ASSET OWNERS NETWORK

EMBEDDING ESG FACTORS INTO PRIVATE EQUITY INVESTMENTS

A summary guide for pension trustees

Private equity (PE) is often used by pension schemes to enhance returns. Capital is committed to the investment or the fund for a number of years, and investors expect higher returns to compensate for the reduced liquidity. Private equity structures are typically less regulated and scrutinized than their public market peers. The terms of each investment can vary significantly, but management fees and performance-based compensation tend to be significantly higher than in liquid or public markets. Pension schemes' approach to private equity can vary widely in terms of the type of instruments they invest in, the part of the market they invest in and the strategies they use. The lack of a standard approach and the limited transparency of data tend to make due diligence processes for prospective funds more expensive. Investing in private equity can be a way to diversify portfolios that rely on public markets, depending on the strategy of the private equity fund.

Relevance of ESG considerations in achieving these objectives

Private equity has attracted a steady inflow of assets over the last couple of decades and plays an increasingly important part in pension portfolios. As with public equities, ESG factors can drive both downside risk and upside opportunity – many direct impact investment opportunities, for example, can be found in private equity markets. Private equity houses are beginning to look beyond risk management, exploring how to create value from ESG opportunities. They are making businesses more sustainable and investing in disruptive and transformational technologies that can support a low-carbon economy.

There tends to be less transparency in private markets, hence less disclosure of ESG information (and other nonfinancial information) by the general partners (GPs) who run private equity funds and their investee companies. This can be a risk: investors have less information to assess the scale of ESG risks and ensure this portion of their portfolio is aligned with their overall strategy.

The lack of liquidity and multiyear commitments make it critically important for pension schemes to understand and trust the GPs' investment strategies. This includes the approach to identifying, monitoring and managing ESG risks and opportunities within their portfolio companies at all stages of the value chain. Pension schemes that don't do this run the risk of holding "stranded" illiquid assets further down the line. There is also an opportunity, though: a multiyear commitment gives trustees the scope to build a strong relationship with the GPs, which trustees can use to promote more transparency around ESG data and disclosures. Finally, there is the opportunity for trustees to influence GPs to integrate ESG factors at the exit phase.

ESG maturity map

The A4S ESG maturity map, part of its ESG Toolkit for Pension Chairs and Trustees, sets out example behaviours for integrating ESG factors into private equity investment decision making. At the beginning of a pension scheme's journey, trustees might seek to consider and document their appetite to integrate ESG into private equity investments; whereas at the leading edge of this journey, trustees may be actively promoting better measurement and disclosure, as well as engaging with GPs on embedding ESG factors into investment strategies.

	Level 1 Understanding	Level 2 Adopting	Level 3 Deepening	Level 4 Leading
Example behaviours	The Board: • can confidently discuss the challenges and opportunities that ESG integration presents for private companies, and the need for private equity funds to consider these factors when investing • has considered different approaches to engaging with GPs to encourage good practice in ESG integration • has considered the potential exposure to impact investment opportunities that can be found in private equity • has considered and documented its appetite to integrate ESG factors into private equity investment decisions and risk management practices	The Board: • is developing a framework for integrating ESG factors into private equity investments and engaging with GPs to embed these into their strategies • has identified the material issues their investments are exposed to and has defined expectations of the role of GPs in managing and mitigating these • has identified sources of ESG information and data that GPs may use to assess ESG credentials of portfolio companies	The Board: • has implemented a framework for integrating ESG factors into private equity investments and engaging with GPs • has a process for continual assessment of private equity managers' ESG investment capabilities through regular reporting against a clearly defined set of metrics • encourages greater measurement and disclosure of ESG data by GPs and their underlying portfolio companies	The Board: • actively and publicly talks about the challenges and opportunities of ESG investing in private equity • is active in engaging with GPs to embed ESG factors into investment strategies • is active in promoting better measurement and disclosure of ESG factors in private equity funds. • collaborates with other Limited Partners (LPs) to apply collective engagement and stewardship on GPs

Practical actions that trustees can take

Area	Action
Training	• Arrange for all trustees to receive training to understand the ESG risks and opportunities associated with investing in private equity, including: – The relative lack of ESG data and transparency in private, as opposed to public, markets which gives asset owners less oversight of the potential risk exposure, and potential actions to overcome these data gaps; – The opportunity to invest for impact in private markets due to the potential to invest marginal capital into specialized areas.
External manager expectations	• Engage with GPs to ensure they are aligned philosophically with the scheme trustees on their ESG investment objectives, and have embedded ESG factors across their investment process, for example by: – Embedding ESG-related topics into a due diligence questionnaire (including operational due diligence); – Requesting and analysing copies of GPs' ESG policies and any ESG reporting; – Explicitly adding ESG considerations into manager scorecards / investment committee criteria. • As part of ongoing monitoring of GPs, test the extent to which they are: – Considering how to identify / mitigate new ESG risks arising in the portfolio; – Assessing potential impact of ESG-related regulation and tax across underlying investees; – Undertaking periodic climate-stress tests across the portfolio; – Actively engaging GPs to improve their internal monitoring and reporting practices; – Using side letters to codify specific and any arising ESG expectations. • Consider joining and leveraging membership of LP advisory committees to further the ESG investing agenda in line with your priorities.
Direct equity investing	• Fully integrate ESG factors within targeting, deal analysis, ongoing monitoring and exit strategies, covering areas such as: ESG policies, existing ESG risks and mitigation strategies, opportunities to derive value from ESG themes, internal governance of ESG and identification of emerging ESG risks. • Use any Board seat influence to raise ESG-related themes and influence behaviour. • Encourage transparent reporting of ESG-related information such as alignment with TCFD recommendations.
Stewardship	• Engage with GPs to test alignment with the scheme's stewardship objectives. • Seek evidence that GPs are using their influence on their portfolio companies to push for better standards around governance, sustainability and mitigation of ESG risks. • Collaborate with other LPs to engage collectively and apply stewardship to GPs.
Collective action	• Encourage participation by GPs in collective action platforms such as the One Planet Private Equity Funds Initiative, to encourage companies to focus on ESG issues and provide better disclosures.
Measurement and reporting	• Engage with GPs to explore options of disclosure on ESG metrics, both at the fund and firm level. • Encourage better standards of disclosure and reporting from private equity funds and underlying investees, including audit of ESG data; • Consider agreeing specific ESG-related Key Performance Indicators ('KPIs') to be reported, which you can subsequently monitor. • Include private equity portfolio in overall carbon emissions calculations and / or climate scenario models.

This summary guide for pension trustees is part of an ESG Toolkit for Pension Chairs and Trustees by The Prince's Accounting for Sustainability Project.