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ESG and the SDGs: Insights from private equity managers

"Private equity managers are uniquely positioned to embed ESG issues directly into their value creation plans."

Front cover: Isle of Skye, United Kingdom, unsplash.com

Contents

1. Introduction and scope of the survey

Private equity is arguably the asset class best suited to address environmental, social and governance (ESG) issues in companies. The typical buy-for-control investment model means that private equity managers have the greatest scope for mitigating ESG risks and capitalizing on opportunities. While many other types of investors have to limit themselves to "buy/no-buy" decisions at the outset, with some scope for engagement after the fact, private equity managers can build ESG issues into their value creation plan. They do not have to shy away from ESG challenges, as they can actively embrace the issues to profit from improvements.

Given the unique position of the asset class in the ESG landscape, LGT Capital Partners (LGT CP) wanted to gauge private equity managers' current thinking on the topic to see where it is headed. This builds on the ESG work we carry out each year, assessing how the managers in our portfolios integrate ESG into their investment processes. This has given us a rich data set on how ESG practices have evolved over time, which we wanted to complement with insights on managers' beliefs on ESG and their priorities for the future.

The current study also builds on research we published in 2019, "ESG to SDGs: the road ahead," in which we asked more than 200 institutional investors, worldwide, about their views on ESG and the Sustainable Development Goals (SDGs). In this new survey, we focus exclusively on private equity managers to better understand their views on sustainable investing.

The 117 managers who responded shared their views on a wide array of ESG topics, telling us about the importance of ESG in their day-to-day decision-making, the ESG issues that get most of their attention, their motivations for integrating ESG, as well as what they will focus on in the future. They also shared their expectations for integrating the SDGs into their investment practices, a topic that has been growing in importance in recent years. Beyond this, we were able to look at correlations between various manager responses to identify five different ESG archetypes, from Skeptics to True Believers, who populate the ESG landscape.

Some of the key questions we explore in the survey are:

- What do managers think about the effect of ESG integration on risk-adjusted returns?
- 76% of managers say ESG is relevant to their decision-making, but what does that mean in practice?
- What are the three most important ESG topics for managers?
- What do managers think about the investability of the SDGs?
- What steps have managers taken to adopt the SDGs in investment decisions?

We invite you to read on to learn more about these topics, and we look forward to discussing them with you in the months to come.

117 PRIVATE EQUITY MANAGERS GLOBALLY

76% SAY ESG IS RELEVANT TO DECISION-MAKING

GOALS

90% BELIEVE SDGs HELP TO ADDRESS PRESSING “E” AND “S” TOPICS

54% BELIEVE THAT INCORPORATING ESG INCREASES RISK-ADJUSTED RETURNS

! BETTER DATA SOURCES NEEDED TO DEEPEN ESG INTEGRATION

5 ESG ARCHETYPES IDENTIFIED

SDGs

34% PLAN TO START INTEGRATING SDGs

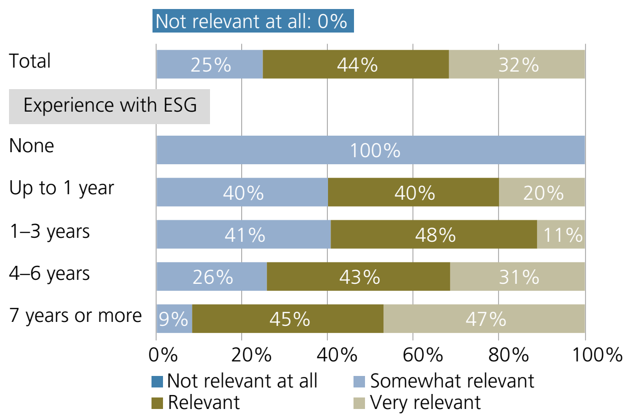
No.1 CLIMATE CHANGE IS THE TOP “E” CONCERN

2. Relevance of ESG to private equity

Importance in investment decision-making

As we observed in the introduction, private equity is uniquely positioned to address ESG risks and opportunities, given managers' wide latitude for making changes in the companies they own. But what do they do in practice? Do they live up to the ESG potential of private equity? When asked to rate the relevance of ESG to investment decision-making, more than three-quarters (76%) of managers told us it is either "relevant" or "very relevant" (Figure 1). We also see that as managers gain experience in ESG integration, its importance in decision-making increases. A full 91% of the most experienced managers (7+ years) said it is "relevant" or "very relevant," while 60% of managers who have only recently begun their ESG journeys (<1 year) see it that way.

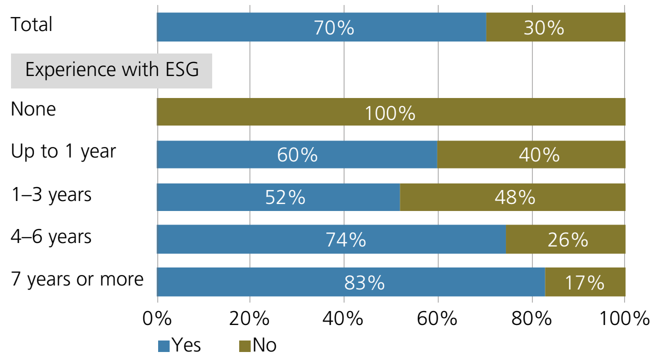
Figure 1: Relevance of ESG in investment decision-making



We also asked whether managers have ever excluded investments because of ESG concerns. Their willingness to do so says something about how they put their ESG aspirations into action. We find (Figure 2) that 70% have declined investments over ESG concerns, which is broadly in line with the 76% who say that ESG is "relevant" or "highly relevant" to their decision-making.

Furthermore, managers with significant ESG experience (4+ years) are more likely to have excluded investments because of ESG concerns than those who are new to it (<3 years). It suggests a consistency in practice over time, as managers who take sustainability seriously will eventually exclude investments on ESG grounds.

Figure 2: Excluded investments over ESG concerns?

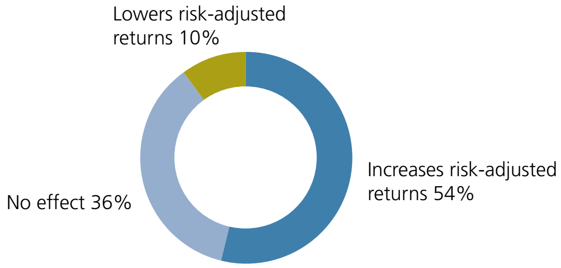


> "A solid majority of managers (54%) believe that incorporating ESG increases risk-adjusted returns."

Manager beliefs on the effect of ESG factors on risk-adjusted returns

ESG and risk-adjusted returns are a perennial topic of discussion within the investment community, so we wanted to know where private equity managers land in this debate. We find (Figure 3) that a solid majority (54%) believe that incorporating ESG increases risk-adjusted returns, while another 36% think that it has a neutral impact. A small minority of 10% are convinced that ESG integration has a negative effect. So while the debate might continue among investors and in academia, private equity managers have largely concluded that ESG factors do not entail a sacrifice in risk-adjusted returns.

Figure 3: What is the impact of incorporating ESG on risk-adjusted returns?

