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Critical Success Factors for ESG Integration in Mid-Market Private Equity

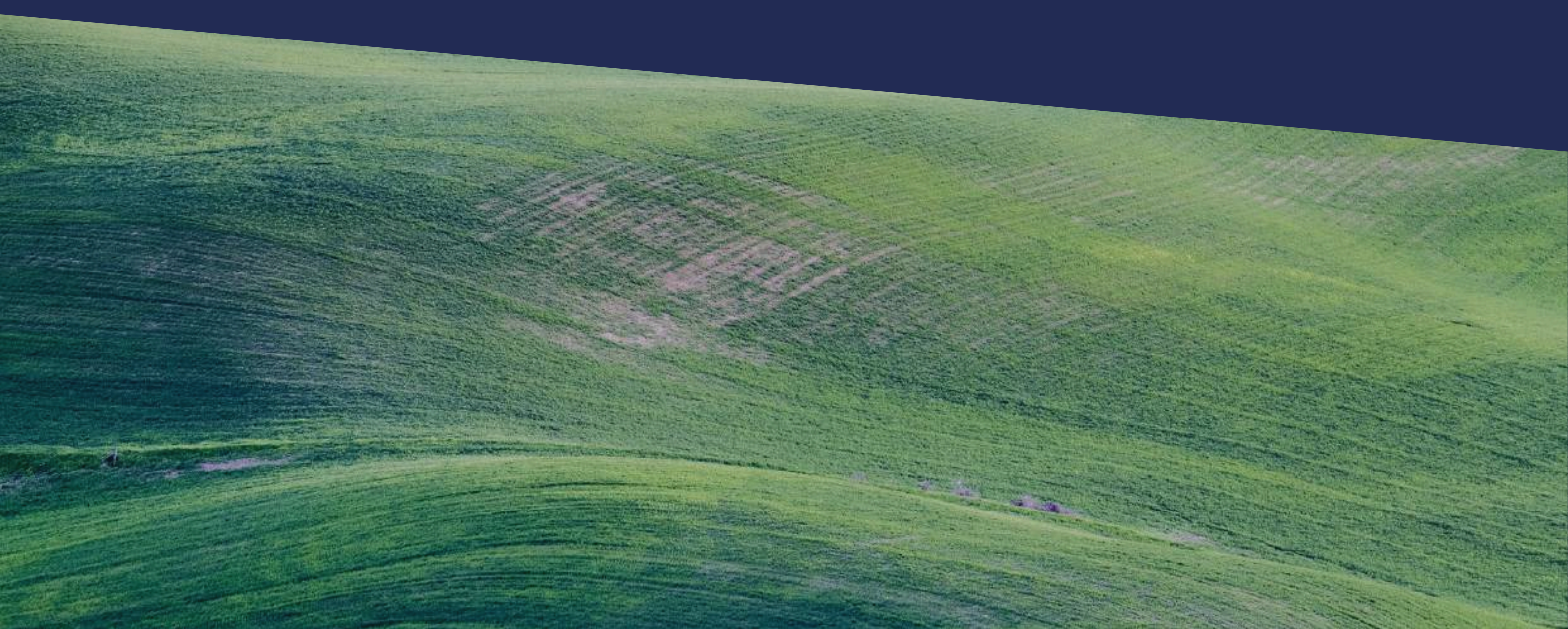

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Table of Contents

What's Driving ESG Integration in Private Equity

Section Summary

There are 2 factors driving ESG Integration in Private Equity today:

Factor 1:
Investor (LP) Priorities

Factor 2:
Evolving Regulatory Requirements

The Private Equity (PE) market has seen greater adoption of Environment, Social, & Governance (ESG) in these past four years than ever before. Today, PE firms are highly motivated to integrate ESG considerations at the firm & portfolio company (PortCo) level, primarily because of:

Factor 1:
Investor (LP) Priorities - ESG Reporting & ESG Integration:

What the Market has Shown Us:

Rise in LP Data Requests

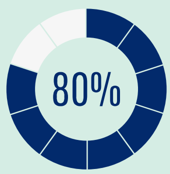
General Partners (GPs) globally are reporting a rise in Limited Partner (LP) requests for ESG data in Due Diligence Questionnaires (DDQs). This data provides critical insights into how a company is responding to emerging societal and climate risks.

