Harvard Business Review

Magazine Article

Sustainable Business Practices



Private Equity Should Take the Lead in Sustainability

by Robert G. Eccles, Vinay Shandal, David Young, and Benedicte Montgomery

Do Not Copy or Post

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860



Do Not Copy or Post

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860

FOR ARTICLE REPRINTS CALL 800-988-0886 OR 617-783-7500, OR VISIT HBR.ORG

AUTHORS

Robert G. Eccles
Visiting professor, Saïd Business School

Vinay Shandal
Partner, BCG

David Young
Senior partner, BCG

Benedicte Montgomery
Lead knowledge analyst, BCG

SUSTAINABLE BUSINESS PRACTICES

Private Equity Should Take the Lead in Sustainability. Here's How.

Do Not Copy or Post

PHOTOGRAPHER **CIUCO GUTIÉRREZ**

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860

ABOUT THE ART

In the series Desserts, *Ciuco Gutiérrez brings together images of nature and opulence in dreamlike and emotionally ambiguous combinations.*

IDEA IN BRIEF

THE PROBLEM

Private equity has long overlooked sustainability issues, but the industry is now so large that society won't be able to tackle climate change and other major challenges without its active participation.

THE OPPORTUNITY

The PE business model gives private equity clear advantages over investors in public companies when it comes to promoting a sustainability agenda.

THE SOLUTION

PE firms should integrate ESG considerations into their deal-making, be more transparent with their investors about their sustainability efforts, make net-zero commitments for carbon, and take steps to reduce inequality in their own firms and in society.

Despite their reputation in the 1980s as corporate raiders, most private-equity firms attempt to improve the performance of their portfolio companies through better corporate governance.

Historically their business model has been to create value by sharpening the focus and oversight of largely ignored business units inside conglomerates or poorly managed private companies, such as dysfunctional family-run businesses. But although the G in "environmental, social, and governance" has been important in the PE industry from the outset, the E and the S have been virtually nonexistent. The industry has been content to seek returns with little concern for the long-term sustainability of portfolio companies or their wider impact on society.

A huge opportunity for private equity—and for society—now exists. PE has moved far beyond its Wall Street niche to become a major player in the global economy. In 2021 the industry had $6.3 trillion in assets under management (compared with about $90 trillion for public equities) and close to $2 trillion in "dry powder" (funds raised but not yet invested). Those assets are projected to exceed $11 trillion by 2026. Roughly 10,000 PE firms worldwide oversee more than 20 million employees at about 40,000 portfolio companies. Some of the largest PE firms—Apollo, Blackstone, Carlyle, EQT Partners, KKR, and TPG—are now publicly listed themselves and therefore subject to the same pressures that all public companies face.

