ESG and the Private Markets

Navigating the application of ESG in the private markets

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Introduction

As noted in our recent analyst note "The Double Bottom Line," the terminology and perceptions surrounding sustainable investing have hindered the smooth flow of capital within the investment industry, particularly in the United States. The first big wave of the movement came in the 1990s, with the Socially Responsible Investing (SRI) technique of screening companies out of portfolios for vice, health, or other reasons. Many saw this as a values-based approach that conflicted with maximizing financial returns. For example, while a tobacco company was selling an unhealthy but addictive product to consenting adults, it might also be a top-performing stock—thus introducing the dilemma of how to think about the trade-off between values and profits. Some came down on the side of investment returns, while others chose not to reward the company with their investment dollars.[1]

Many credit SRI practices for the collapse of apartheid in South Africa, as investors throughout the US divested themselves of investments in companies with significant South African operations. It took over two decades of international handwringing, but Congress passed the Comprehensive Anti-Apartheid Act of 1986 over President Reagan's veto. The movement had begun in 1962 with the United Nations Special Committee Against Apartheid, which called for, in a nonbinding resolution, imposing economic and other sanctions on South Africa. The widespread divestment of economic interests in the 1980s led to economic destabilization and eventually regime change in South Africa. In the US, this success was seen as an affirmation of the power of SRI, which led to a massive increase in investment products serving a wide spectrum of values-based investment approaches.

Fast forward to 2004, when Environmental, Social, & Governance (ESG) was first used in a United Nations report entitled "Who Cares Wins." This report arose after the launch of 2000's UN Global Compact, which

1: Shares are typically acquired on the secondary market, so the investment goes to a seller, not the company. But if enough people divest themselves of the stock, the price would go down, thereby punishing the company management who presumably hold a significant number of shares themselves.

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"[sought] to advance responsible corporate citizenship so that business [could] be part of the solution to the challenges of globalization."[2] The report called upon investment analysts to tie ESG factors into their research and also asked educational institutions to support the development effort. While some parts of the world such as Europe and Australia took quickly to this approach, US investors who prioritized profits over values during the 1990s SRI boom were slower to grasp that ESG was its own thing rather than a repackaging of the outcomes-oriented SRI.

Upon first dismissing the framework, some failed to understand that, instead of being values based—which the environmental, social, and governance terminology does admittedly bring to mind—ESG is really about risks. Rather than being a distraction from the goal of making money, ESG identifies material risks that are absent from typical financial statements. Because these risks may have a significant impact on financial results, assessing ESG risk factors must be an important component of any investment process, whether investing in companies, public securities, or fund managers.

The prior paragraph mentioned "the framework" as if it were one single thing, but the sustainable investment universe abounds with organizations attempting to boil ESG down to a usable taxonomy or set of standards. At a high level, however, we can explain the terminology and its practical implications to clarify what is meant by ESG factors.

Sustainable investing

Socially Responsible Investing (SRI)	Environmental, Social, & Governance (ESG) factors	Impact investing
• Investors use screening and exclusion, divestment, positive reinvestment, and shareholder activism to achieve positive social or environmental outcomes • Most commonly used in public markets; easily accessed by all investors	• Metrics to measure a company's risks outside of a financial accounting framework • More public market funds are incorporating this framework, though private market participants are starting to as well	• Investing in companies and funds for both financial returns and measurable social and/or environmental impact(s) • Prominent in private markets investments; limited access for smaller investors

Source: PitchBook

2: "Who Cares Wins: Connecting Financial Markets to a Changing World," The UN Global Compact, June 2004.

What is sustainable investing?

Shouldn't a company's primary objective be to make money? Most definitely. But under what time frame? And are maximum immediate profits or long-term profits—which could be an entirely different proposition—the goal? Profits comprise revenues and costs measured in a particular period of time. For short-term gain, some companies neglect the sometimes costly actions required to sustain the business for the long haul.

To clarify the thought process, consider a business that puts profits ahead of all else, with no consideration given to safety or environmental impacts. If the business is managed to maximize the stock price at any given moment, what would happen to the company when a defective product is released or an accident occurs? Not only would both the stock price suffer and avoided costs become due, but lawsuits would likely ensue, as could fines, recalls, cleanup costs, and reputational damage—all of which might lead to bankruptcy or liquidation. In this case, the short-term gain of immediate profits led to an unsustainable business. Investing with an eye to mitigating or avoiding potential risks is thus called sustainable investing.