LPs Mandate ESG Data Collection During Fundraising

In some cases, LPs are even placing ESG data collection conditions on their investment commitments, leaving GPs with no choice but to comply. Our PE clients are sharing that a frequent LP requirement during fundraising is a commitment to portfolio level ESG data collection by the GP.

LPs now consider ESG central to their investment decisions

Over 80% of LPs now consider ESG factors central to their investment decisions, according to a report by the UN Principles for Responsible Investment (PRI). In 2021 alone, half of total fundraising flowed into firms with formal ESG policies, underscoring the growing importance of ESG in private markets.



of LPs now consider ESG factors central to their investment decisions

In fact, our experience with PE clients confirms that LPs are now applying sophisticated scoring mechanisms to score current & potential fund managers' performance on ESG, further influencing future fundraising allocations.

Increased Management Fees

According to a PwC Survey, LPs are willing to absorb between 5% and 9% in management fees if there are **quality improvements** in their GPs' ESG data reporting practices.

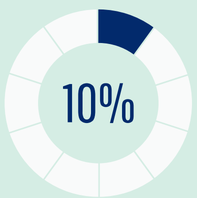
'Quality improvements' Include:

- Improvements in a PE firm and its PortCos' data coverage & accuracy
- Access to trends & visualizations for analysis at all level
- Benchmarked ESG data to evaluate performance against a set of sustainability metrics relative to peers

Factor 2:
Evolving Regulatory Requirements - ESG Compliance & ESG Integration:

Globally, regulators are demanding greater transparency around how companies and funds incorporate ESG considerations their business and address sustainability concerns. In response, GPs are exploring how to report on new requirements from regulations such as the Sustainable Finance Disclosure Regulation (SFDR) and the Corporate Sustainability Reporting Directive (CSRD).

Despite their efforts, GPs continue to feel the pressure of the evolving regulatory landscape. According to a 2024 Accenture Survey, most respondents did not feel ready to meet many new regulatory requirements: Only 22% reported feeling well prepared to disclose climate-related risks and opportunities, and only 10% felt well prepared to meet these reporting requirements in all sustainability areas, such as resource use and circularity.



Only 10% reported being well prepared to meet these reporting requirements in all sustainability areas

This, along with the fact that GPs globally are expecting an increase in mandatory disclosures over the next three years, builds a strong case for PE firms to prioritize:

1. Understanding the impact of existing and emerging mandates across their value chain
2. Taking the critical steps required for effective firm-wide ESG integration, ESG reporting, & ESG compliance

Table 1 below provides an overview of the most relevant ESG disclosure regulations and standards for Private Markets, as of July 2024.

Table 1

Body	Framework	Description	Foundation	Focus Areas
Regulatory				
European Commission	Sustainable Finance Disclosure Regulation (SFDR)	Transparency in relation to sustainability risks, consideration of adverse sustainability impacts in investment processes and the provision of sustainability-related information with respect to financial products	• EU Taxonomy • EU Green Deal • UN SDGs • Paris Agreement	• Sustainability risk policies • Adverse sustainability impacts • Remuneration policies
Standard Setters				
ESG Data Convergence Initiative (EDCI)	Metrics selected from the most accepted and widely regarded frameworks	Industry-led partnership of private equity stakeholders committed to streamlining the industry's approach to collecting and reporting ESG data	• TCFD • SASB • GRI • WEF • SFDR	• Emissions • Renewable energy • Diversity • Work-related accidents • Net new hires • Employee engagement
Institutional Limited Partners Association (ILPA)	Diversity in Action (DIA) Framework	Concrete actions for private market participants to advance diversity, equity, and inclusion	N/A	• Foundational activities for carrying out, communicating, tracking, and advancing DEI within an organization • Required for signatories of ILPA's DIA Initiative, and broadly applicable to those outside of it
International Sustainability Standards Board (ISSB)	IFRS S1 for general requirements IFRS S2 for climate requirements	Objective to deliver decision-useful information to investors, lenders, and creditors Individual jurisdictions may decide to require or permit application of ISSB standards as a basis for sustainability reporting	• TCFD • SASB • CDSB • IIRC • WEF	• Sustainability-related risks and opportunities • Industry-specific disclosures • Disclosure of transition planning and scope 1-3 emissions when material • Points to sources of guidance to meet investor needs • Financial effects over the short, medium, and long term