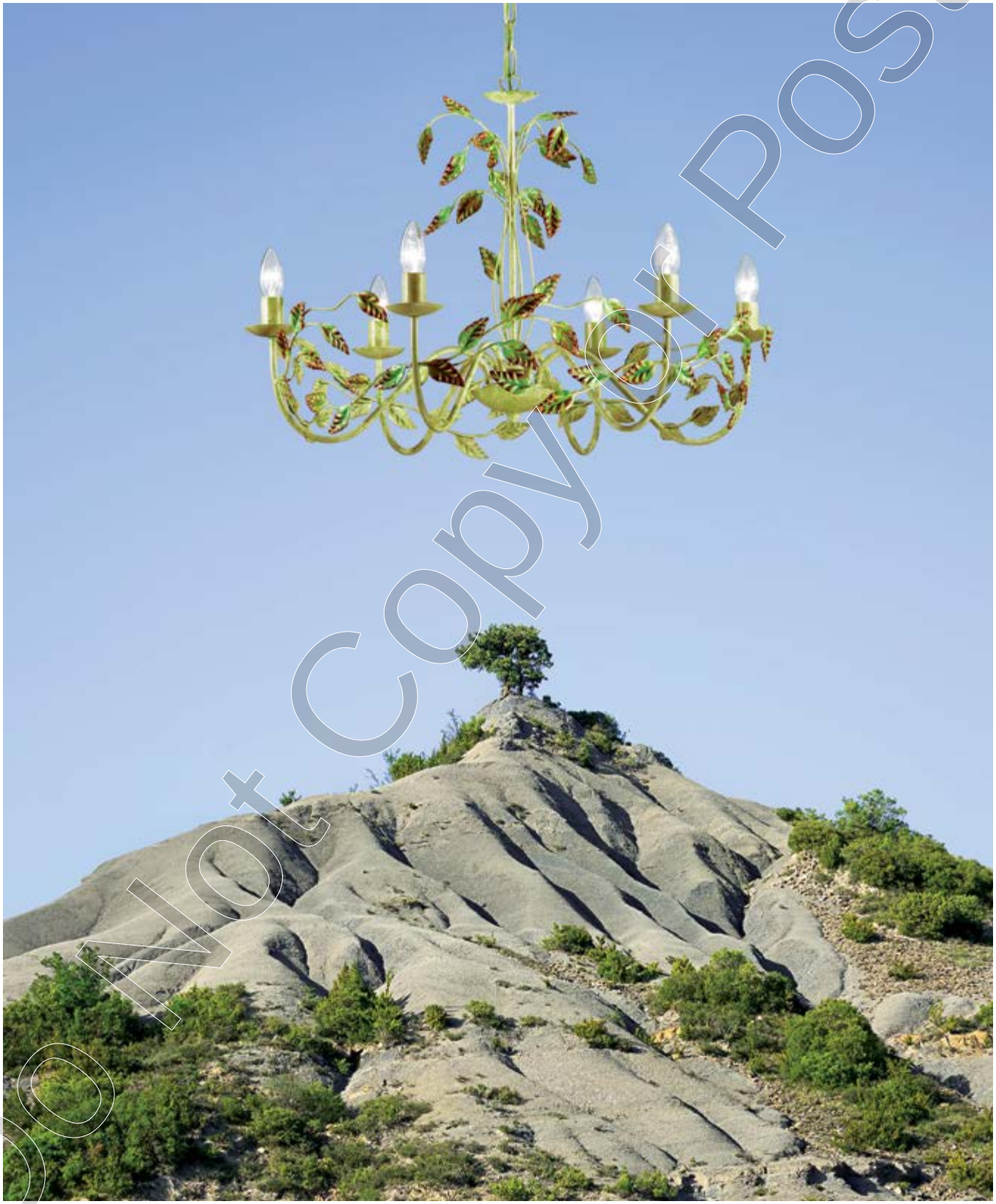
Because the industry is now so large, society won't be able to tackle climate change and other major challenges without the active participation of private-equity firms and their portfolio companies. And unless those challenges are addressed, the PE industry, along with all other economic activity, will fail to thrive.

To better understand ESG's impact on PE and the opportunities and challenges facing the industry, we interviewed 100 people across the globe. They included industry experts and individuals from 22 limited partners (LPs)—the pension funds, insurance companies, sovereign wealth funds, endowments, and wealthy families

Do Not Copy or Post

COPYRIGHT © 2022 HARVARD BUSINESS SCHOOL PUBLISHING. ALL RIGHTS RESERVED.

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860



Do Not Copy or Post

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860

PE-owned companies operate on a longer time horizon than publicly traded companies do, giving them ample time to make investments without the glare of quarterly earnings calls.

and individuals whose money firms use to make investments—and from 39 general partners (GPs), which manage and invest money for LPs. (Disclosures: One of us, Robert, serves as the chair of KKR's Sustainability Expert Advisory Council. Vinay, David, and Benedicte are consultants to the industry, including to several firms at which we conducted interviews for this article.)

We found that members of the industry have been slow to realize the importance of ESG for its future relevance, profitability, and even license to operate. The immediate challenges that PE faces are numerous and substantial: job losses at portfolio companies, the location of funds in tax havens, investments in private prisons and other controversial industries, the purchase of oil and gas assets from publicly listed companies (especially without a credible plan to improve their sustainability performance), donations to far-right organizations, and substantial payouts—sometimes hundreds of millions of dollars—for senior partners and other employees at a time when income inequality is a major societal challenge. But we also learned why the industry is well-placed to take the lead in sustainable investing—and how it can accelerate an adoption of ESG principles.

WHY PE NOW

Private equity's business model gives it clear advantages over investors in public equities when it comes to implementing a sustainability agenda. A PE firm has virtual control of its portfolio companies from an ownership and governance perspective, even when it doesn't own 100% of a company: It has one or more representatives on the board and a strong influence on who else serves. It has access to any information it wants about both financial and sustainability performance—whereas investors in public companies see only what the company reports. Finally, the firm determines executive compensation and can fire a CEO who is not delivering. "Our investment model—whereby we are often in control ownership positions and have a long-term perspective—and our expertise can help our portfolio companies advance their ESG journeys," says Elizabeth Lewis, the deputy head of ESG at Blackstone.

