

Investing for impact

# ESG in private equity



Accenture Strategy

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**Financial value has long been the sole driver of investments and success in private equity (PE). Today's private equity sector, however, must define success differently as stakeholders across industries and business sectors demand it.**

Pioneering private equity firms are showing that profit and purpose can go hand in hand when embedded into the business in tandem.

Accenture surveyed 120 private equity leaders currently working on sustainable investment strategies to identify and prioritize areas for change in this emerging practice.

# Time is of the essence

Environmental, social and governance (ESG) criteria have acted as a driving force within investment portfolios for venture capitalists and other investors for years. Yet, the PE sector is lagging.

Challenges for PE firms included a hardnosed financial audience, lack of data availability and transparency in private companies, and a flux in ESG measurement standards.



**To catch up with the times, PE firms can combine the entrepreneurial mindset that built their industry with the ESG value creation that is essential now. In doing so, they will forge a new model for success—one far more sustainable than their current one.**

**Why put resources and strategy into ESG now? Four major trends indicate the time is right.**

# 01

## **Millennial investors and employees are on the rise**

US\$68 trillion in wealth will transfer to millennial investors by 2030<sup>1</sup>. Seven out of 10 of them expect their wealth managers to screen investments based on ESG criteria.<sup>2</sup>

However, millennials are a force not just as investors, but also as employees. Nearly three-quarters of millennial employees say they would take a pay cut to work for a sustainable company that shares their ESG values.<sup>3</sup> As a PE firm, showing a commitment to ESG is crucial to continuing to attract top talent.

# 02

## **Regulatory environments are embracing ESG**

Around the globe, regulatory bodies are adopting ESG mandates for company and investor actions. Europe is the most advanced in this respect. For example, the EU Sustainable Finance Disclosure Regulation requires fund managers to disclose how sustainability risks are integrated into investment decisions and to ensure remuneration policies are consistent with the integration of sustainability risks.<sup>4</sup>