Sustainable investing goes beyond just the catastrophic, however. Every business, if it hopes to survive, must act with the future of the company in mind. Companies must also invest to stay relevant. Apple (NASDAQ: AAPL) would not be the company it is today if it had stopped innovating beyond Macintosh computers. AOL and MySpace failed to invest appropriately to adapt to the rapidly evolving uses of the internet and, as a result, are now footnotes to the internet age.

Other areas of sustainability exist that improve a business' chances of maintaining ongoing operations to survive into each successive year. If a company opens a production plant in certain parts of the world, assuming there will be continuous access to power and clean water could prove fatal to the plant's longevity. One private company addressed this issue by building small power plants adjacent to bottling plants in places with frequently interrupted power sources. It even managed to capture the carbon dioxide emitted from the power generation to carbonate the soda being bottled. To have a sustainable business model, a company needs to foresee and forestall as many potential business interruptions as possible. By taking actions despite their potential impact on short-term profits, a company can ensure it is in a position to make profits for the long term.

What is ESG?

The Environmental, Social, & Governance concept encourages investors to seriously consider mission-critical risks that could injure a company if it fails to properly protect itself. Sometimes the risks are to reputation, sometimes they invite lawsuits, and other times they harm a company as forces interrupt or damage a business.

To help contextualize, we will discuss the E, S, and G separately, though they can become blended and difficult to untangle. Poor governance (G), for example, could lead to decisions that cause worker strikes (S), which could interrupt safety protocols and lead to an environmental disaster (E). Thus, a shortsighted decision can lead to consequences that were completely avoidable.

Environmental risks: This area draws controversy, as some investors feel that the objective of profitable ventures should not be to save the planet. This perspective is much too narrow, however. A business should pay attention to environmental risks not to care for the planet, but to safeguard and even improve the long-term viability of the business. In 1989, Exxon—now ExxonMobil (NYSE: XOM)—was running a ship that was only three years old, but it was single hulled rather than double, which increased the chances of a catastrophe should it run aground. If Exxon had paid for a double-hulled ship and better controlled the alcohol consumption of its ship captains, it could have avoided the $2 billion in cleanup costs and $1.8 billion in habitat restoration that resulted from its ship running aground in Prince William Sound. Reports conservatively estimate that Alaska's economic loss from the Exxon Valdez oil spill was as much as $2.8 billion.[3] The additional expense Exxon would have paid for a ship less likely to spill need not have been for save-the-planet reasons—but rather to sidestep crippling costs down the road.[4]

Beyond the downside risks, opportunities can arise from considering ESG factors. In the environmental space, companies that find new, more-efficient ways to do things can reduce their water and energy usage, which both helps the environment and lowers business costs.

Social risks: This area can be difficult to articulate, as extreme examples such as utilizing child or slave labor seem unlikely with most modern businesses. That said, some well-known companies that would never have directly employed such methods have been associated with these practices after outsourcing production and failing to verify the standards of their supply chains. In December 2020, workers attacked an iPhone factory in India, claiming forced overtime and paycheck withholding.[5] While the factory was not run by Apple itself, this incident damaged the company's global reputation, despite its rules for suppliers intended to prevent such a maelstrom.

3: "Contingent Valuation and Lost Passive Use: Damages from the Exxon Valdez Oil Spill," Kluwer Academic Publishers, Richard T. Carson, et al., March 31, 2003.
4: Here is a cost-benefit analysis of opting for a single- versus double-hulled ship. It concludes that the added expense would not be worth the economic benefit, but it also does not appear to take into account fines or reputational risks.
5: "Why Workers in India Attacked an iPhone Factory," *Fortune*, Naomi Xu Elegant, December 14, 2020.

More recently, the COVID-19 pandemic offered a rare opportunity to study the effects of companies' social policies through the lens of stakeholder—rather than just shareholder—objectives. Harvard published a study reporting its findings from the COVID-19-induced market crash of March 2020. The researchers used natural language processing to identify positive and negative news stories related to "human capital, supply chain, and products and service response." Looking at the response of stock prices to these news stories, the researchers found that positive sentiment around a company's social response to the pandemic—such as providing sick leave for afflicted workers, prepaying suppliers to ensure they stayed in business, and shifting production to address the immediate needs of the pandemic—led to stock performance that significantly exceeded that of companies that had cut workers and costs and hunkered down to wait out the pandemic.[6] In other words, spending more to do the right thing socially led to improved stock market performance. Returning to our sustainable investment language, these proactive social investments likely led to businesses better able to survive the pandemic, as they will have won the loyalty of the workforce, supply chain, and even customers.

