is often too soon. Featherby says that "it's hard to overstate how ambitious the net-zero 2030 goal is".

What sets the National Trust apart from most others, however, is the fact that they've set themselves the challenge of not using carbon offsets to achieve this. Instead, they're using their ability to be long-term investors to finance carbon capture opportunities, including more proven strategies, such as regenerative forestry, as well as more novel technologies, accessed through their venture capital portfolio. The focus is on being truly additive, not just refinancing existing or more preventative measures, Featherby says.

There is also a noticeable move among some of the more progressive LPs to drive their GPs to begin investing in ESG or increase these investments, and in some cases, refusing to work with GPs who don't meet their standards.

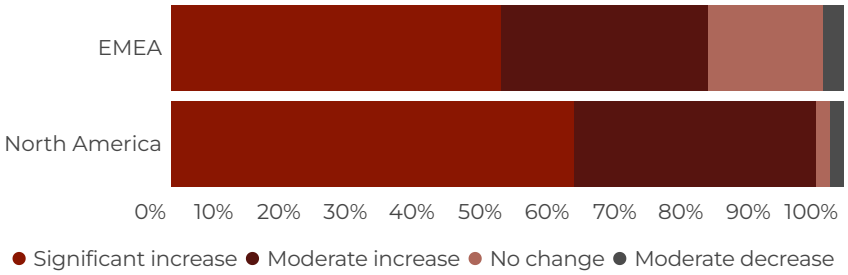
GPs are responding to this: 94 per cent of GPs have an established ESG approach, up by 16 per cent in 2020 according to PineBridge Investments.

However, this "approach" bears many interpretations and has not always been consistent, with only 46 per cent of GPs tracking diversity for their portfolio companies' board of directors, for example.

63 per cent of LPs plan on increasing their allocation to ESG funds in the next 24 months, with 55.9 per cent of LPs planning on increasing their allocation between 10 and 20 per cent: a significant increase.

"Today, the pressure on LPs and GPs to think about ESG is coming

How do you expect LP scrutiny of ESG/ ESG reporting to change in deals over the next three years



Source: Dechert LLP

from all angles," says Featherby. "Before, it used to only come from a relatively small pool of loud critics or student bodies. But today, even corporate pension funds are being pressured by their employees, by their parent company, by their peer and wider stakeholders – it's a cacophony of noise which can no longer be ignored."

Morgan Stanley's annual 'Sustainable Signals' report shows that 57 per cent of asset owners also foresee a time when they will only allocate to managers with a formal ESG approach.

ESG has been in the background of portfolios for the past ten years, but has often been an optional investment choice rather than a requirement. Now, however, it's at the forefront of countless LPs' investment intentions and commitments and has become a necessity rather than a choice.

The initial push for PE firms to sign up to UNPRI (United Nations Principles for Responsible Investment) came from LPs asking whether their managers were signatories, and now LPs are asking for more.

As a point of progress for GPs, Manuela Fumarola, ESG manager, private markets, Aberdeen Standard Investments recommends that "GPs start considering technology tools for SFDR and also begin considering climate modelling." ('How Limited Partners Are Mitigating the ESG Data Gap', SS&C Intralinks, 2021).

"It's great to see that lots of GPs are starting on their ESG journey, but to receive the highest ESG rating from Mercer, you need to have established ESG processes which have been in place for a while and are measurable in terms of progress," notes Rhonda Ryan, Mercer's head of European private equity.

Though ESG has been a topic of conversation for many years, many feel that it is only now that there is a real momentum and sense of change, as increasing regulation looms.

"For pension funds, in particular, regulation in the UK has also helped to force them to address ESG," says Featherby. "Five years ago, there were many LPs and GPs who were delaying or even avoiding the conversation altogether, but now it's one of the first discussion points on the agenda. It has to be."

New legislation and guidance, including the introduction of the first LP and GP partnership to standardise ESG reporting led by Carlyle and CalPERS and the first net zero guide for PE for GPs and LPs launched by IIGCC and based on the Paris Aligned Investment Initiative, is contributing to this shift.

"It has got to the point where fund managers that don't start incorporating ESG into their investment processes are facing 'existential risk'," says Featherby. "Not only will they likely struggle to raise capital from LPs, but their performance is also likely to suffer in the meantime."

> "Five years ago, there were many LPs and GPs who were delaying or even avoiding the conversation"



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Published by: Global Fund Media, 8 St James's Square, London SW1Y 4JU, UK

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