Challenges to ESG Integration

Evidently, LPs and GPs recognize sustainability as a strong value driver but, despite evolutions in regulation and investor priorities, sustainability still isn't mainstream. This is because:

ESG encompasses a wide array of topics

ESG encompasses a wide array of topics, from climate change and sustainability to diversity, human rights, consumer protection, and corporate governance. Depending on specific circumstances, certain ESG factors may greatly influence PortCos and funds, while others may not. Because of this, GPs struggle to prioritize which ESG metrics to report on at all levels (The Metrics Working Group)

Mid-market PE firms have limited data collection, analysis, and aggregation capabilities at the fund level

LPs are requesting disclosure of ESG data at multiple levels, including the PE firm itself, its PortCos' aggregated data, and individual PortCo level data. Additionally, this data becomes difficult to compare if all industries and companies are placed in the same peer group. (The Metrics Working Group).

It is difficult for PE firms to collect complete, consistent, and reliable ESG data

GPs must commit valuable time and resources to obtain and measure ESG data from PortCos. In parallel, LP priorities and regulatory requirements are putting pressure on PE firms to build more sophisticated data collection and reporting capabilities. This can be an overwhelming process for GPs of mid-market PE firms, who consistently report lacking internal resources for handling ESG data collection and needing guidance around ESG data collection methods.

The situation gets more complex given that a PE firm's ability to collect ESG data is driven by its PortCos' ability to prepare requested data, as well as the PE firm's influence and degree of control over the PortCo. Even having a controlling interest does not mean the PE firm controls the day-to-day activities of a PortCo, or has direct access to the required information. In short, mid-market PE firms struggle to collect complete, consistent, and reliable ESG data. (The Metrics Working Group)

In this Guide for GPs, we will delve into how you can use **three Critical Success Factors (CSFs)** to effectively address these challenges to ESG integration.

Read our Industry Report on GP Sentiments around LP Data Requests to learn more.

Learn More >

Critical Success Factors for ESG Integration in Mid-Market Private Equity Firms

Section Summary

The three **CSFs** for firm and PortCo-wide ESG integration are summarized below:

Critical Success Factor #1:
Build a Robust ESG Integration Strategy & ESG Policy

Critical Success Factor #2:
Choose Decision-Useful Sustainability Metrics to Meet Your ESG Goals

Critical Success Factor #3
Invest in ESG Resources for Best-in-Class ESG Reporting & Compliance

CSF #1:
Build a Robust ESG Integration Strategy & ESG Policy

To remain competitive, GPs need to be intentional about incorporating ESG factors into business practices, and be agile in meeting changing expectations. As a first step, focus on establishing a robust ESG integration strategy and policy to stay ahead of your LP DDQs and regulations. An ESG integration strategy (a.k.a ESG strategy) is a broad term used to describe how an organization integrates ESG considerations into its investment portfolio and decision-making processes.

Why Does it Matter?

- Fundamentally, ESG considerations lead to better risk management and value creation by helping investors account for material risks—such as climate change or looming regulatory requirements—and identify opportunities to increase the profitability of PortCos.

- While every GP has its own investment philosophy and investment process, having an ESG strategy that embeds sustainability across the investment lifecycle can enable your firm to make the following gains at each stage (see Table 2 below):

Table 2

Pre Investment	Post Investment	Exit
Pre-investment, ESG information can provide insight into how companies account for existing and emerging risks material to the business, which produces a more comprehensive due diligence assessment. Some material risks could look like waste and water management for a manufacturing company or privacy and data security concerns for technology companies. How a company is preparing for the impact of climate change on business activities is also a necessary consideration as collapsing ecosystems create significant operational risks.	Post-investment, ESG can inform how GPs engage with portfolio companies to mitigate operational and reputational risks, drive bottom-line impact, and improve the valuation upon exit. According to McKinsey, rising operating expenses can affect operating profits by as much as 60%, and ESG implementation can help mitigate these rising expenses. In fact, the specific initiatives and support that a firm may prioritize will vary based on the PortCo's materiality, and tailored to its unique opportunities for value creation.	In a 2021 EY study, 72% of PE executives said they expect an ESG premium in companies they are considering exiting. As mentioned in the previous section, a company's ESG performance can impact its valuation, and GPs that have alread engaged portfolio companies on ESG will be able to better answer long-term sustainability questions. Adapted from Novata