# 03

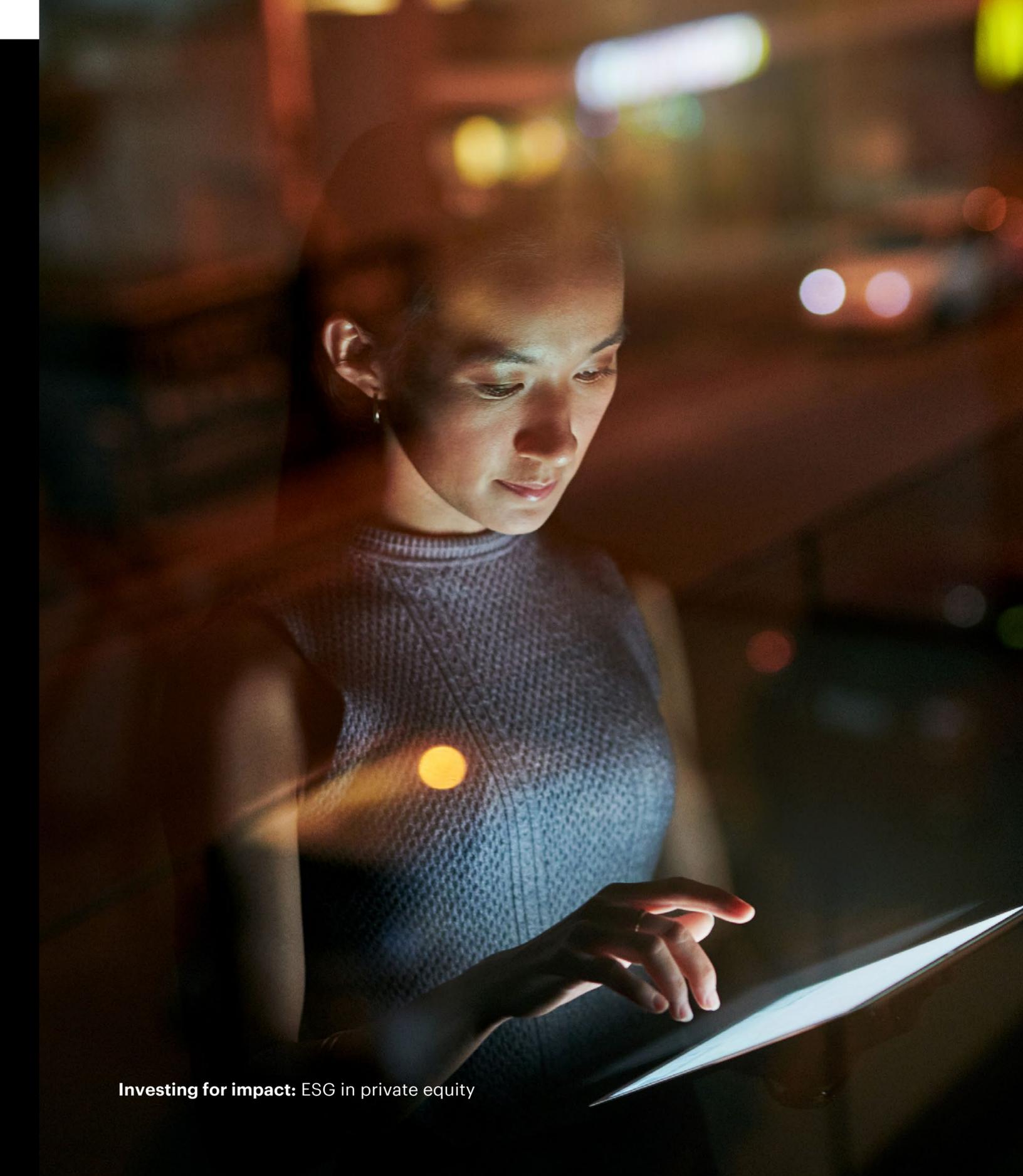
## Early mover advantages abound

PE firms that cannot reposition in time are leaving money on the table that is up for grabs by ESG frontrunners. Talent attraction and retention, sellers attracted by an ESG mindset, and investment gains are just a few of the advantages for early movers.

# 04

## Portfolio rebalancing provides new opportunities

For reasons ranging from activist investors to evolving corporate governance, conglomerates are high grading their business portfolios to meet investor quarterly internal rate of return (IRR) expectations. These trends have forced boards to rethink their current business models where they aren't advantaged owners of businesses. PE firms have the capital and speed to act and transform legacy businesses with a focus on ESG considerations.



# Good for the world, good for business

ESG is being embraced for more than just humanitarian reasons. In many cases, sustainable investments are seeing returns superior to non-sustainable counterparts.

**As Thomas Gottstein, CEO of Credit Suisse, put it:  
“There is no contradiction of sustainable investments  
and sustainable returns, quite the opposite actually.”<sup>5</sup>**

The numbers support Gottstein’s assertion. Morningstar research examining the long-term performance of 745 Europe-based sustainable funds shows that the majority have done better than non-ESG funds over one, three, five and 10 years.<sup>6</sup> Blackrock states that 81% of sustainable indices outperformed their peer benchmarks in 2020.<sup>7</sup>