Governance risks: Governance has been a consistent focus since the headline-grabbing corporate governance scandals of the early 2000s that led to reforms such as adding more independent directors and holding public company executives legally responsible for their communications to investors. More recently, many advocates for corporate governance reform have focused on the diversity profile of boards of directors as well as pressuring companies to incentivize a focus on stakeholders, not just shareholders. While some feel that business is not the place to make social change, ample research exists proving that diverse teams make better decisions, as they avoid groupthink and view problems through multiple lenses, thus helping to produce better products and services and anticipate risks.

What and how to report

Once an investor—be it an LP or a GP—comes around to the benefits of the ESG framework, the next step to consider is implementation. What risks should be considered and managed? What do various constituencies want to see? Most of all, LPs and GPs want to know the most material risks and have them reported on in a way that allows for comparison and aggregation. Based on our 2020 Sustainable Investment Survey, both LPs and GPs want a better way to measure and report sustainable investment activities and risks.

Measuring and reporting the material factors has complicated the widespread integration of ESG factors into investor and company thinking. It is difficult enough for a company to identify and measure the most material ESG risks to their business, but then a fund manager with a diversified portfolio could get wildly different reports from each of its companies. Stepping up a level, that fund manager's investors—not to mention ESG rating agencies—will demand to see consolidated portfolio-

6: "Corporate Resilience and Response During COVID-19," Harvard Business School, Alex Cheema-Fox, et al., September 2020.

level ESG factor exposures. It is a complex issue to say the least. Investors want comparable and reliable data—something sorely lacking in the early iterations of Corporate Social Responsibility (CSR) reports, which often promoted carefully cultivated, favorable vignettes that companies chose to selectively highlight.

Many organizations have attempted to tackle these identification and reporting difficulties, which in turn has led to a proliferation of "standards" that cause even more confusion. If one company or asset manager uses one standard and others turn to different standards, then the recipient is still left with a mishmash of data that is difficult to turn into information. However, some standards are being widely adopted and progress has been made toward a global agreement on the best way to approach this complicated issue.

United Nations Sustainable Development Goals (SDGs)

In 2015, all UN member states adopted the 2030 Agenda for Sustainable Development, though this was the culmination of work that began decades earlier, developing over many summits focused on putting the planet and its people on a better path. With companies, governments, and investors all focused on the 17 SDGs, the UN believed improvement could be effected across areas as varied as "Responsible Consumption & Production" and "Peace, Justice & Strong Institutions."[7] One downside from an investor's perspective is that the goals were not designed solely for investors or companies, so there is not always a clear path from an SDG to an investment opportunity. Given the global acceptance of these goals, however, many investors are adopting the SDGs and reporting on which goals their portfolios are impacting. As a result, many of the other standards or frameworks, which are more focused on investor uses, have mapped their taxonomies to the SDGs, thus leading to a dual system of reporting being produced and received by many investors.

The SDGs align more closely with impact investing—seeking the double bottom line of financial returns and measurable social or environmental improvement—than with the identification and measurement of ESG factors. Even as an impact investing framework, the SDGs fall short. They were created as goals for governments, businesses, and charitable organizations to direct efforts toward—not all of which involve profitable investment opportunities. The Global Impact Investing Network's IRIS+ framework was developed with a nod to the SDGs but was meant to represent investable opportunities for market participants.[8] We will explore impact investing and the IRIS+ framework further in a future note.

Sustainability Accounting Standards Board (SASB)

The SASB, a US-based organization, spent several years consulting with investors, companies, and asset managers to develop standards that any

7: "The 17 Goals," UN, accessed on April 10, 2021.
8: "IRIS+ Thematic Taxonomy," Global Impact Investing Network, May 2019.

company could utilize in order to identify which of the 26 sustainability-related business issues are relevant for their industry.[9,10] Recognizing that no one-size-fits-all approach existed, the standards were designed to identify the material risks that each of the 77 industries faces and provide accounting metrics that would cover the reporting of those risks. As an example, the sector Extractives & Minerals Processing includes the Construction Materials industry. Greenhouse Gas Emissions is a risk flagged for this industry, with two accompanying accounting metrics: one highlighting emissions to be measured and the other discussing strategies for emissions management. The seven industries in the Consumer Goods sector, however, have little material risk to Greenhouse Gas Emissions, so the SASB does not recommend that these businesses provide any reporting on this topic. Consumer Goods companies do, however, face material reportable risks related to Product Quality & Safety.