As mentioned, **material ESG risks have shown to lower company valuations in 80% of cases** and can even turn into a deal-breaker. Vice versa, companies with strong ESG fundamentals tend to outperform their counterparts on their EBITDA margin by up to 21%, and have less systemic risk exposure, lowering the firm's cost of capital and translating into a valuation premium (Accenture). For this reason alone, an ESG strategy and resultant ESG policy that incorporates ESG considerations into decision-making processes is a crucial lever to pull for your stakeholders.

21%

Companies with strong ESG fundamentals tend to outperform their counterparts on their **EBITDA margin by up to 21%**, and have less systemic risk exposure, lowering the firm's cost of capital and translating into a valuation premium

What Can You Do?

Step 1.
Establish a Stakeholder-Led ESG Policy Development Process

You can do this by:

Table 3

Identifying your Stakeholders	Defining your Stakeholders' ESG Requirements	Identifying Every Stage of the Investment Process where ESG Factors Could Be Relevant
Typically, GPs have the following Stakeholders: 1. Your LPs 2. Your PortCos 3. Your Employees 4. Any other stakeholders unique to your specific business	Ask each of your stakeholders what ESG topics are material to them. Since your PortCos will have different levels of maturity on ESG, you must be prepared to help them understand their ESG requirements. Additionally, It might be difficult to engage directly with your LPs for their ESG requirements, so the best way to retrieve this information is via their DDQs. Regardless of the approach, GPs must clarify the data collection expectations that they have from their PortCos in order to enhance data coverage rates.	Generally, ESG factors can be relevant in the following stages of the investment lifecycle: **Stage 1: Pre-Investment** Stage 1a: Screening Stage 1b: Due Diligence Stage 1c: Investment Decision (quantify ESG-related risks & opportunities via risk scores) **Stage 2: Holding Period** Stage 2a: Monitoring Stage 2b: Rebalance **Stage 3: Exit Phase** Stage 3a: Exit Plan

This first step will guide your vision for ESG integration and ensure that your ESG policy is relevant to the concerned stakeholders. Following this, the second (and arguably most impactful) step (i.e. CSF #2) will anchor your ESG policy in LP demands and regulatory requirements by helping you:

CSF #2:
Choose Decision-Useful Sustainability Metrics to Meet Your ESG Goals

Why Does it Matter?

Identifying the type of ESG data that needs to be collected is critical to investment analysis and PortCo management. Today, ESG metrics have become highly relevant because:

- **LPs** now use them to monitor progress on ESG for invested funds and underlying PortCos
- **PE Firms** (GPs) need them for compliance with evolving sustainability regulations and LP demands
- **Deal Teams** now rely on them (along with financial and operational metrics) during due diligence processes for investment decisions
- **PortCos** use them to drive action and become more transparent among their stakeholders (customers, boards, GPs). Since PortCos are usually the main source of data for most ESG metrics, a major point of interest for GPs is maximizing ESG data coverage from their PortCos. However, materiality factors such as geography and regulation, ownership and influence, and investor data requests, makes this a complex goal to achieve.

What Can You Do?

Step 2.
Asses where You and Your PortCos Stand on Key Materiality Factors

As discussed in the Introduction of this Guide, one of the biggest challenges to ESG integration in PE is prioritizing which ESG metrics to report on, at all levels. To address this challenge, a best practice is to first assess where you and your PortCos stand on the three materiality factors known to influence a PE firm's decision on which ESG metrics to report on (see Image 1 below):