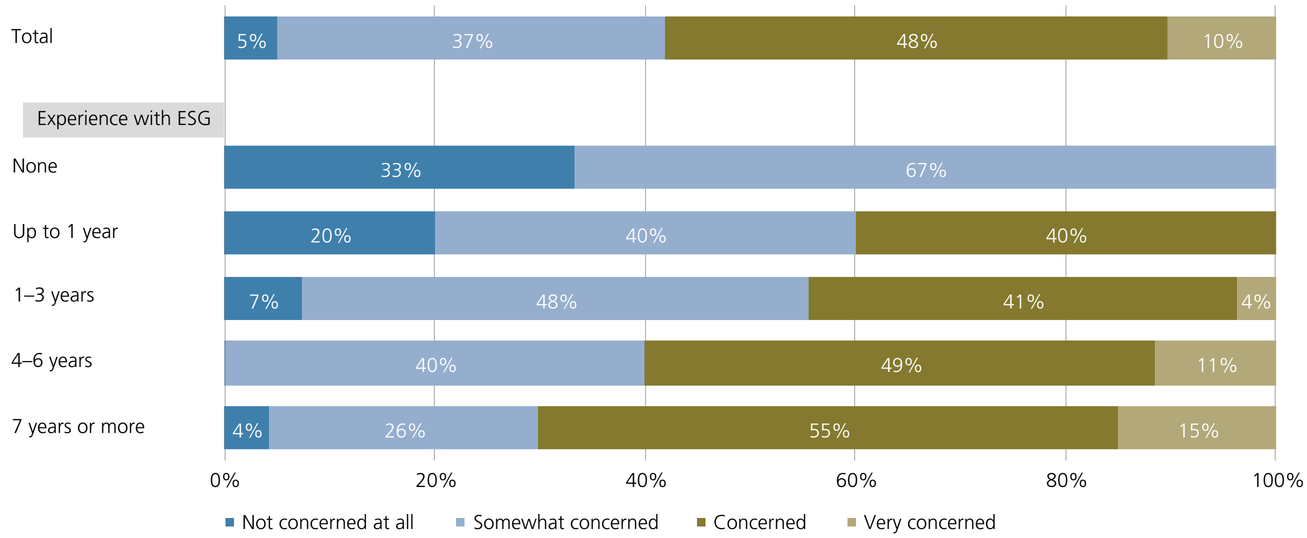


Investor concern about ESG integration in private equity

The private equity managers we surveyed ultimately serve many different kinds of investors – whether pension funds, insurance companies, foundations or others – who hold a range of views on the importance of ESG. Manager perceptions of the relative importance of ESG to their investors likely guides the pace and depth of ESG adoption. Only a small minority of respondents (5%) said their investors are "not concerned at all" about it, while a considerable majority (58%) said their investors are either "concerned" or "very concerned."

We also see that the longer managers have been integrating ESG in their investment decisions, the more likely they are to perceive it as a matter of concern to investors. Some 70% of managers with long track records in ESG integration (7+ years) said their stakeholders are "concerned" or "very concerned" about ESG, while only 40% of recent ESG adopters think the same.

Figure 4: How concerned are investors about ESG integration?



3. The most important ESG issues

Managers looking to build up portfolios that reflect the latest thinking on ESG must consider a wide array of factors. Environmental issues range from well-publicized topics like climate change and pollution to more niche issues like biodiversity and genetically modified organisms. Similarly, for social and governance, the breadth of potential topics – from human rights and workforce diversity to board independence and accounting practices – can be a challenge. Managers simply do not have the resources to address all possible issues with equal effort. They naturally need to assign priorities, based on what they believe will have the most material effect on an investment over the long term, as well as reflecting the priorities of their investors. In this section, we explore the highest priority issues for managers.

The most important environmental topics for managers
Climate change has attracted significant attention in the media, industry forums and the wider public. The topic is also very much on the minds of policy makers, with the 2015 Paris Agreement on climate change and its many follow-on activities, so it is not surprising that it is the area of greatest concern to private equity managers (Figure 5). Energy efficiency and pollution also rank high among managers' concerns, followed by waste management. Other factors such as deforestation, biodiversity and genetically modified organisms are much lower priorities for managers.

The strength of concern about climate change and carbon emissions is further illustrated in Figure 6, which shows the proportion of managers ranking each topic as their number one priority. They are considerably more likely to say climate change is their most important environmental topic than either pollution or energy efficiency.

Figure 5: What are your most important environmental topics?

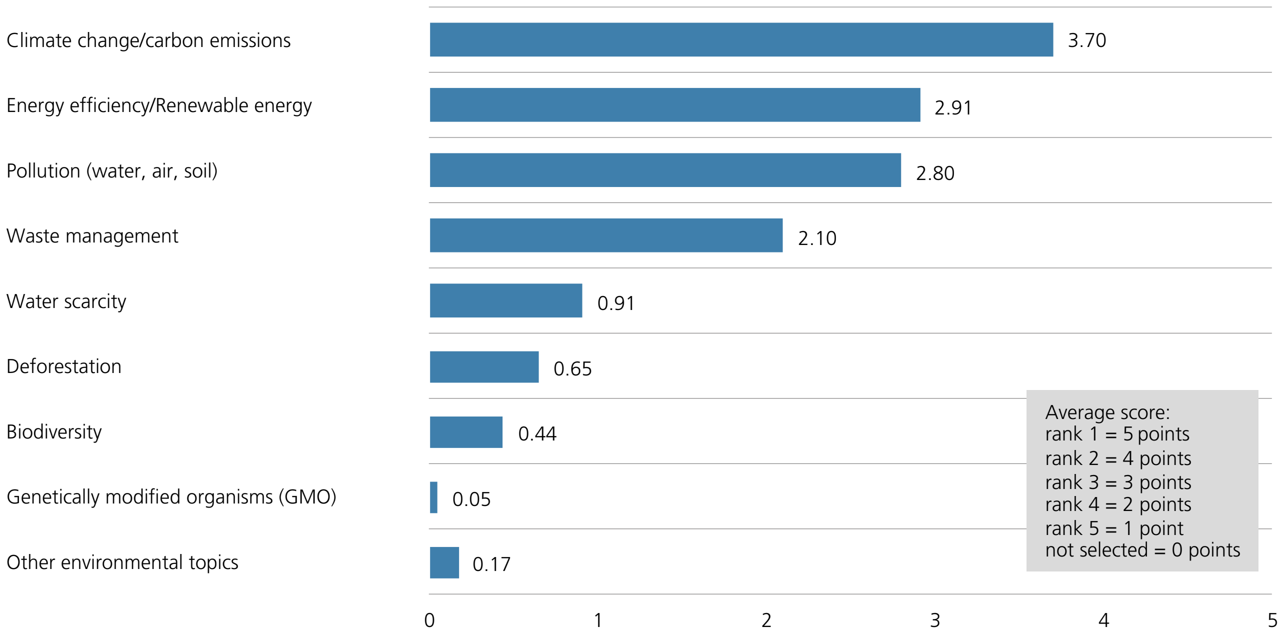
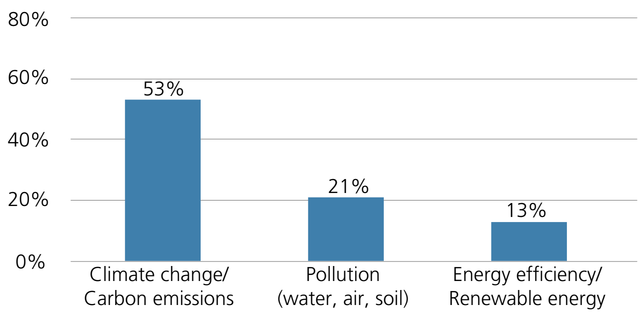


Figure 6: What is your number one environmental concern?