PE-owned companies operate on a longer time horizon than publicly traded companies do, further facilitating a focus on ESG. The average holding period for portfolio companies has increased from about two years in the industry's early days to about five today, which gives a GP and its handpicked CEOs ample time to make investments without the glare of quarterly earnings calls.

Of course, private-equity firms aren't likely to integrate ESG into their management unless they feel it's in the interest of long-term profitability—which is why they've largely ignored it until recently. But signs suggest that this mindset is quickly changing. Principles for Responsible Investment (PRI) reports that the number of PE and venture capital managers among signatories to the network has quadrupled over the past five years, for a total of 1,090 today. Nine of the top 10 GPs globally are now members of PRI. Of the world's 100 largest PE firms, 70 are based in the United States. Twenty-eight of those are PRI signatories, and 13 have signed on in the past two years—evidence of how quickly the industry is evolving.

Three forces are pushing ESG in the industry. First, ESG is becoming more important to limited partners and their beneficiaries. The largest asset owners—among them pension and sovereign wealth funds—are increasingly concerned about the system-level effects of climate change and inequality. A recent survey of LPs by INSEAD's Global Private Equity Initiative found that 90% of them factor ESG into their investment decisions and 77% use it as a criterion in selecting general partners. Many LPs are developing more-sophisticated approaches to evaluating the ESG capabilities of their GPs, and some are helping them improve their ESG capabilities.

For example, the Dutch pension investor APG has about $36 billion invested with 75 GPs across the globe. Starting in 2016, APG put processes in place to draw greater attention to sustainability from its GPs. Every year it scores each GP on a scale of 0 to 100 using a framework of 30 questions. No minimum score is required of a new GP, but all must report annually on what they are doing and show progress. Failure to do so will put future fund allocations at risk, however attractive a GP's financial returns may be. APG also gets yearly reports on the key performance indicators for ESG issues that are material to each of the GP's portfolio companies.

Another Dutch pension fund, PGGM, publishes an annual report on PE responsible investment. It uses a 1-to-5 scale to

Do Not Copy or Post

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860



evaluate GPs. The fund won't allocate capital to those getting a 1 rating but will do so for those getting a 2 if it has reason to think they'll improve. Throughout the year PGGM monitors the approaches of its GPs and engages with them on ESG issues. The distribution of scores vividly illustrates how PGGM's general partners have improved on ESG: In 2016, 13% were rated very low or low, and 16% were rated high. In 2020 those percentages were 3% and 37%, respectively.

The rise of coinvesting, whereby an LP makes a direct investment in a portfolio company alongside the GP, is increasing pressure on GPs to focus on ESG. Coinvesting gives the LP direct access to the ESG performance data of portfolio companies. The Institutional Limited Partners Association has published an ESG assessment framework to help LPs evaluate and build the capabilities of their GPs.

The second force pushing ESG in the industry derives from the belief of many LPs and GPs that it will be essential if private equity is to continue delivering its historically high returns. The work of Harvard Business School's George Serafeim and others has shown that attention to ESG can lead to outperformance in public markets. LPs such as CalPERS, the largest U.S. pension fund, and Nuveen, a subsidiary of TIAA, believe that ESG is as relevant to private equity as it is to public equities. "ESG is important for all asset classes," says Amy O'Brien, the global head of responsible investing at Nuveen. "ESG is agnostic to ownership structure."

The third force is portfolio companies' increasing recognition of the importance of ESG issues. The reasons are unsurprising: a changing zeitgeist reflected in the preferences of employees and customers; growing awareness of the significance of climate change; social expectations regarding diversity, equity, and inclusion; pressure from large public companies to which the portfolio companies are suppliers; awareness of the sustainability focus in publicly listed companies; opportunities to boost their own value through sustainability; and increasing regulation.

The confluence of those three forces has had a powerful, albeit somewhat counterintuitive, effect. Many of the GP representatives we talked to, especially those who were sophisticated about ESG, said that a commitment to sustainability was a selling point and a differentiator in their negotiations with potential portfolio companies that are being targeted by multiple GPs.