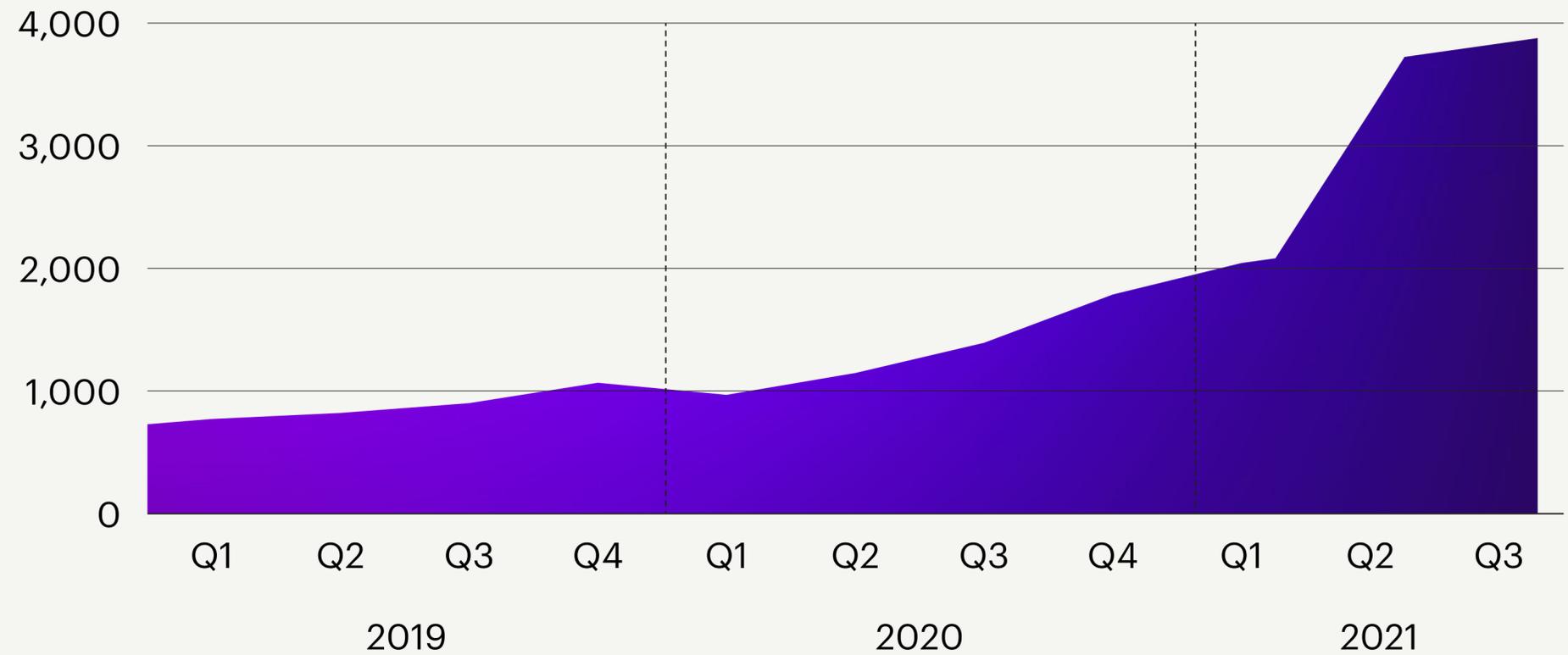
It is no surprise then, that an increasing number of fund managers are helping drive capital to ESG—setting the stage for PEs to invest with updated investment models and exit strategies. For example, one-tenth of the PE firms worldwide—with a total of US\$3.4 trillion under management—belong to Principles of Responsible Investment (PRI), a nongovernmental organization focused on encouraging responsible investment.<sup>8</sup>

We anticipate more movement from firms, as the sea change is just beginning (see Figure 1). For example, an increasing number of PE institutions are weighing whether to link asset manager compensation to ESG performance, with Europe leading the way.<sup>9</sup>

**81% of sustainable indices outperformed their peer benchmarks in 2020.**

**Figure 1:** ESG-oriented investing is seeing a significant rise.

Sustainable funds' asset size globally (US\$ billion)



Source: Patturaja Murugaboopathy and Anurag Maan, [Global sustainable fund assets hit record \\$3.9 trillion in Q3, says Morningstar](#), Reuters, October 29, 2021.