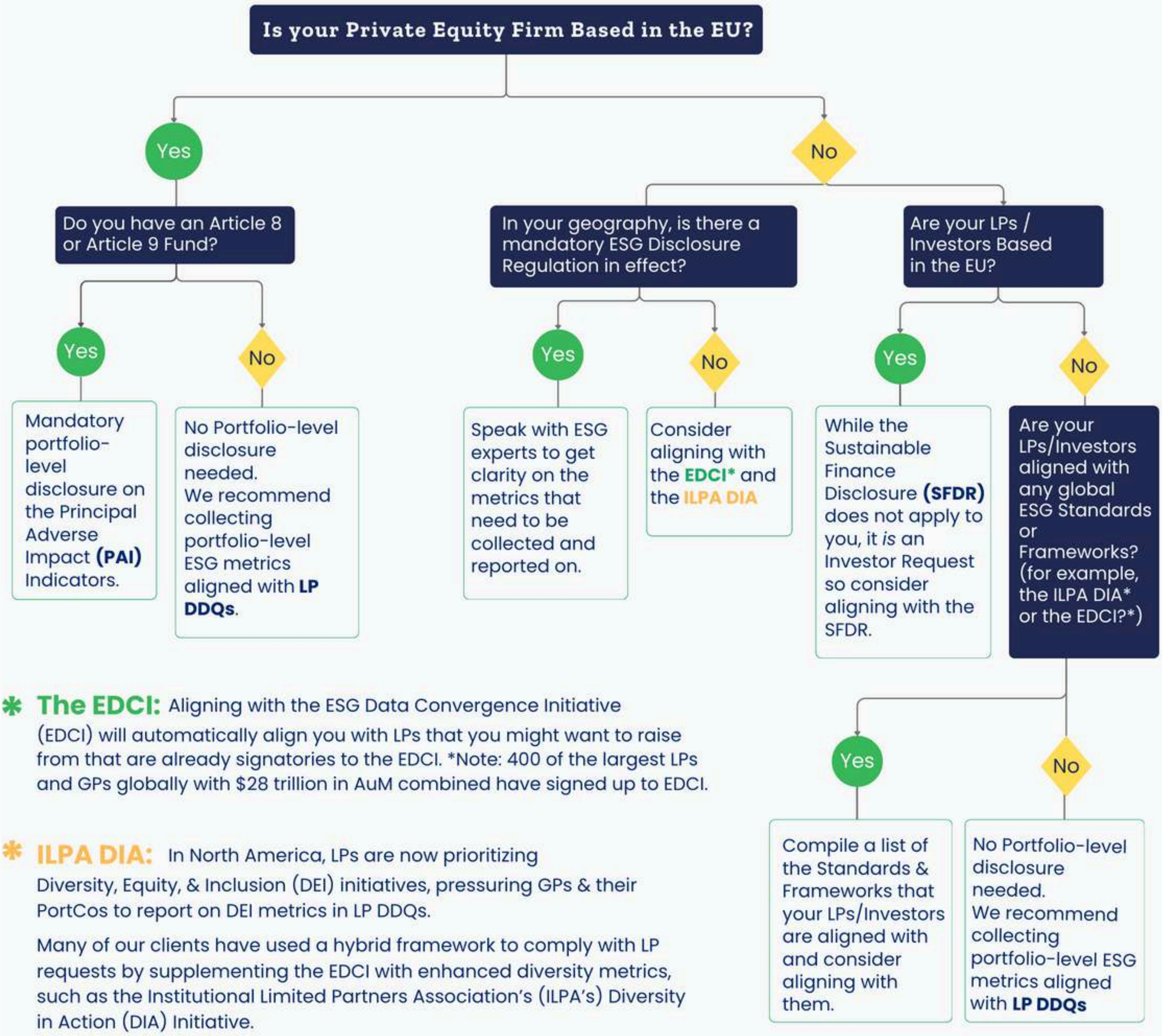
Image 1

Step 3
Apply an Industry-Specific Lens to Choose the Right Metrics & Sustainability Frameworks

- Once the context is established in Step 2, PE firms can then apply an industry-level lens to selecting decision-useful ESG metrics. This can be done by first identifying the relevant industries across your firm's value chain, and then leveraging the SASB Materiality Finder (now part of the IFRS ISSB Standards) to help you quickly find the ESG metrics and disclosure topics that are material to your and your PortCo's industry.

- You can supplement Steps 2 and 3 by using our embedded Decision-Tree below (Image 2) to assess which regulations and sustainability standards apply to your specific use-case.