WHAT DISTINGUISHES THE LEADERS IN ESG?

Until recently, ESG in private equity was a box-ticking exercise at best. LPs would give GPs a form—called an ESG due-diligence questionnaire—to fill out when a new fund was being raised. The form was unique to each GP and often long, and it rarely had any effect on whether the LP invested in the fund. It was simply filed away, and everyone got on with the business of investing and making money.

This approach still exists among less-sophisticated GPs and LPs. But according to Giovanni Orsi, the head managing director of relationships and partnerships and private equity at the Canadian pension fund PSP Investments, "Five years ago there were clear leaders, with laggards significantly behind. Today the gap is narrowing."

What are the leaders in ESG doing differently? They are becoming more sophisticated in three ways: (1) integrating ESG factors in due diligence, onboarding, holding periods, and exit strategies; (2) increasing transparency in the reporting of sustainability performance; and (3) assessing and improving the ESG capabilities of portfolio companies.

Integrating ESG. Each target or portfolio company's performance is assessed on the critical ESG issues that will affect value creation. That means moving from a short "risk and compliance" checklist in the due diligence phase (to screen out any obvious problems that could have financial consequences) to a sophisticated analysis of how well a portfolio company understands and is managing the ESG issues material to its business. That analysis is followed by collaboration with the company's board (on which the GP always has a seat) and with management to improve its performance (often with substantial help from the GP).

Leading GPs are continually improving the integration of ESG considerations into portfolio-company management. For example, in addition to monitoring and managing ESG risks during the holding period, Apollo Global Management is experimenting with a post-exit analysis of investments to determine how ESG issues affected performance and how the firm might apply that knowledge to future investments. "We are developing a template to help us assess ESG performance over the lifetime of an investment, and we will continue to evolve our approach," says Laurie Medley, Apollo's global head of ESG.

DO NOT COPY OR POST

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860





Until recently the separation in PE between those making investment decisions, those overseeing an asset once the deal was done, and those responsible for sustainability was clear. At some firms it is becoming less pronounced as deal teams undertake training in ESG. For example, Investindustrial, a firm with $12 billion in assets under management, sends its deal teams and portfolio-company managers to a sustainability certification course at New York University. They are supported by in-house experts in environmental and social issues. Apollo, Ares Capital, Bain Capital, Carlyle, EQT, Generation Investment Management, IG4 Capital, Investindustrial, KKR, PAI Partners, TowerBrook, and Verdane all told us that they are creating a process to make deal teams more knowledgeable about ESG.

Increasing transparency. With the growing recognition that ESG performance contributes to financial performance, GPs have become much more disciplined about gathering ESG data. They often collect a standard set of key performance indicators from their portfolio companies on an annual or even a quarterly basis. In some cases the number of KPIs ranges from 50 to 100. KPI reporting now almost always includes the ESG issues that are material to a company's financial performance. (For example, water usage is more relevant to a food and beverage company than to a bank or a tech company.) Triton, with $15.6 billion in assets under management, has since 2014 had a reporting system based on "three Ps": *policy* (what it is doing on the ESG front), *program* (its plan to implement the policy), and *performance* (how well the program is being implemented at the portfolio-company level). It uses various resources, including the Sustainability Accounting Standards Board, to identify material ESG issues when screening for investments and when managing them.

Transparency between GPs and their LPs is also increasing. Apollo has been reporting on ESG to LPs for 12 years, and in recent years its annual ESG report has been publicly

Do Not Copy or Post

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860





available on its website—a practice some other GPs have now adopted. Some LPs are requesting ESG data, such as for carbon, at the portfolio-company level.

Improving ESG performance. The private-equity business model puts general partners in a good position to help portfolio companies improve their ESG integration and reporting practices in a number of ways. These include identifying relevant issues and best practices for dealing with them, providing measurement and reporting tools, benchmarking against other portfolio companies, offering access to internal and external experts, and monitoring regulatory developments.

Some GPs have developed methodologies for assessing the degree of ESG sophistication in potential portfolio companies and helping them improve practice. Carlyle's process for evaluating targets starts with risk (basic compliance on environmental, safety, and health issues), moves to value (captured from the company's current business model and capabilities), and ends with growth (how to enter new areas). Its resources can enable portfolio companies to improve on sustainability faster than they could on their own.