Watchdog groups and ratings also play a role. An increasing number of ESG ratings agencies covering a wider universe of companies. Groups of investors such as Climate Action 100+, with over US\$60 trillion in assets under management, are pressuring emitters to enhance their disclosure and act on climate change.<sup>10</sup> In addition, activist investors are becoming a transformative force.<sup>11</sup>

PE firms moving to a progressive approach see ESG as more than just an answer to risk mitigation and regulatory requirements, though. Instead, they tie it to their financial goals. PE firms are particularly well-positioned for positive impact because of their long-term investment horizon and active management.

PE firms who move now can still capture alpha and early mover advantages before their competitors catch up, but they should take measures at both the fund and portfolio level to gain the most value.

From strategy and branding, to data technologies, to operating model transformation, a wealth of actions can help private equity firms improve their investment value chain with ESG.



# Insights from the front line: PE leaders weigh in

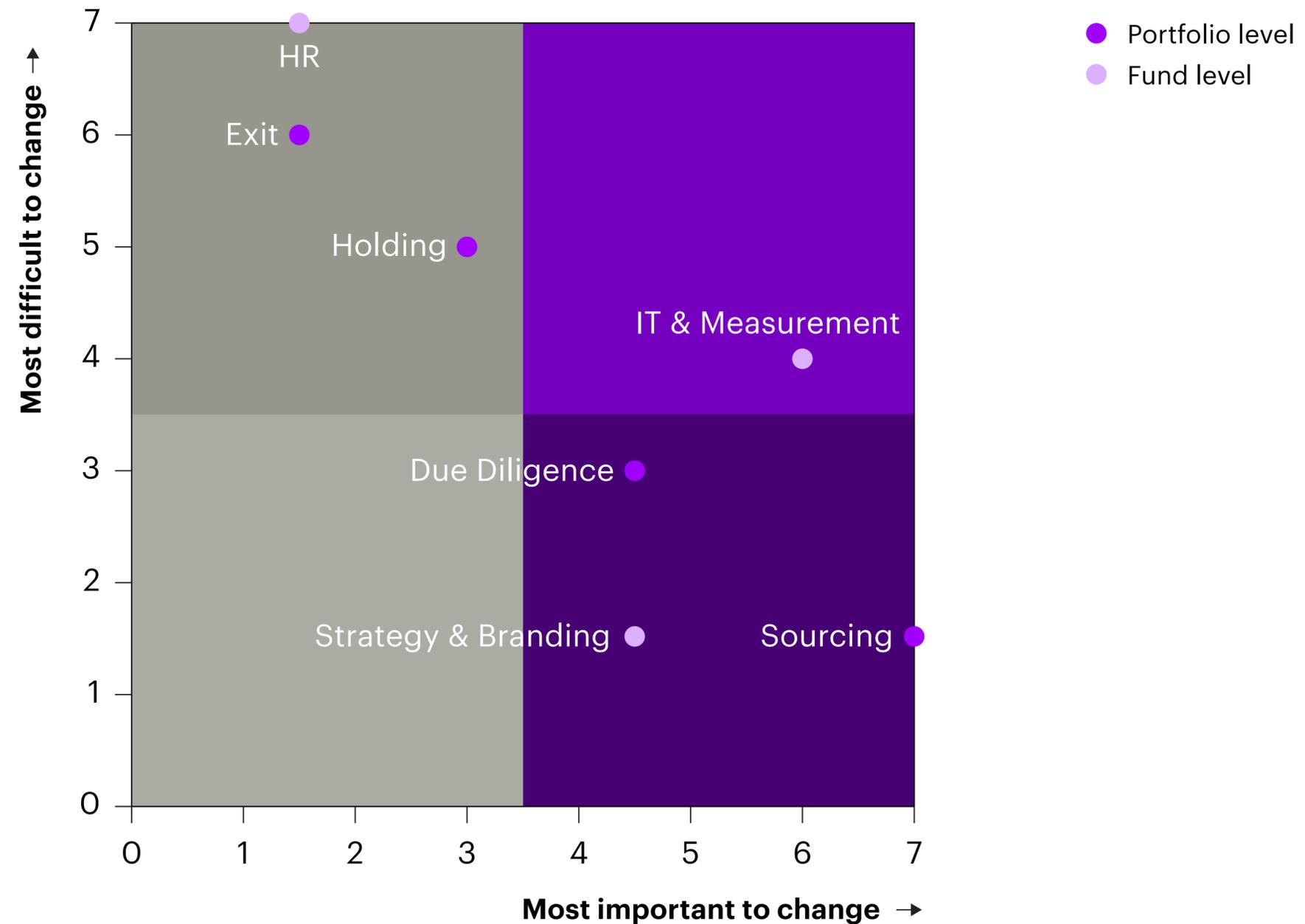
We asked 120 private equity executives currently working on ESG investment strategies about the most important and toughest areas of change when it comes to ESG investing.<sup>12</sup>