The most important social topics for managers

Private equity managers hold much more diverse views on social topics than they do on environmental ones. While their answers cluster around climate change when asked about their most important environmental concerns (Figure 6), the focus on a single social issue is less pronounced (Figure 7). Health and safety sticks out as the area of highest concern, which is likely linked to the increasing attention paid to health and safety issues in many jurisdictions around the world, as well as the growing conviction that employee well-being is critical to the success of a business. Managers also place considerable emphasis on child labor and human rights, where breaches of global norms can result in significant reputational damage to portfolio companies and investors.

In addition, managers cite labor standards, data protection and privacy, and workforce diversity as significant concerns. Here again, getting any of these topics wrong in the course of running a business can lead to swift reputational consequences and financial damage.

This more balanced distribution of views on social topics is also born out in Figure 8, which shows the proportion of managers ranking a particular issue as their number one concern. The differences between health and safety, child labor and human rights are relatively modest, reflecting the fact that managers have to juggle a variety of competing social topics to ensure the ESG integrity of their investments.

Figure 7: What are your most important social topics?

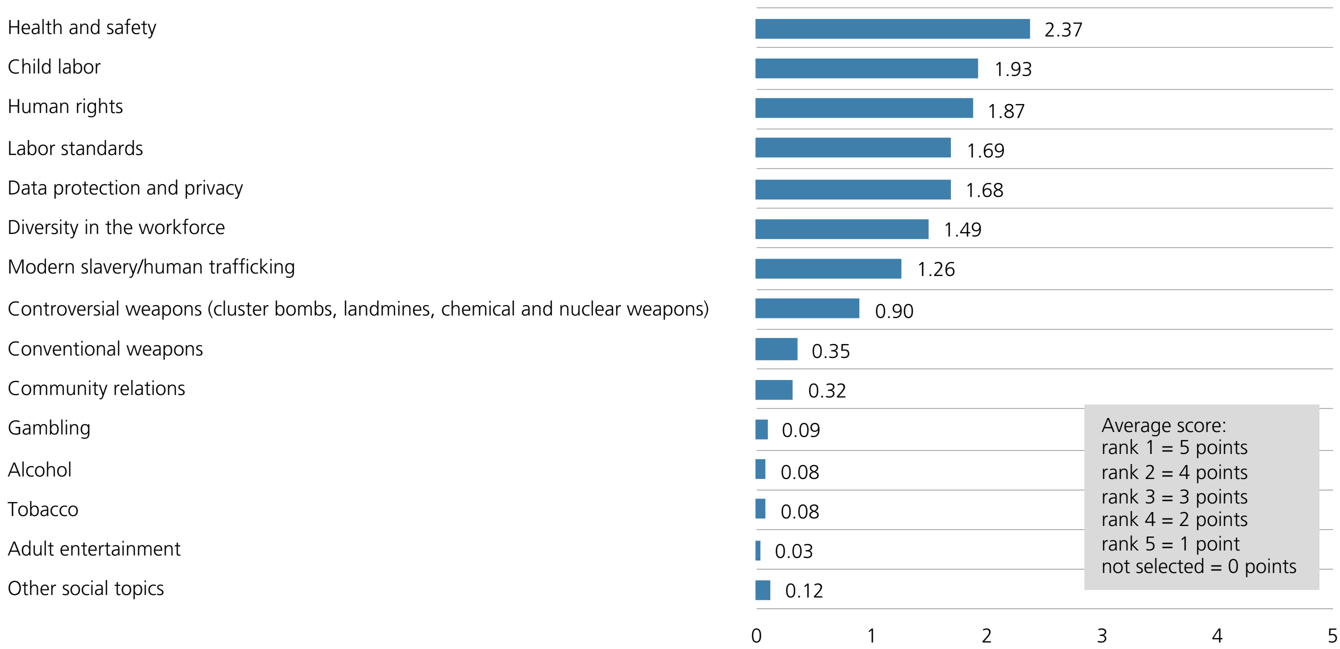
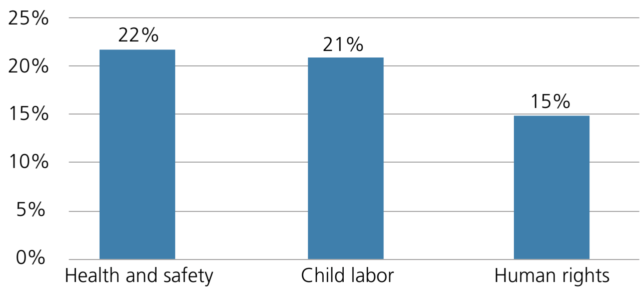


Figure 8: What is your number one social concern?



The most important governance topics for managers

Private equity managers have been integrating governance considerations into their investment decision-making long before ESG came to prominence. It reflects the distinctive nature of private equity investing, where strong governance lays a stable foundation for managers to build value in portfolio companies. Among the governance topics that most concern them, bribery and corruption stand out above all others. This coincides with the growing importance of compliance issues more generally in corporate board rooms. New legislation on bribery and corruption has been introduced in a wide range of countries in recent years, such as Germany, Spain, Australia and China, to name just a few.[1]

Board independence and strong accounting practices are also high-priority ESG concerns for managers, as they both help to create the right conditions for successful companies. From here, we see a gradual tapering in the strength of opinion on the various topics, from management/board diversity to political contributions. The fact that diversity ranks among the top four concerns is a reflection of the topic's growing importance in corporate board rooms and the media, particularly in the United States. Many private equity managers see the benefit of developing diverse organizations that can draw on a wide range of talents.

Figure 9: What are your most important governance topics?