Graeme Ardus, the head of ESG at Triton, told us that "deal teams and portfolio companies can see how each business is doing in comparison to the 'Triton benchmark.'" The firm holds monthly calls to share good practices with its portfolio companies and hosts events where CEOs and other senior executives present what they are doing on ESG. Triton also has a formal annual ESG gathering at which companies can network with and learn from one another.

Another leader where we interviewed is Nuveen, which acts as both a GP and an LP. In its role as an LP, it has a framework for doing an ESG assessment of every general partner and every fund in which it invests. Nuveen also gathers ESG data at both the fund and the portfolio-company level, including carbon footprint and alignment of each investment with the UN's Sustainable Development Goals—among

Do Not Copy or Post

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860

them ending poverty and promoting responsible consumption and production. It then uses those capabilities in its engagements with private companies. "The challenge for many private companies," O'Brien says, "is the lack of capacity and resources to work on ESG integration and reporting. We are almost like consultants for the company."

To spur learning, Investindustrial has for five years held an annual sustainability meeting with its portfolio companies. Attendance is a good indicator of how interest in sustainability has grown in the PE sector. "In the first year the company typically sent only one person—whoever was most closely associated with sustainability," says Serge Younes, Investindustrial's head of sustainability. "At our last virtual meeting we had more than 200 people from 25 portfolio companies, including many members of senior management such as the CEO and the CFO."

WHAT COMES NEXT?

Although our interviews revealed that the private-equity industry is taking (long overdue) steps to adopt a sustainability agenda, considerable room for improvement remains. Here are four initiatives that can be helpful.

Standardize ESG reporting. Firms can adopt a mechanism for simplifying and harmonizing ESG data reported by their portfolio companies to GPs and by GPs to LPs. Every general partner where we interviewed had a bespoke set of KPIs and a methodology for collecting, analyzing, and reporting data, and all agreed that some degree of standardization would be useful. Portfolio companies with multiple GPs face multiple data requests. Similarly, GPs receive wide-ranging and differing data requests from their LPs.

Solid progress is already being made on this front, starting with the ESG Data Convergence Project, led by CalPERS and Carlyle (and to which BCG was an adviser). They brought together a group of leading LPs and GPs to agree on six ESG issues—Scopes 1 and 2 greenhouse gas emissions, renewable energy, board diversity, work-related injuries, net new hires, and employee engagement—and the key performance indicators for each, all based on existing standards and frameworks. GPs participating in the project agree to collect data from their portfolio companies and make it available to their LPs. The data will then be anonymized and put into a database for benchmarking purposes. As of this writing, the project includes a group of 100 global GPs and LPs representing $8.7 trillion in assets under management and 1,400 portfolio companies.

The project's leaders anticipated that getting agreement between GPs and LPs would be extremely difficult, because people have unique data needs and no regulations currently exist to enforce standards. But the rapid uptake of the ESG Data Convergence Project indicates that the industry is ready to meet this challenge in a more aligned way. (That said, nothing prevents a GP or an LP from requesting additional data.) Other groups are working on a similar idea, including PRI, the Ceres Investor Network, the Institutional Investors Group on Climate Change, and the Initiative Climat International (iCI). The Institutional Limited Partners Association is working to ensure alignment rather than competition among these initiatives.

Make net-zero commitments. Given the size of this asset class, the PE industry needs to make the kind of commitment to "net zero by 2050" that all financial institutions under the umbrella of the Glasgow Financial Alliance for Net Zero are making. Important work for private equity is being done by the iCI, which was launched in 2015 by five French PE firms to help achieve the objectives of the Paris Agreement on Climate Change. Thanks in large part to support from PRI, the iCI now includes more than 164 general partners representing more than $2 trillion in assets under management. In March 2022 Elizabeth Seeger, the managing director of sustainable investing at KKR, was named chair of the North American chapter. The iCI's members commit to reducing carbon emissions in their portfolio companies and seek to ensure long-term sustainable financial performance by managing the risks and opportunities presented by climate change. However, there is a major difference between reducing emissions in a portfolio (where a GP may simply ditch dirty companies) and reducing emissions in a portfolio company (which a GP may help go green).