While every PE firm is unique, grouping responses paints a picture of what executives feel is most important to change versus the level of difficulty of that change. Some highlights:

- **Sourcing of ESG-winning deals** was cited most frequently as the most important area for change. Yet many respondents have started to gain experience in this area and therefore saw this change as not too difficult to orchestrate.
- **IT & Measurement areas**, including the knowledge infrastructure behind ESG investing, ranked as both highly important and difficult to change.
- **HR topics**, such as recruiting experts and management with the right ESG mindset for investee companies, was seen as the most difficult challenge of all.

**Figure 2:** ESG in private equity: Balancing priorities and challenges.



Source: Accenture survey of 120 PE leaders currently working on sustainable investment strategies, 2021.



# Embedding ESG into operating models

PE firms are reevaluating their operating model on two levels—the portfolio level and the fund level—with a focus on strengthening their [“Sustainability DNA”](#) and incorporating ESG into the business model and investment value chain.

While there is no one-size-fits-all approach, certain foundational changes are commonly relevant to transformative operating models.

# What to consider at the fund level

## 01 Strategy & Branding

Strategy and branding provide a good starting point, considered important by firms but also relatively straightforward to change. Our research findings show that strategy and branding are considered more important right now in Asia than elsewhere. This is likely because so many funds are still being set up in Asia versus in Europe where there is more fund maturity and established branding.

As leaders look across multiple businesses, they should pursue an external narrative that bridges all sectors. To do this, they can map the UN Sustainable Development Goals (SDGs) and [overlay them onto industry sectors](#) to identify the right priorities. For example, 21 Invest uses societal and environmental benefit as an overall theme for their branding. It is one that resonates well with their audience of family-owned businesses.<sup>13</sup>

## 02 IT & Measurement

Located at the upper-right quadrant of Figure 2 on page 12, IT and measurement are considered important to address but harder to change. We often speak about the importance of data capabilities in any company—and while this is harder for medium-sized businesses to address, PE firms can organize for this at the fund level.

With climate-related net-zero commitments and regular reporting the norm, investing in external data and the ability to combine it intelligently with internal metrics becomes critical. At the investment level, trends analysis will point toward the right targets for circular economy progress, but firms require advanced data analytics capabilities to do this well.

## 03 Human Resources

Our quantitative research findings show that HR is the hardest area to change. In-depth interviews confirm this: determining the traits of a purpose-driven portfolio company CEO and recruiting leaders with the mindset and skills to drive both financial and ESG issues is tough.

As one global private equity client we interviewed attests, even finding the right external experts to help from a technical standpoint—for example on science-based emission targets—can be a challenge. Yet, these aspects are also crucial to get right.<sup>14</sup>

# What to consider at the portfolio level

## 01 Sourcing

The strategy developed at the fund level will help to identify the right target portfolio companies based on impact themes. As one private equity client explains, industry selection is the first layer they address—with certain industries being excluded due to a high risk of stranded assets.

Within the industries selected, it is important to apply a broad lens. Looking at electric vehicles for instance, consider all key components that go into these vehicles and compose watchlists of companies winning in critical domains in the supply chain.

