

ESG IN PRIVATE EQUITY: A TIME TO SHINE?

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Legal Briefings - By **Joseph Dennis and Rebecca Perlman**

Environmental, social and governance (ESG) issues dominated public discourse and boardroom agendas in the months leading up to the COVID-19 outbreak. The pandemic has laid bare the clear nexus between business and society. This is reflected in calls for, and commitments made by, governments to link bailout support and stimulus packages to ESG standards. In this context, many businesses are revisiting their corporate purpose and beginning to more meaningfully integrate ESG factors into their decision-making processes and business plans.

Even pre-pandemic, there was a growing acknowledgement that sustainable business practices are not only essential from the point of view of risk management, they are also often accretive. In the context of private equity (PE), fund managers traditionally approached ESG considerations from a risk management perspective, with the goal of assessing and mitigating the negative impact such factors could have on an investment, whether through the creation of significant liabilities, stranded assets due to regulatory changes or changes in market sentiment or reputational damage. There is, however, a growing appreciation among PE funds - and the institutional investors that invest in them - that ESG factors can have a material impact on value creation and company performance, in addition to wider benefits to society. The pandemic has served to accentuate this, with recent analysis by BlackRock suggesting that companies with higher ESG ratings performed better during the upheaval in early 2020 and that investments with strong sustainability profiles are “better positioned to weather adverse conditions” in the recovery phase and beyond.

Investor sentiment had also begun to drive significant changes in investment trends pre-pandemic. Given that the beneficiaries of many institutional investors are often large groups of citizens, such as the pensioners in pension funds, many such investors had already formalised ESG considerations in their internal guidelines (which, in turn, form part of their duties to their beneficiaries). As a result, encouraged and assisted by standard-setting bodies, such as the United Nations Principles for Responsible Investment and the Institutional Limited Partners Association (ILPA), investors in PE funds were already increasingly looking for demonstrated integration of ESG factors into the full life cycle of the investment process.

As global lockdown eases, attention is turning to the opportunities presented for PE. With their large pools of undeployed capital, PE funds will be incentivised to invest and there is increasing speculation that governments could encourage PE firms to provide longer-term capital to struggling businesses. With these opportunities may well come increased scrutiny of PE funds and their approach to their investments, not only from their investors but also from politicians, regulators, the media and the broader public. While recognising the opportunities and the crucial role that PE funds could play in rebuilding economies, recent press has been punctuated with calls (both from within and outside the industry) for PE funds and other asset managers to use these opportunities to demonstrate how they can be a 'force for good' in the economy. As one asset manager recently put it: "our duty of care stems from managing \$50 trillion worth of debt and equity in listed and private companies globally that, in turn, employ many millions of people directly and via suppliers. The ultimate owners are mums and dads, pensioners, public institutions and charities — the same people whose livelihoods are under pressure".

This emphasis on employees, communities and suppliers has shifted the existing dialogue around ESG from a more singular focus on the 'E', to a balanced approach which also considers the 'S' and brings the 'G' back into prominence. For example, as at the end of June 2020, 335 long-term institutional investors representing \$9.5 trillion in assets under management (AUM) have signed the Investor Statement on Coronavirus Response, which states that "when it comes to employees, we expect company responses...to be a proxy for their broader approach to human capital management. Companies with good human capital management have invested in their employees and will be well-served by having retained a well-trained and committed workforce when business operations are able to resume".