While the SASB framework was initially rolled out to the public market community, such as public companies and stock analysts, nothing precludes private market participants from adopting it. Any company can recognize itself among the 77 industries and find guidance on how to measure and report on the material risks that industry faces. With widespread adoption of the Standards, reporting will emerge that is both comparable and able to be rolled up into cohesive portfolio views—something for which both public and private market investors have been clamoring.

Global Reporting Initiative (GRI)

The GRI got its start in 1997 with its first sustainability reporting framework.[11] It focuses primarily on a company's impacts on the world—in contrast to the SASB, which is concerned with the ways the world may affect the company. The GRI philosophy is one of stakeholder value, not just shareholder value, which is a concept that is gaining global traction as pursuing profits alone has been recognized as an incomplete objective for a sustainable organization.

On April 8, 2021, the SASB and the GRI co-released a guide to the ways their approaches complement each other. In their words, "GRI defines sustainability reporting as the practice of companies disclosing the most significant economic, environmental and social impacts that arise from their corporate activities," while "SASB Standards help companies communicate effectively with investors about performance on the subset of industry-specific sustainability issues that are most relevant to risk, return and long-term enterprise value."[12] The two groups believe that they can coexist and be complementary to each other. The recent report highlights the ways some companies are using them in tandem.

9: "Understanding SASB," SASB, accessed on April 10, 2021.
10: A mapping of each of the material ESG factors to the 11 sectors and 77 industries can be found here.
11: "Welcome to GRI," GRI, accessed on April 10, 2021.
12: "A Practical Guide to Sustainability Reporting Using GRI and SASB Standards," GRI and SASB, April 8, 2021.

Sustainable investment framework comparison

Standard	Purpose	Strengths	Drawbacks
UN SDGs	Improve the world	Widespread recognition and adoption	Not always investable goals
SASB	Recognize material business risks	Industry-specific guidelines, material business risks	Stakeholders are secondary to inbound business risks
GRI	Report on a company's impact on the world	Stakeholder value framework	Ignores some risks to companies

Implementing ESG in the private markets

In the public markets, conflicting forces exist wherein Wall Street wants every quarter to be better than the last, while investors with a longer-term view pressure companies to spend now to mitigate potential future risks. Many large investors have been using their significant ownership stakes to agitate for public companies to take a longer-term view and manage and report on the material risks faced by their businesses. In recent years, ESG-related shareholder resolutions have been on an upswing, and some are even finding success.[13,14] This avenue does not have a true corollary in the private markets, however.

Even without shareholder pressures, private capital fund managers are feeling pressure from LPs and other stakeholders to think within a sustainable investment framework. Our 2020 survey indicated that GPs are increasingly receiving questions from potential investors. Many are working to incorporate sustainable investment thinking into their business models. While we are a long way from standardized reporting that LPs can pull together from disparate managers to get a total portfolio view of their risks, movement is nonetheless happening.

Some posit that private equity enjoys the benefits of being private—particularly not having to answer to shareholders every quarter—and this accounts for some of ESG's slow progression into private market funds. Another reason given particularly in the VC universe is that considering ESG factors would be too burdensome for a young company; it would be expensive and distract from growing the business. The objections reflect narrow, shortsighted thinking, however.

A good case can be made that the private space is exactly the right place to incorporate sustainable investment ideas. For starters, private markets investors have the luxury of longer-term thinking—as opposed to the public markets, which are hemmed in by quarterly expectations. In addition, when

13: "Investors Pile Pressure on Companies over ESG at Annual Meetings," *Financial Times*, Attracta Mooney, October 31, 2020.
14: "Shareholder Resolutions," The Forum for Sustainable and Responsible Investment," accessed on April 10, 2021.

it comes to startups, it is far better to start a company with proper E, S, and G principles than to try to retrofit a mature company. One considerable example relates to diversity. For well over a decade after founding, most economic benefits going to company employees will typically flow to the founders rather than the rank and file. If the founders consist of one demographic and fail to offer significant stakes to other demographics, then the economic benefits that could spread to a more diverse set of stakeholders remain limited. When the founders eventually sell, they receive capital to start more businesses, thus further exacerbating these economic inequities.

On the other hand, if the founders were to start out with a diverse group, then not only would economic benefits flow to underrepresented populations, but the company would also be in the hands of a group better equipped to make decisions than a homogenous body. If VC firms insisted that targeted companies build diversity into their businesses from the start, it would have a greater immediate impact than the recent requirements that public companies set up long-term plans to incrementally improve their diversity profiles.[15,16]

Considering the amount of money involved and the fact that signed LP agreements are rarely renegotiated, it is difficult for all but the largest LPs to influence GPs disinclined to consider ESG factors. Smaller LPs often commit in a vacuum and are unlikely to unite to make demands of GPs during LP agreement negotiations. In fact, some LPs feel it is not their place to try to influence a GP's investment process, as the blind pool aspect of these funds already presupposes that the LP has faith that the GP is best equipped to make decisions on behalf of the fund's investors.