Moving to another industry, such as consumer goods, one adjacent area regarding food waste is packaging. For example, some companies make biological particles that can be incorporated into packaging to help food stay fresh longer. Run selected companies through a holistic due diligence process, with quantifiable goals focused on key value drivers as well as more classic ESG metrics.



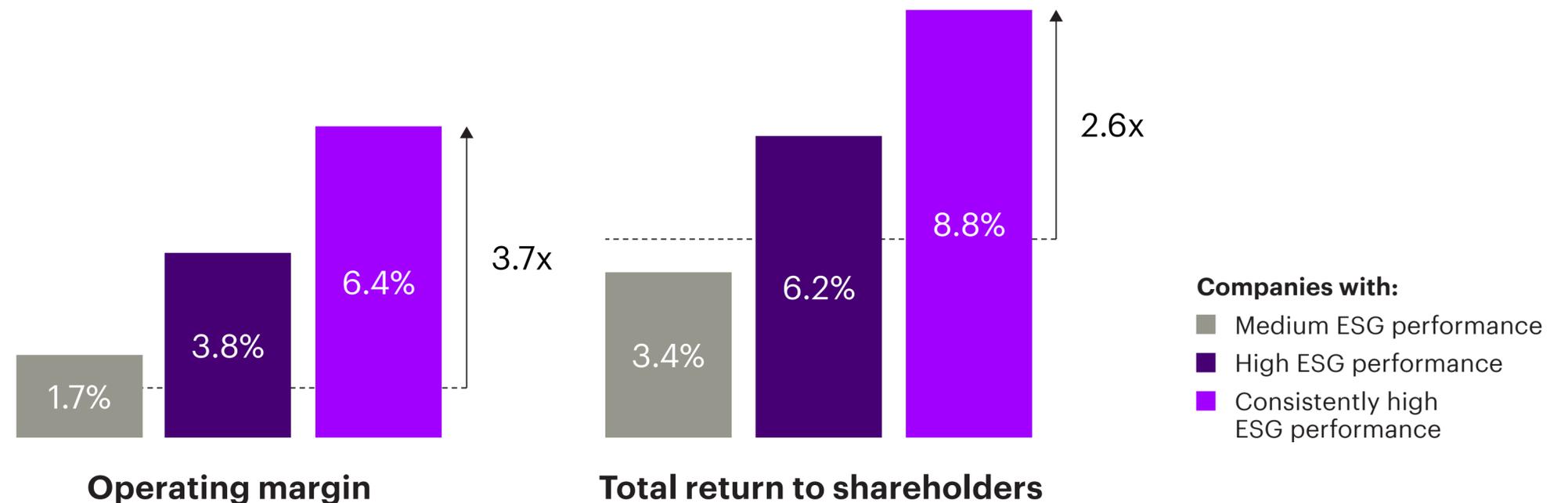
## 02 Due Diligence

When screening for ESG factors in due diligence, seeing sustainability as more than a risk mitigator is key. It is also a value creation driver. Accenture research across industries shows that businesses with high ESG performance ratings had operating margins 3.7x higher, on average, than lower ESG performers. They also generated higher annual total returns to shareholders, outperforming lower performers by 2.6x (see Figure 3).<sup>15</sup>

Turning around a bottom ESG performer can therefore be a strong hypothesis for value creation. Leaders can look for companies with characteristics that set them up well for ESG and that they are currently not utilizing as such. This works across industries—even in those that are traditionally carbon-heavy. The most interesting aspect is whether

leaders can quantify the dual business case—the financial case and the impact one. Ensuring both accelerates the transition to a virtuous cycle, which helps drive long-term positive impact on all fronts by holding business leaders accountable to metrics.

**Figure 3:** Top ESG performers outperform their lower-performance industry counterparts based on operating margin and total return to shareholders.



Source: Research analysis of Arabesque S-RAY® and S&P Capital IQ data. Number of companies analyzed: Operating margin=8.398; Total shareholder return = 9.139. Outputs from panel econometric regression models with coefficients significant at the 1% level. Operating profit = earnings from continuing operations, defined as earnings before tax including unusual items less income tax expenses.