Improve diversity. The industry needs to improve its track record with DEI. Today private equity is still predominantly white and male, particularly on deal teams. Evidence continues to mount that a more-diverse workforce leads to better performance. Diversity is also important in the war for talent. Hence it has become a top issue for limited partners

Do Not Copy or Post

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860

Despite the best of intentions, it is all too easy for the PE industry to get lost in the weeds of the ESG agenda and forget that its social license to operate is not guaranteed.

in managing their investments (and themselves), and they are putting pressure on their GPs. Encouragingly, some GPs already recognize the importance of DEI. EQT, for example, is committed to creating truly diverse, gender-balanced (at least 40% female) investment-professional teams. To demonstrate the seriousness of its commitment, EQT has issued a credit instrument whereby its interest rate will ratchet up if EQT fails to meet the short-term target of 28% female by 2026. Other firms should follow its lead.

DEI standards must apply to portfolio companies as well. Sherrie Trecker, the sustainability officer at the Washington State Investment Board, says, "GPs have the ability to change board structures quickly. This is impactful, and I think we will see rapid change here, especially compared with public equities." Kara Helander, the chief diversity, equity, and inclusion officer at Carlyle, says, "Ten years ago there was less focus on this, but today DEI is a business priority for our portfolio companies." Carlyle has a goal of at least 30% diverse board membership for its controlled portfolio companies. Since many of those board members are Carlyle employees, the firm understands its obligation to improve its own diversity. Carlyle's CEO, Kewsong Lee, leads the DEI initiative and, along with other Carlyle executives, sets the tone from the top by holding all Carlyle colleagues accountable through DEI objective setting and by hosting discussions on mitigating unconscious bias.

Spread the wealth. The PE industry needs to directly confront the fact that the tremendous wealth it has created has been unevenly distributed. LPs, GPs, and the top executives of portfolio companies have benefited to a much greater degree than other employees of those companies. Shared ownership, whereby *all* company employees participate in the value created during the holding period, is important. Take TowerBrook's 2020 investment in CarTrawler, a company providing technology solutions to the global travel industry. All 400 or so employees have received shares that will allow them to garner proceeds when they depart. Similarly, in a number of its investments KKR offers substantial ownership to employees outside the C-suite and provides them with basic financial education.

Demonstrating a broader industry commitment to spreading the wealth, 19 PE firms have mobilized a group of asset managers, financial services firms, foundations, and nonprofits to launch the nonprofit Ownership Works. Its mission is "to increase prosperity through shared ownership at work." It has set an ambitious target of generating at least $20 billion by 2030 for hundreds of thousands of new employee-owners—among them lower-income workers and people of color who have been excluded from this wealth-building opportunity for generations. According to Anna-Lisa Miller, the executive director, "This movement is about working in concert to create a future...where employers and employees can win together."

To be sure, shared ownership doesn't work for all companies. In the retail sector, for example, where turnover is high, it would be an ineffective way to incentivize and reward employee performance.

IMPORTANT ELEMENTS—INCLUDING SOCIAL pressure, LP pressure, and shareholder pressure on publicly listed PE firms—are pushing private equity to take the lead in ESG integration. But will that be enough? PE firms must commit to moving their involvement in ESG from box-ticking to the center of their reason for being. Despite the best of intentions, it is all too easy for the industry to get lost in the weeds of the ESG agenda and forget that its social license to operate is not guaranteed.

To be successful in the future, PE leaders must speak openly and often about the importance of sustainable value creation. They must recruit people who care about it in the broadest sense and aren't joining the industry just because it can be very lucrative. We foresee three consequences if the industry fails to fully embrace ESG: Its social legitimacy will increasingly come under attack. It will no longer be able to deliver its historically high returns. And it will fail to fulfill its potential to help solve, rather than exacerbate, environmental, social, and governance problems.

HBR Reprint R2204E

ROBERT G. ECCLES *is a visiting professor of management practice at Saïd Business School of the University of Oxford and a senior adviser to Boston Consulting Group.* **VINAY SHANDAL** *is a managing director and a partner at BCG.* **DAVID YOUNG** *is a managing director and a senior partner at BCG and a Henderson Institute fellow.* **BENEDICTE MONTGOMERY** *is a lead knowledge analyst at BCG.*

Do Not Copy or Post

This document is authorized for educator review use only by Ramon Fabre, Universitat Autonoma de Barcelona (UAB) until Oct 2024. Copying or posting is an infringement of copyright.
Permissions@hbsp.harvard.edu or 617.783.7860