While the pandemic has brought the full range of E, S and G factors into sharper focus and provided renewed impetus to all stakeholders to better articulate how they are taking them into account, fundamental challenges remain. Perhaps the greatest hurdle is the absence of a common disclosure and reporting framework. While private market investments, namely investments in private rather than listed companies of the kind generally undertaken by PE funds, have historically fallen outside of the scope of some of the regulation associated with governance practices or reporting that facilitate scrutiny of ESG issues in the public markets, this may change post-pandemic. There is already a wave of ESG-related regulation, emerging largely out of Europe, requiring asset managers, such as PE funds, to integrate ESG risks into their investment decisions and provide detailed disclosures on the ESG credentials of their products and portfolios and on their impact on ESG factors. The EU's Taxonomy Regulation is the most ambitious of these measures and will increase the focus on corporates, institutional investors and asset managers to provide certain forms of ESG disclosures relating to the nature of their activities and classifying their activities and returns in accordance with the taxonomy. Outside of the EU, there are a range of additional 'principles-based' taxonomies being developed, including in Canada, Japan and Malaysia. Going forward, the challenge will be to harmonise these.

What is clear at this stage is that there will be pressure on PE funds to demonstrate tangible examples of their approaches to, and the results from, the integration of ESG considerations into their investment processes. The many voluntary reporting frameworks available to institutional investors contain numerous questions investors should be asking PE fund managers regarding their approaches to integrating ESG considerations in the investment process and, importantly, they all recommend requesting specific evidence and examples. Indeed, the third edition of the ILPA Principles, which provide guidance and best practice around transparency, governance and alignment of interests to institutional investors in PE fund partnerships, note that a PE fund manager's ESG policy should identify procedures and protocols that can be verified with practical examples; vague commitments to an investment philosophy or behaviour will no longer suffice.

There are plenty of examples of individual, high profile success stories demonstrating how ESG factors in PE-backed companies have contributed to the creation of stronger, more sustainable and employee-friendly companies while also leading to enhanced returns. One such example is Blackstone's investment in Hilton. In 2018, the world's largest PE firm fully exited one of the world's largest hospitality companies in what is, perhaps, the largest PE profit on record. At the time, Hilton's chief executive, Christopher Nassetta, credited the transformation of the Hilton business to the culture that was built under Blackstone's management, supported by the implementation of industry-leading benefits and investment in programmes and initiatives. In March 2019, shortly following Blackstone's exit, Fortune named Hilton to the top spot on its list of 100 Best Companies to Work For in the US (a spot it retained in 2020). As Mr Nassetta noted: "It's a great example of how private equity can get involved in something and add a tremendous amount of good...The company that was floundering a little bit and was transformed to do great things again". Another example is Carlyle's acquisition of DuPont's auto paint division (renamed Axalta), which resulted in Carlyle reaping its second largest profit ever when it exited in 2016, at least in part due to the reduction in Axalta's use of solvents, its switch to waterborne paint and its development of lower-carbon paint application methods.

But beyond the high-profile examples of enhanced returns, there is a growing body of evidence that not only rebuffs some of the criticisms historically levelled at the buyout industry but also demonstrates the more subtle ESG credentials of PE funds and their approach to investing, such as the fact that the management of PE-backed companies often leads to greater investment in employee training and development, the creation of more greenfield jobs and the development of cleaner, safer and better restaurants.

It is perhaps not surprising for a traditionally secretive industry that the ways in which PE can have a positive impact on ESG performance have historically been underreported. The pandemic, and the economic opportunities that it presents for the PE industry as we begin to recover, should provide a renewed impetus for PE fund managers to adopt clearly defined positions on ESG. The growing regulatory burden will inevitably drive greater ESG data flows in private markets investing and we anticipate that this will only accelerate globally following COVID-19. Together with wider changes in investor and broader public sentiment, these shifts are expected to have a significant impact on ESG-related reporting going forward, including increased pressure on PE funds to provide the ESG disclosures that will enable their investors to fulfil their own obligations to their beneficiaries. This underscores the need for a uniform taxonomy regarding ESG disclosures in order to drive reporting in a common direction. For the time being, however, until such a framework emerges, there is an opportunity for PE funds to work with their investors, peers, industry associations and broader stakeholders to build a compelling narrative around their role, and better demonstrate their ability to be a force for good, in the economies and communities in which they operate. As one industry insider recently put it: “at the end of this crisis, we will be judged by how we helped our portfolio companies and their communities succeed in a profoundly changed world”.

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