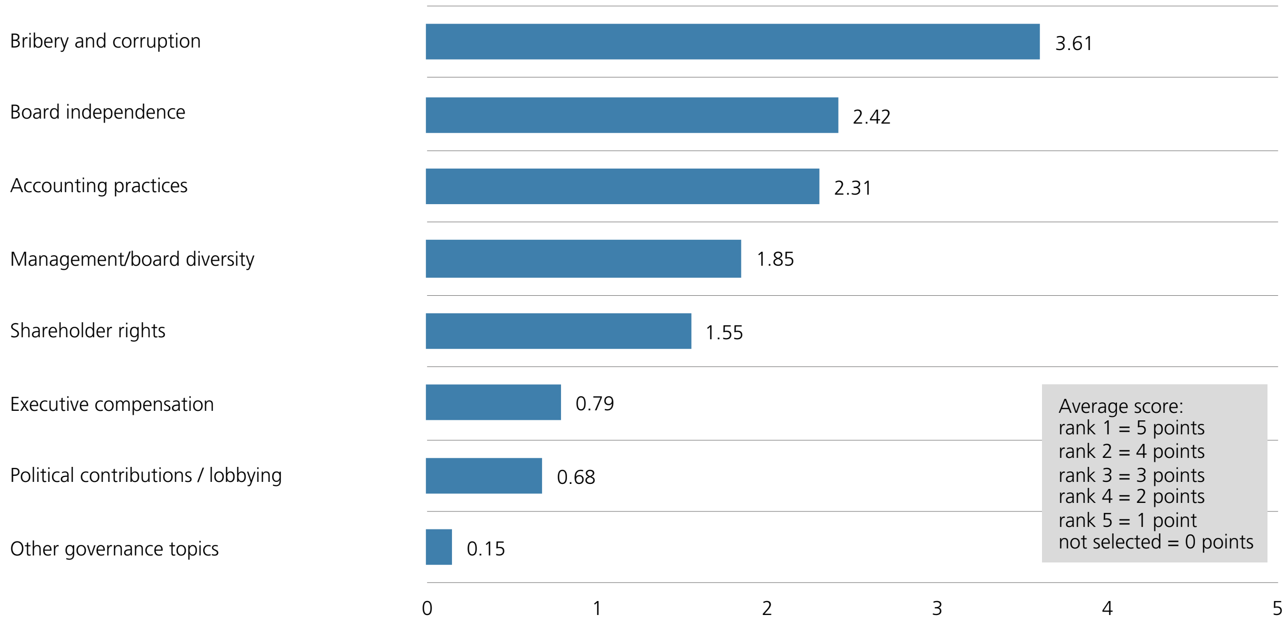
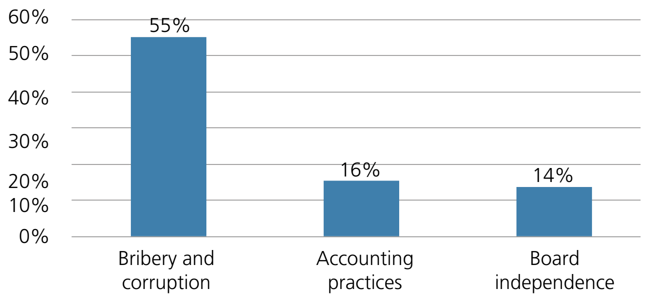


Figure 10: What is your number one governance concern?



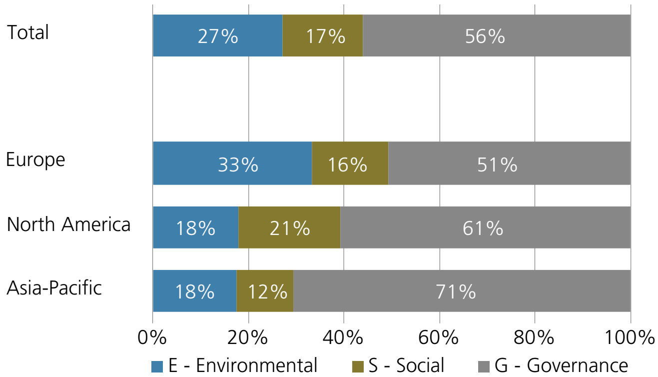
[1] "An International Guide to Anti-Corruption Legislation," Clifford Chance, 2019

Area of ESG that gets the most manager attention

While climate change occupies an important place in the minds of private equity managers – as it does with investors in general – we wanted to understand the relative weightings of E, S and G in their thinking on the subject. Given the historic importance of governance issues for private equity, it is not surprising that the majority of managers (56%) point to this as their top area of concern (Figure 11). It stands in contrast with the views of institutional investors as a whole, according to our 2019 report "ESG to SDGs: the road ahead," where most investors (51%) cited environmental issues as their main area of ESG focus. Private equity managers presumably see governance as the essential starting point for driving change in a company, whether addressing environmental and social issues, or traditional operational and financial challenges.

We also see difference in the relative weightings of E, S and G across different geographies. Private equity managers in North America (61%) and Asia-Pacific (71%) report that they prioritize governance topics over both environmental and social factors by even wider margins than in Europe. In addition, European managers are nearly twice as likely as those in North America or Asia-Pacific to cite the environment as their top concern.

Figure 11: What area of ESG gets the most attention?

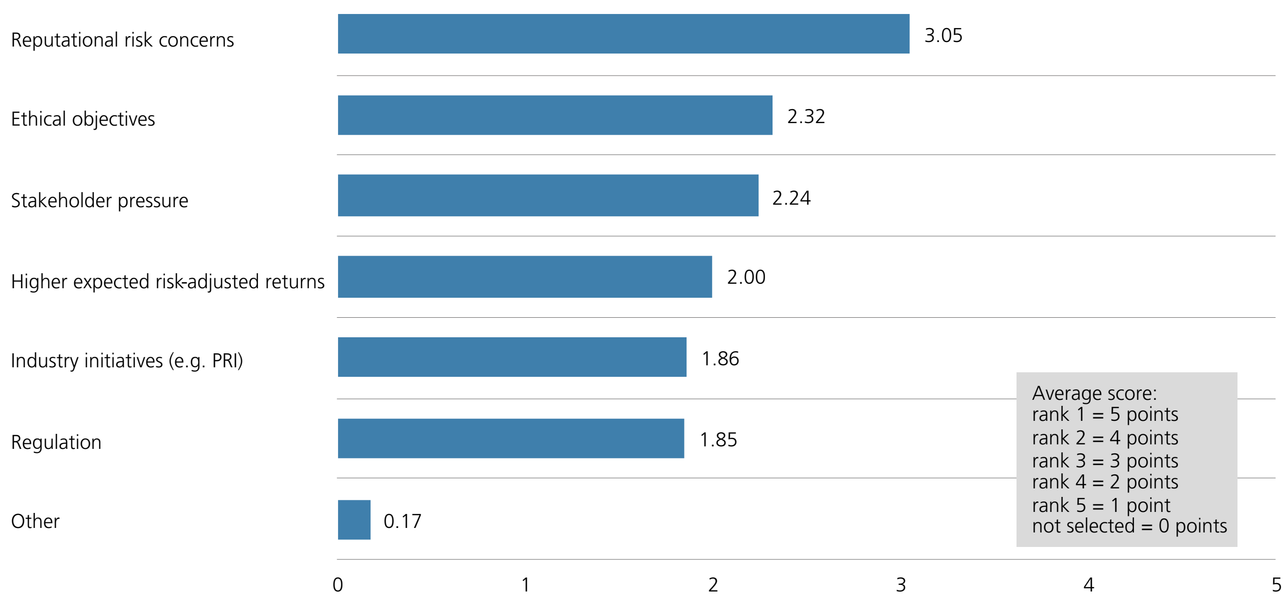


4. ESG drivers and future development

The most important ESG drivers for managers

Managers face many different pressures to incorporate ESG into their investment decision-making, so we wanted to know which ones were the strongest. Reputational risk stands out as the most important driver, followed by ethical objectives, stakeholder pressure and higher expected risk-adjusted returns (Figure 12). Undoubtedly, the growing importance of social media and a 24-hour news cycle keep reputational concerns at the forefront of managers' minds. At the same time, the relative strength of ethical objectives as a driver confirms the notion that a large proportion of managers see ESG as an effective way of linking investment decision-making to their values. Finally, the ranking of stakeholder pressure among their top three shows that managers are operating in an environment where investors have high expectations on ESG. Integrating these factors into their investment decision-making allows managers to respond to many different pressures and opportunities simultaneously.

Figure 12: What are the most important drivers of ESG integration?