## 03 Holding

In the holding period, it is critical to bring in managers who understand the dual-value strategy. These need to be people who can lead with purpose and who have the skills to help turn around the portfolio business. It is also where HR efforts at the fund level will start paying off at the portfolio level.

As Cristina David, director of Finance & Investor Management at 21 Invest, explains: “It can be challenging at the portfolio level to ‘change the engine while the plane flies.’ For example, when our firm acquired a packaging company, the company had not significantly developed sustainable packaging.”

The key was to make a strong business case, convincing management teams of the importance of ESG to reach new clients and its long-term value. Through our active ownership and ongoing dialogue with the company leadership, we were able to make the change, developing sourcing and production capacity for sustainable packaging.

**“The success we created provided a business case that in turn helps convince other portfolio companies of the value potential of investing in ESG.”**

**Cristina David, Director of Finance & Investor Management at 21 Invest**

## 04 Exit

As PE firms increasingly make ESG a key component of their investment strategies, we can expect to see an increase in exits generating increased returns to investors. For example, brand value in the context of ESG is becoming increasingly relevant due to the linkage between product or service pricing power and therefore profitability.

In addition to setting up post-investment reviews to improve methodologies over time, leaders will want to start curating a field of investors who will invest after their firm does, showing them what has been built as well as how and why the company is positioned for sustained success. This type of network building helps ensure PE firms capture the full benefits of the dual (financial and impact) value they create.



## Company example

# Summa Equity: Beyond compliance and reporting to value creation and growth

While many firms practiced ESG through compliance and reporting, Reynir Indahl founded Summa Equity with the goal of applying ESG for value creation and growth. His vision of a new PE model is working. Characterized by a focus on long-term value creation, Summa Equity seeks to future-proof the businesses it invests in.

Summa Equity started by investing in four areas linked to the UN Sustainable Development Goals (SDGs), believing businesses could provide commercial solutions for these challenges. It was the first PE firm to commit to the SDGs in their entirety. Integrating these issues from the beginning, Summa Equity placed ESG at the core of profitability.<sup>16</sup>

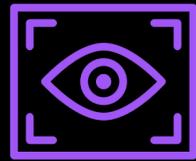
Indahl, who has been ahead of the times for some time now, summed up his thoughts on the lag in ESG in a letter to the Financial Times: “The problem is that ESG is still seen by too many organizations as being independent of commercial success, rather than an integral part of how they drive value and create competitive advantage. By focusing on strategies that span social and commercial, organizations will not only have the greatest impact on society and the environment, but also identify the biggest opportunities for innovation and growth.”<sup>17</sup>



# Leading with purpose

Purpose and profit can go hand in hand, but it takes deliberate steering from PE leadership to get there.

## We leave you with a few broad-brush actions that can help your PE team begin on the right foot.



Ensure the leadership team **aligns on a vision** for environmental and social impact and agrees on the right investment model based on its values, differentiated capabilities and sector attractiveness.



**Communicate the vision broadly.** Build sector strategies and define thematic focus areas. Being vocal and credible on concrete ESG topics will help attract investors, investment opportunities as well as talent.



When reporting, distill **key facts and challenges** on material issues—such as climate change—and seek to combine them with financials into hybrid metrics, for example showing how your portfolio companies decarbonize profitably. Ensure data and measurement are watertight, leveraging a dedicated impact team or outside advisors where needed.

**The world has left behind a “tick-the-box” mentality regarding ESG, as citizens and leaders embrace the gravity and enormity of the sustainability goals our globe is facing.**

For PE firms, investing for impact has become an essential driver of long-term success. Accenture is using our combined expertise in mergers and acquisitions, sustainability and technology to help PE firms continue to deliver profits—and to ensure those profits are fueled by purpose. The world will accept no less.



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