Image 2



✱ **The EDCI:** Aligning with the ESG Data Convergence Initiative (EDCI) will automatically align you with LPs that you might want to raise from that are already signatories to the EDCI. *Note: 400 of the largest LPs and GPs globally with $28 trillion in AuM combined have signed up to EDCI.

✱ **ILPA DIA:** In North America, LPs are now prioritizing Diversity, Equity, & Inclusion (DEI) initiatives, pressuring GPs & their PortCos to report on DEI metrics in LP DDQs.

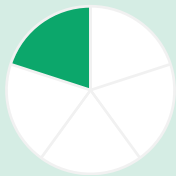
Many of our clients have used a hybrid framework to comply with LP requests by supplementing the EDCI with enhanced diversity metrics, such as the Institutional Limited Partners Association's (ILPA's) Diversity in Action (DIA) Initiative.

- In parallel, consider aligning your firm and PortCos with the global baseline for sustainability reporting, i.e. the IFRS ISSB Sustainability Disclosure Standards. These Standards also contain the SASB Materiality Finder that can further help you identify decision-useful and industry-specific ESG metrics for reporting.

- While Steps 1-3 are useful to GPs who are starting their ESG journey, they are just one part of the equation. You can develop a strong ESG strategy and policy and still not be able to operationalize it fully. [This is what most PE firms struggle with (Accenture).]

According to an Accenture Survey, most executives feel ill prepared to meet upcoming reporting and compliance requirements, with only one out of three European investment managers and one out of five North American investment managers reporting being confident about ESG integration in their fund's practices and policies. Oftentimes, GPs find themselves committing valuable time and resources to obtain and measure ESG data from their PortCos and end up spreading themselves thin.

only 1 out of 3 European investment managers



only 1 out of 5 North American investment managers

report being confident about ESG integration in their fund's practices and policies

ESGTree

How ESGTree Supports Mid-Market Private Equity Firms

As you get started on your ESG journey, investing in a technology platform can help you simplify your reporting processes. ESGTree's ESG reporting & compliance data management platform is designed to address the unique needs of private markets with a simple and customized solution to help you easily collect, report, and analyze ESG data. ESGTree provides:

- **A clear starting point** for GPs to confidently choose what to measure and track
- A straightforward data collection process with in-platform **guidance and support for PortCos**
- Data collection indicators aligned with **standardized frameworks**
- Insightful reporting and analytics to track and **manage ESG data across the portfolio** through benchmarked data
- **Value back to PortCos** to drive higher engagement on ESG via scorecards and/or annual refresher sessions on ESG
- **Expert guidance on ESG** integration and capacity building through Advisory and Client Success Services

Our goal is to help the market transition from perceiving ESG data collection as a "tick-the-box exercise" to truly integrating these metrics and factors into measurable and meaningful business drivers. However you decide to begin your ESG journey, we're here to support you with simple but powerful sustainability solutions.

To tackle the conundrum of operationalizing ESG policies and strategies and bringing the entire ESG integration effort full circle, GPs should:

CSF #3:
Invest in ESG Resources for Best-in-Class ESG Reporting & Compliance

Why Is it Important?

Emerging ESG standards and regulations are requiring entities to report on sustainability information in tandem with financial information. While Finance Teams are equipped to deliver on the latter, they may struggle to collect sustainability data. This is because ESG data collection requires inputs from all ends of the organization. This cannot be done without developing internal capacity and competencies for ESG.

What Can You Do?

Step 4:
Establish Designated Roles for Sustainability and Supplement Them with Technology

- Normally, smaller PE firms don't have a designated Head of ESG, so ESG is often subsumed under Finance, Compliance, or Investor Relations. Even in cases where PE firms do have a Head of ESG, they will be supported by at least one resource tasked with: manually creating templates for ESG KPIs, sending those KPIs to PortCos, liaising with PortCos, trying to get data back, version control, and then making sense of this data. As LP and regulatory requests get more sophisticated and complex, these manual processes become obsolete.

- To effectively execute the ESG imperative, PE firms need to build internal capacity. Larger firms tend to hire in-house sustainability teams that can coordinate and deliver on the many moving parts of the ESG data collection and reporting process. However, for Mid-Market PE firms (with less than $1 billion in AuM) this option is neither scalable nor economical. In fact, even for larger PE firms, this one dimensional human-centered approach will only take them so far in meeting their ESG integration goals.