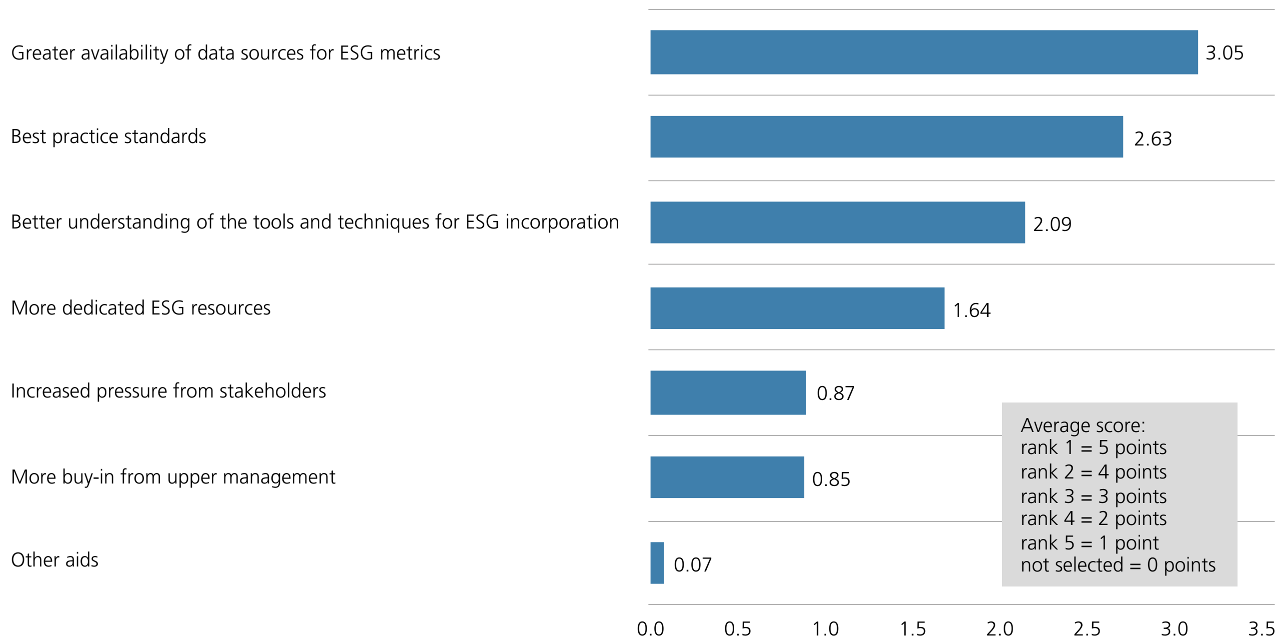


How to deepen ESG considerations in investment decision-making

When private equity managers think about what would help them most in developing their approaches to ESG, two things stand out: better data sources for measuring ESG factors and best practice standards (Figure 13). This is consistent with the discussions frequently taking place at ESG industry conferences, where corporate reporting standards and sources of consistent, comparable data are often on the agenda.

The latter is especially a challenge for private equity managers, who typically cannot make use of the many well-established sources of ESG data available to managers of listed assets. To address this, some industry bodies are exploring ways of creating common standards for information exchange. For example, in 2019, the Institutional Limited Partners Association (ILPA) released its Portfolio Company Metrics Template, which includes a section on ESG, and the International Finance Corporation (IFC) launched its Operating Principals for Impact Management, which seeks to establish standards for impact investing. The year before, the Principles for Responsible Investment (PRI) published its report "ESG Monitoring, Reporting and Dialogue in Private Equity" in an effort to move the discussion forward within private equity.

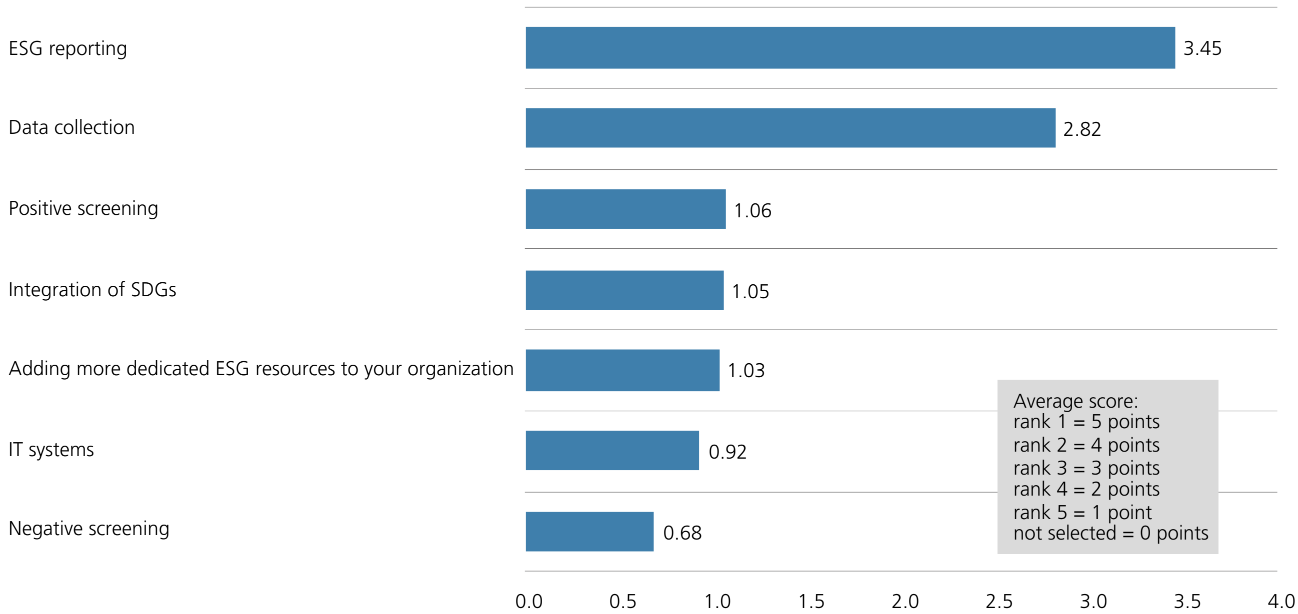
Figure 13: What would aid in the further integration of ESG into investment decision-making?



Where managers are planning to enhance ESG practices

Private equity managers see improving their reporting on ESG (Figure 14) as their top priority, which could be connected to their need identified in Figure 13 for better ESG data sources. This is consistent with what we have seen in the ESG assessments we carry out each year of the managers who partner with us in private equity.[2] They typically begin their ESG journey by integrating ESG into their investment due diligence process and subsequent portfolio management, and they build up their reporting capabilities over time.

Figure 14: Where are you planning to enhance ESG practices?