Some investors are coming together to effect change, however. The Institutional Limited Partner Association (ILPA) is currently collecting best practices for LPs implementing ESG programs. LPs can submit ideas across several areas, including Organizational Policy and Infrastructure, Due Diligence and Investment Decision-Making, and Managing GP Relationships.[17] Each of these has subcategories as well, including resources LPs can use to develop or improve their own practices.

In June 2019, ILPA released Principles 3.0 for LPs.[18] These principles, the origins of which date back to 2009, cover economic terms that a variety of investors came together to deem best practices for private market funds. The latest edition included a section on ESG policies and reporting. To quote ILPA: "GPs should consider maintaining and periodically updating an ESG policy, provided to all LPs or to potential LPs on request. The Principles also recommend how GPs can demonstrate their commitment to ESG and identify reporting frameworks to help LPs understand, verify and assess GP processes for ESG integration."[19]

15: "Emerging Trend Aims to Improve Diversity on Corporate Boards," Society for Human Resource Management, Lisa Nagele-Piazza, J.D., November 30, 2020.
16: "Diversity Boost in the Boardroom: Nasdaq Proposes New Rules to Spark Increased Board Diversity for Listed Companies," *JD Supra*, Cynthia Krus, January 6, 2021.
17: "ESG Roadmap and Resources," Institutional Limited Partners Association, accessed on April 10, 2021.
18: "ILPA Principles," ILPA, accessed on April 10, 2021.
19: "ILPA Releases Principles 3.0," *IQ-EQ*, Gaurav Marwah, July 10, 2019.

What is leading private markets investors into ESG?

In our recent Sustainable Investment Survey, investors of all stripes demonstrated significant interest in and progress toward implementing ESG risk factor approaches. Some GPs came to ESG thinking independently by recognizing the benefits of adopting the risks into their investment processes. Others are responding to the growing number of LPs that ask ESG-related questions as part of their due diligence and that may, on the margin or even as a requirement to invest, pressure GPs to incorporate sustainable practices as part of their investment processes.

Some GPs, upon recognizing that ESG is influencing LP commitment decisions, may insert buzzwords into their due diligence materials to signal that they have adopted ESG principles—but may be doing little to walk the walk. This practice, called greenwashing, is drawing efforts to bring truth in advertising to this space. Not only are many LPs becoming adept at laying asset manager ESG claims bare, but regulators are also requiring that asset managers accurately and honestly represent themselves and their strategies.

European Commission's Action Plan on Sustainable Finance

In March 2021, the sustainability-related disclosure requirements announced by the European Commission in 2018 were implemented.[20] The action targets asset managers and financial advisors in an attempt to combat greenwashing. The requirements do not require asset managers to incorporate sustainability into their thinking, but they do require disclosures about actions they are taking, if any, on a number of sustainable investing topics. While this action does not apply generally to US-based asset managers, if they want to sell into the European Economic Area, they will need to comply. Throughout 2020, we heard from GPs scrambling to understand these new requirements and how to properly incorporate sustainable investment practices.

US Securities and Exchange Commission (SEC)

While the SEC has not gone so far as to require itemized disclosures from all asset managers about their sustainable investment practices, in February 2021, it did announce the creation of a Climate and ESG Task Force in the Division of Enforcement.[21] The group "will develop initiatives to proactively identify ESG-related misconduct," which means it will find and hold responsible those who make unsubstantiated claims.[22] The US is currently playing catch-up on several sustainability-related fronts after several departments within the previous administration made rules and announced opinions that set back efforts to normalize ESG as an acceptable element in managing investment portfolios.

20: "Sustainability-Related Disclosure in the Financial Services Sector," European Commission, accessed on April 10, 2021.
21: "Statement on the Review of Climate-Related Disclosure," SEC, Allison Herren Lee, February 24, 2021.
22: "SEC Announces Enforcement Task Force Focused on Climate and ESG Issues," SEC, March 4, 2021.

Conclusion

Overall, regulation and LP pressures seem to be pushing the private markets toward the precipice of widespread ESG adoption. Measurement and reporting tools are coming together, LPs are turning their attention from public market programs to private market adoption, and some GPs are beginning to agree that the risk factors identified as part of the ESG framework are worthy components of the investment process.