- ★ The demand for talent with the expertise to collect, analyze, and report on ESG data is on the rise — and as the focus on ESG grows, private market participants expect these skills and capabilities to become core competencies across private equity firms.
- ★ However, Mid-Market PE Firms have cost & resource constraints, so for some firms this option may not be as economical or scalable.
- ★ Plus, improving and expanding in-house expertise takes time, and many firms are looking to start their ESG journey today.

- A better way to operationalize ESG integration goals is to adopt a hybrid approach that will enable you to retain a lean and efficient organizational model while ensuring scalability. So, instead of hiring an entire sustainability team, you can simply invest in a designated ESG resource and supplement that with an ESG automation and reporting platform that offers implementation support at the PortCo level. Building internal capacity in this way will likely lead to quality improvements in your firm's ESG reporting practices, increasing your chances of capturing an ESG premium during fundraising and/or exits (PwC).

- Many firms are looking to start their ESG journey today, so it is imperative they start building capacity now.

Step 5:

Select an ESG Reporting & Advisory Platform Using the Evaluation Criteria Below

Oftentimes, determining the fit of an ESG technology solution can be a difficult process. To make things easier for you, we've developed a list of capabilities and features to look out for when evaluating ESG reporting platform providers in Table 4 below:

Table 4

	General Capabilities	Specific Features
1	**Portfolio-level data collection & aggregation capabilities**	• Automated data collection at the firm and portfolio levels
		• Built-in guidance for portfolios to facilitate their understanding of and capacity development for the requested ESG metrics
		• Priority support for the firm and portfolio entities on platform usage or guidance regarding the metrics to report on
		• Ability to track the status of portfolio entities as they add data to the platform
		• Visibility and access to all the data provided by the portfolio entities

Sr#	General Capabilities	Specific Features
2	**Value creation opportunities at the firm and portfolio levels*** *This capability is instrumental in: operationalizing fund-level ESG goals across PortCos, managing ESG metrics at the PortCo level, and driving meaningful, auditable progress	• Ability to generate company specific scorecards for engagement • Ability to provide recommendations against each metric so portfolio entities can get a better sense of what they can do to improve
		• Ability to create custom benchmarks and hone in on performance metrics for every portfolio entity
		• Historical performance charting of every metric at the portfolio level
		• Ability to auto export data to client databases and data portals like EDCI
		• Trends analysis and visualizations by indicator, framework, and reporting periods
3	**Engineering support to ensure that overlaps in metrics are added only once**	• Ready to implement framework automations including SASB, IRIS+, TCFD, EDCI, PCAF, SFDR and more
		• Aligning data collection indicators with standardized frameworks
4	**Advisory and Customer Success (CX) support in identifying the right metrics**	• Add-on advisory services for ESG policy creation, strategy road mapping, training, capacity building, and reporting needs
		• Dedicated client success support from the Platform's team of experts

If you are looking for support, we can help connect you for a **complimentary consultation** with one of our **ESG experts** and get you started on your ESG journey today.

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An ESG Data Management & Reporting Solution for Private Markets

Our Industry Report on GP Sentiments around LP Data Requests revealed that tech-enabled service providers like ESGTree provide immense value to GPs by delivering flexible solutions that can:

Provide independent ESG assessments and benchmarks

Standardize the taxonomy of ESG

Offer GPs flexibility in adhering to different standards that are constantly changing

Every single GP that we interviewed in this Report admitted that if they had a centralized platform to house all the DDQs, it would help them give better quality answers, drive sounder ESG policies, and boost overall LP portfolio performance. Our proprietary software not only bridges the gaps experienced by GPs through DDQ automation, but its in-built collaboration tools allow for easy access to synthesized data across departments to drive the necessary organizational shifts to harness the power of ESG.

Key Finding

While a majority of GPs believe that ESG is a core value, 90% of them find investor DDQs to be excessive, repetitive, and inefficient. This frustration is exacerbated by the fact that 88% struggle to find effective ESG reporting solutions. (source: Independent ESGTree survey)

Demystifying LP DDQs through ESG Integration with ESGTree's Advisor Tanya Carmichael - Former chair of the Institutional Limited Partners Association **(ILPA)**

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