[2] LGT CP ESG Report 2019

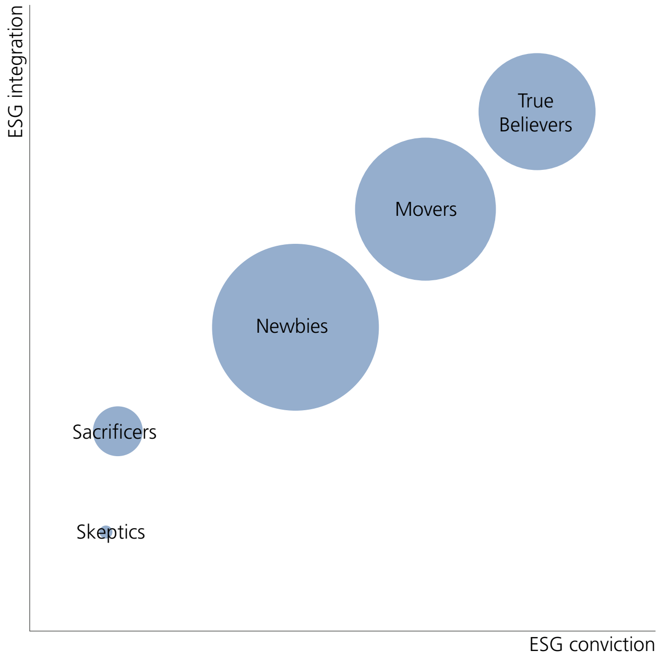
"The five ESG archetypes represent a broad range of views and practices, but each one represents a fairly consistent set of thinking and actions on ESG"

5. ESG archetypes

The responses we have collected from 117 private equity managers in the US, Europe and Asia-Pacific give us an opportunity to examine more than simply their responses to individual questions. We also analyzed the correlations between answers on various themes – such as ESG experience, decision-making relevance, stakeholder concern and the effect of ESG on risk-adjusted returns. Doing so enabled us to create groupings of managers with similar views on these four topics, which provide a richer picture of ESG beliefs and practices.

Five different manager archetypes emerged from this analysis, as shown in Figure 15. They are arranged according to their level of ESG integration (as measured by ESG experience and reported relevance to investment decision-making) and conviction (as measured by the level of stakeholder concern and their belief about the effect of ESG on risk-adjusted returns). The size of the bubbles indicates the relative size of the groups, with the Newbies being the most numerous and the Skeptics being the fewest in number. Skeptics score lowest on both ESG integration and conviction, while True Believers score the highest on both. In between the Skeptics and True Believers are three other types who have varying ESG views and practices.

Figure 15: Five ESG archetypes



Key characteristics of the five archetypes

The five ESG archetypes represent a broad range of views and practices, but each one represents a fairly consistent set of thinking and actions on ESG:

- **Skeptics** – As the name suggests, this group has the least engagement with ESG. They have virtually no experience of integrating it into their investment activities, their investors are not interested in the topic, and it has little if any relevance to their investment decision-making. They are also convinced that ESG negatively impacts risk-adjusted returns.
- **Sacrificers** – This group has somewhat concerned stakeholders, some experience with ESG, and finds it relevant to their decision-making. Nevertheless, they are convinced that ESG has a negative effect on risk-adjusted returns, so they willingly forgo a certain amount of risk-adjusted return for the sake of ESG.
- **Newbies** – These managers have only recently begun integrating ESG into their investment activities, and they say it is relevant to their decision-making. They also have stakeholders who are concerned about it, but they do not think integrating ESG factors has any effect on risk-adjusted returns. This group of managers are likely taking their first steps on ESG and may not have enough experience to hold strong views on the risk-adjusted return question.
- **Movers** – This group is similar to the Newbies in terms of stakeholder concern and ESG relevance in their decision-making, but they have more experience in integrating ESG and appear to be moving toward greater integration over time. Perhaps guided by their greater experience in the topic, they are convinced that ESG enhances risk-adjusted returns.
- **True Believers** – These managers have unequivocally embraced ESG, as it plays a significant role in their decision-making and they have investors who are very concerned about it. They have significant experience with ESG, and they are convinced of its positive effects on risk-adjusted returns.

Figure 15 suggests a fairly linear relationship between ESG integration and conviction, which makes intuitive sense, as you would expect rising integration to follow rising conviction. The data also shows that Newbies are the single biggest group, followed by the Movers, so there is still much ESG integration work to be done by private equity managers. At the same time, there are very few Skeptics and Sacrificers, who remain unconvinced about the ability of ESG to mitigate risk and identify opportunities. Understanding these archetypes and their relative sizes in the ESG landscape may be useful to those who are allocating to private equity, as it can help them to identify the ESG orientation of the managers they are evaluating.

Figure 16: How the five archetypes compare

	ESG experience	Level of stakeholder concern	ESG decision-making relevance	Belief about ESG and risk-adjusted returns
Skeptics	0	0	+	↘
Sacrificers	+++	++	+++	↘
Newbies	+	++	+++	→
Movers	+++	+++	+++	↗
True Believers	++++	++++	++++	↗

0 = None   + = Low   ++ = Some   +++ = Medium   ++++ = High   Negative effect = ↘   No effect = →   Positive effect = ↗

6. Manager views on the Sustainable Development Goals

The Sustainable Development Goals (SDGs) have gained increasing attention in the last several years, with many managers exploring how to embed the goals into their ESG frameworks. The collection of 17 global goals was put forward by the United Nations and approved by 193 countries in September 2015. The SDGs address topics like poverty, hunger, health, education, climate change, gender equality, water, sanitation, energy, environment and social justice. Achieving them is estimated to require investment of USD 5 to 7 trillion per year until 2030.[3]

Some private equity managers are turning to the SDGs in order to make their sustainable investment activities more outcome-oriented. Initially, ESG efforts focused mainly on establishing policies and processes, as well as providing basic reporting, whether qualitatively or through a selection of ESG-related key performance indicators (KPIs). Typically, there has been far less focus on how investments impact the broader environment or society as a whole. Increasingly, investors want to see how their capital is being used to affect the bigger picture, and the SDGs enable managers to measure impact on achieving targets that have been globally agreed and quantitatively defined.

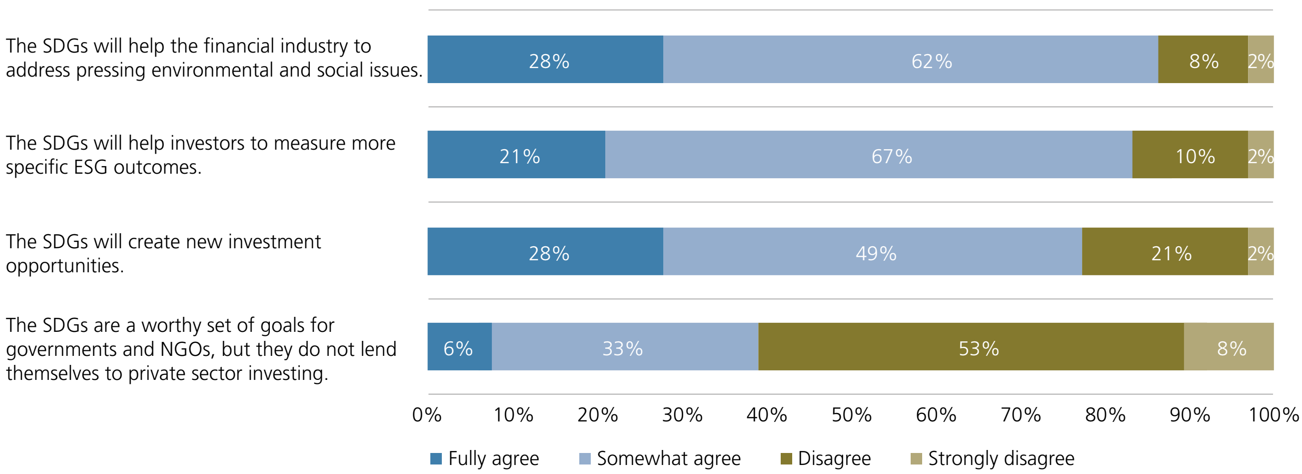
The complication is that the SDGs were never designed as an investment framework, but rather as a set of environmental and social goals for the world, defined by governments. Managers have the challenge of translating the goals into investable opportunities that offer the prospect of a financial return, as well as a positive impact on the SDGs. Some managers have already started translating the SDGs into their own investment frameworks, while others have started making SDG-targeted investments. In order to understand where private equity managers stand as a group, we asked survey respondents to share their thoughts and future plans regarding the SDGs.

Expectations for the SDGs within the financial industry

The SDGs have only recently begun to gain traction among private equity managers, but our survey shows that most have high expectations for the goals. A full 90% believe (Figure 17) that the SDGs will help the financial industry to address pressing environmental and social issues. A similarly large proportion, 88%, think the goals will help managers to measure more specific ESG outcomes. A slightly smaller but still significant majority (77%) think the SDGs will create new investment opportunities.

By contrast, only a small minority (6%) strongly believe that the SDGs do not lend themselves to private sector investing, while 33% have some doubts over the usability of the SDGs for private sector investing. This reflects the challenges involved in adapting the SDGs to the requirements of managers, who need the ability to carefully measure impact while achieving a financial return.

Figure 17: What are your expectations for the SDGs within the financial industry?



[3] United Nations, "Financing for SDGs", 2018

SDG integration

Many private equity managers have already taken concrete steps to help turn the promise of the SDGs into an investable reality. More than a quarter of them (28%) integrate the SDGs into their investment activities in some way, as seen in Figure 18, while 18% say they are already reporting on the SDG impact. Even more telling is the large proportion of managers who are planning to start integrating (34%) and reporting (41%) on the SDGs in the next two years.

The survey also shows that many managers have begun incorporating the SDGs into their investment processes. Some 19% said they assess the impact of investee companies on the SDGs, and a similar proportion (18%) map their existing ESG metrics to the SDGs. As the two approaches represent basic starting points for SDG integration, it seems that many private equity managers have gotten a strong start in adopting the framework.

These numbers are broadly in line with what we at LGT CP have seen in the market, where many investors are talking about the SDGs, defining taxonomies and mapping their existing investments to them. If the managers surveyed in our study realize their ambitions, the majority of them will be both integrating and reporting on the SDGs within the next two years.

Resources used to address SDGs

Given the scope of the SDG challenge, many managers are considering the team resources that will be required to engage with the goals effectively. The vast majority of private equity managers (68%) are using, or planning to use, their current ESG team to address the SDGs (Figure 19), and a large proportion (58%) are also collaborating with external consultants. Just over a quarter of managers (26%) said they are still defining the set-up, which reflects the fact that many managers are still early in their engagement on the SDGs.

Figure 18: How are you integrating the SDGs?

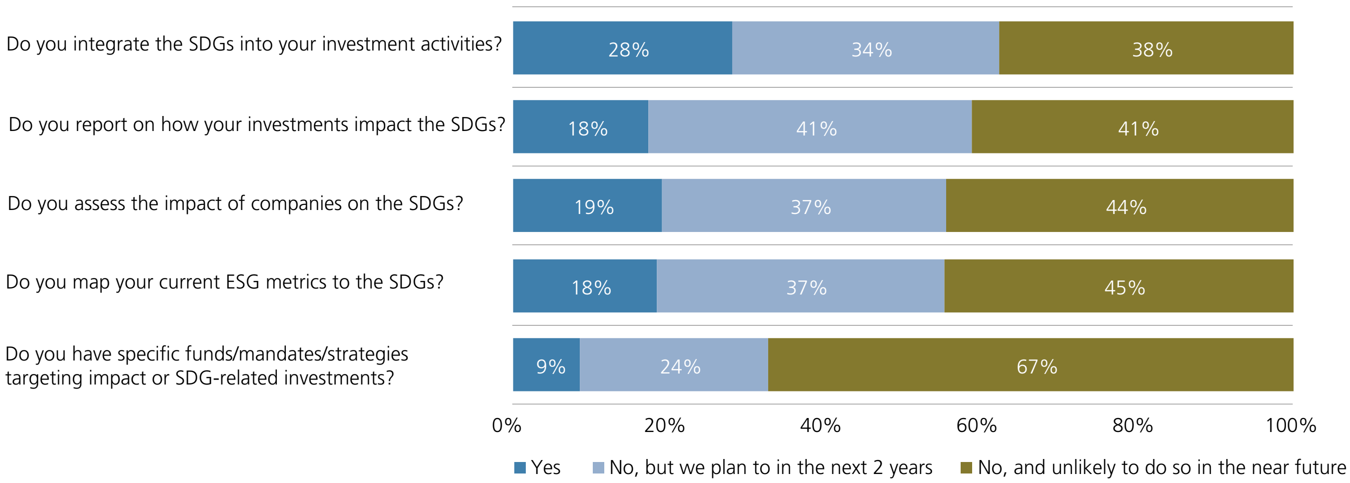
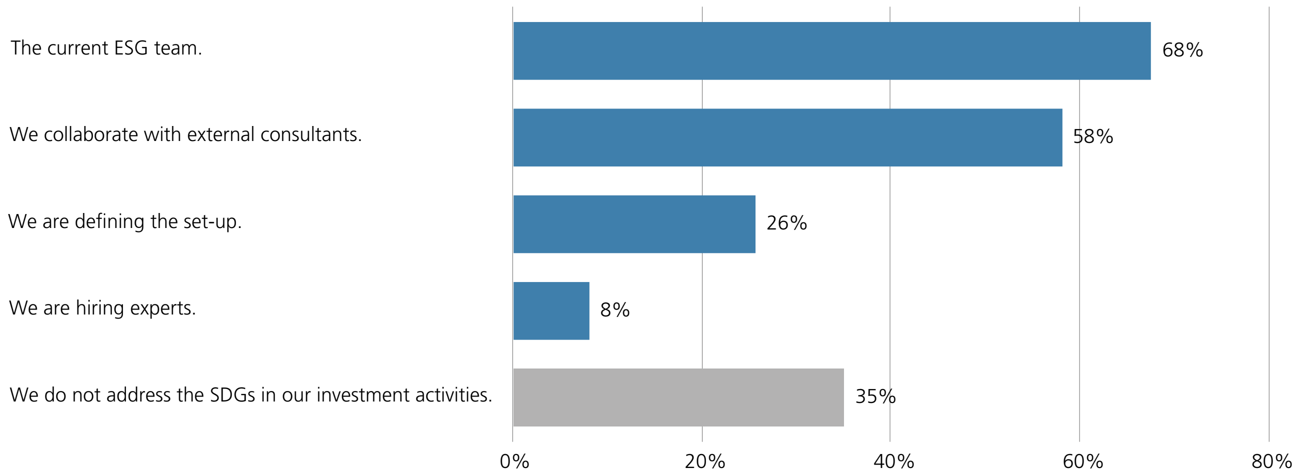


Figure 19: What resources do you use to address the SDGs?



The most important SDGs for managers

Private equity managers have clear preferences for certain SDGs, similar to their strong focus on select ESG topics highlighted in section 2 of this report. As Figure 20 shows, Decent Work and Economic Growth (Goal 8) and Good Health and Well-being (Goal 3) rank the highest among manager priorities, followed closely by Responsible Consumption and Production (Goal 12) and Climate Action (Goal 13). Three of these – 3, 13 and 8 – are also most often cited as the number one focus area for managers, as shown in Figure 21.

If there is a common denominator in views on the SDGs, it is a preference for goals that can be linked to a specific investment thesis or set of opportunities. For example, it is easy to imagine investments in companies that will contribute towards economic growth, healthcare solutions, sustainable production or new green technologies. By contrast, goals such as Peace, Justice and Strong Institutions (Goal 16) are not readily investable, while others, such as Life Below Water (Goal 14) and Life on Land (Goal 15) have a significant focus on conserving and protecting specific types of ecosystems. Investment opportunities related to such activities may be more indirect, making it difficult for managers to incorporate them into their investment decision-making.

Figure 20: What are the most important SDGs for you?

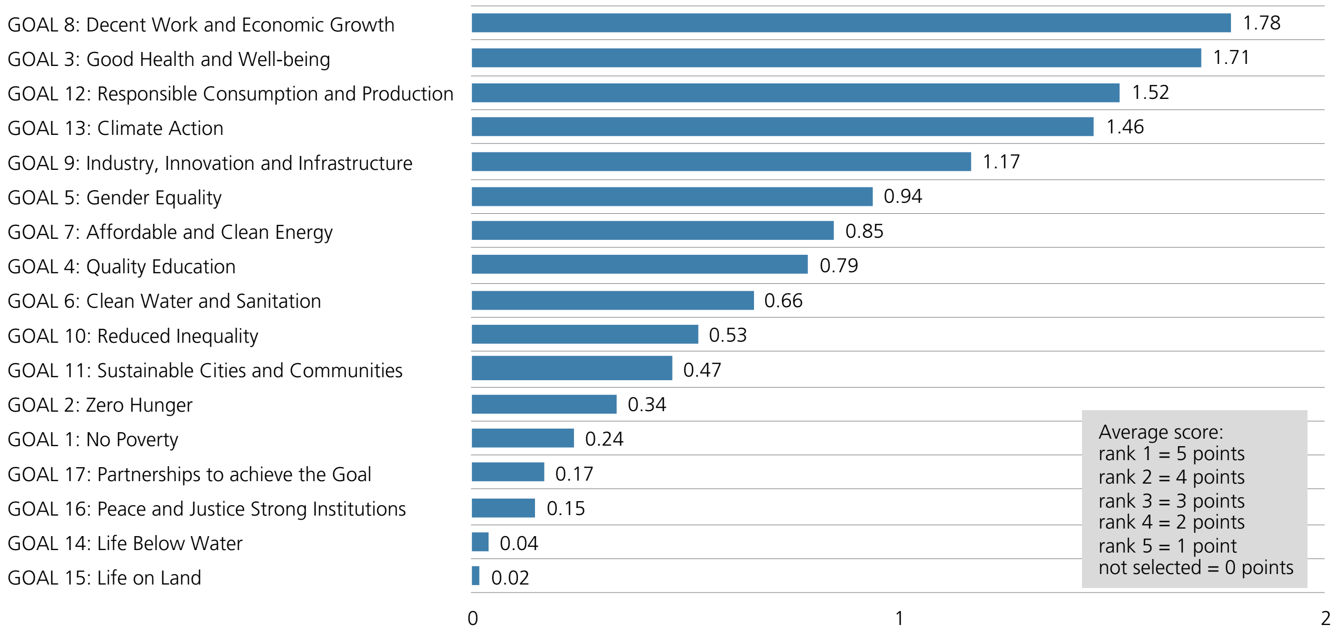
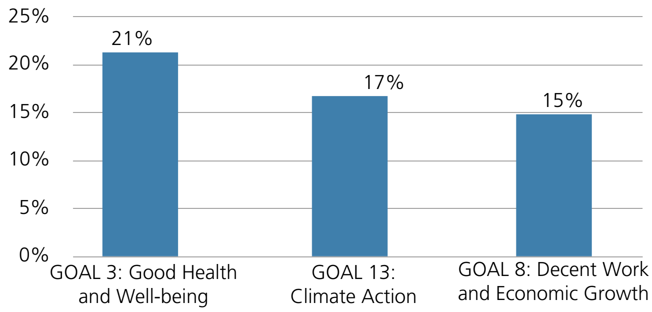


Figure 21: What is your number one SDG?



7. Conclusion

In this study, we have explored the views of 117 private equity managers on ESG and the SDGs. It has given us a snapshot of current practices and beliefs and provided a glimpse of the way ahead for future developments.

Most managers surveyed (76%) say that ESG is relevant to investment decision-making, and a similar proportion (70%) demonstrate their conviction through a willingness to decline investments over ESG concerns. Among this global group of managers, views vary on the effect of ESG considerations on risk-adjusted returns. A significant majority of 90% believe that integrating ESG has either a positive or neutral effect on risk-adjusted returns, while 10% think that ESG entails a sacrifice in risk-adjusted returns.

When integrating ESG factors into their investment decision-making, managers prioritize certain ESG topics over others. Among environmental concerns, climate change stands out as the top issue among managers, by a wide margin. They hold more diverse views on social factors, while bribery and corruption is the single most important governance issue among managers. Overall, we found that the majority of private equity managers (56%) consider governance issues to be the most important ESG factor, which differs from institutional investors, where the majority (51%) prioritize the environment.

As managers have begun looking to the SDGs in order to make their sustainable investment activities more outcome oriented, they have high expectations for the goals. Most managers (90%) believe that the SDGs will help the financial industry to address pressing environmental and social issues, and 77% think they will create new investment opportunities.

Looking ahead at how managers are likely to adopt the SDGs in their investment practices, it is clear that Decent Work and Economic Growth (Goal 8) and Good Health and Well-being (Goal 3) will be their top priorities. Overall, we see a preference for individual SDGs that can be linked to a clear investment thesis or opportunity.

We are excited about the new opportunities that will emerge as ESG and the SDGs evolve, and we look forward to continue partnering with private equity managers to turn their ambitions into reality.

8. Survey participation

Our ESG survey of private equity managers included 117 participants from the US, Europe and Asia-Pacific. They shared their views on the role of ESG in investment decision-making, the top ESG issues, their motivations for ESG integration and their priorities for the future, including for the SDGs.

Participants were largely senior decision-makers, including a large proportion of C-level professionals and investment managers.

Participants also represented institutions of all different sizes, ranging from less than USD 500 million in assets under management to more than USD 5 billion.

Figure 22: Positions of survey participants

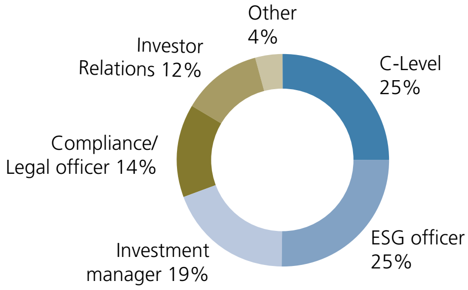
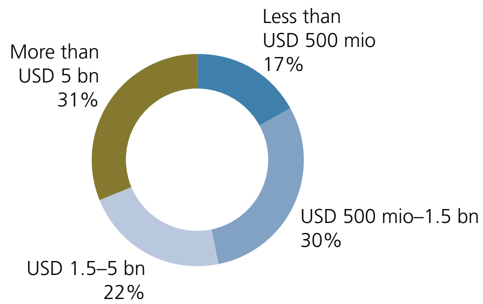


Figure 23: Assets under management



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