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Responsible Investment in Private Equity

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Responsible Investment in Private Equity

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Abstract

In this paper, we aim, as a follow-up of the broader paper we recently published on this topic[1], to analyze how Private Equity (PE) investors approach responsible investing cross-linking again conclusions from academic research with our experience as a PE investor as well as a survey of PE investors, including both Global Partners[2] (GPs) and Limited Partners[3] (LPs). We first show that through its long investment horizon – despite potential conflicts with short-term performance pressure -, its tighter control of portfolio companies and its natural focus on governance, the PE industry is well positioned to embrace responsible investing (RI).

We then find that PE investors are encouraged to take the sustainability route by pressure from final investors and often by their belief that RI is favorable to the risk/return features of their portfolio, particularly as RI practices are seen by many as a risk management tool. Regulatory pressure has up to now been less of a driver than on public investment activities, but this has started to change in Europe, mainly under the impact of SFDR and CSRD regulations.

As a result, we observe that although PE is often considered as lagging in the sustainability journey, the industry is catching up quickly and ESG has become a core due diligence criterion in PE. A 2022 survey reports that 70% of PE firms have integrated ESG considerations in their investment policy, but there are significant regional differences: the US and Europe stand at different levels in terms of adoption of responsible investing policies, making life complex for PE firms that are active in both continents.

Fourth, in terms of investment implementation, the engagement component, for instance in defining a net zero objective, is a natural one for PE investors whose role is precisely to accompany portfolio companies in setting strategy. Likewise, PE is often active in thematic investing due to its focus on innovative and high-growth sectors and more specifically on new business opportunities in the environment and health care, although traditional industries that need to transition should not be neglected.

Finally, challenges remain in terms of data quality and homogenization of reporting standards, although recent investor initiatives aim at closing the gap. Our observations also confirm that in order to be successful, responsible investing needs to be embedded in a PE firm's overall organization and driven at the highest level of the institution.

Keywords: Institutional Investors, Private Equity, Responsible Investing, Sustainability Regulation, Thematic Investing

[1] https://research-center.amundi.com/article/institutional-investors-approaches-responsible-investing

[2] General Partners (GPs) are managing partners in a private equity management company who have unlimited personal liability for the debts and obligations of the limited partnership and the right to participate in its management

[3] Limited Partners (LPs) are the investors into private equity funds that are managed by a General Partner

About the authors

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Sandrine is overseeing the SRI strategy and policy for Amundi Alternatives & Real Assets strategies (real estate, infrastructure, private debt, private equity, social impact, fund of funds).

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Sandrine started her career in Asset Management at the CDC (Caisse des Dépôts et Consignations) in 1995, and then joined AEW Europe, in charge of retail assets. Sandrine joined Amundi in 2007 and was in charge of asset management as well as the SRI monitoring within the real estate department before taking in charge the ESG for ARA in 2022.

Sandrine Lafon-Ceyral, Mrics, holds a degree from Kedge Business School (EBP International) and the University of Humberside (UK) and a Master in wealth management and real estate from the Institut du Management du Patrimoine et de l'Immobilier (IMPI).

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Lorna Lucet is Head of ESG at Amundi Private Equity MidCap. She is in charge of developing the ESG strategy internally and accompanying investees in structuring and implementing their ESG policies to ensure that business-models are resilient. Previously, she worked at Société Générale and Deloitte in ESG. She is graduated from HEC and Sciences Po Lyon.

About the authors

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Eric Tazé-Bernard has been a Senior Advisor to the Amundi Institute since 2022, producing research on asset allocation and responsible investing issues, participating in knowledge transfer activities and in advisory missions for institutional investors.

He joined Amundi as Head of Long-only Multi-management in June 2008, and became Chief Allocation Advisor from 2012 to 2022. He has also been a Director of Amundi from 2016 to 2021. Before that, he was CIO of INVESCO France from 2002 to 2008, with a special focus on the Multi-management business, after having been CIO of Multi-management at BNP Paribas Asset Management from 1999 to 2001, and Director of Research, Strategy and Asset Allocation at Indosuez Asset Management, and then CAAM from 1993 to 1998. He began his career as an economic consultant in the Caisse des Dépôts Group in 1983 and joined Banque Indosuez in 1987 to become Deputy Head of Economic and Financial Research.

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Viviane TING

Viviane joined the multi-management team in February 2018. Viviane has 16 years of experience in alternative and traditional asset management. She began her career in Hedge Funds selection at CAAM in Chicago, London and then Hong Kong before becoming a multi strategy hedge fund manager in Paris. In 2011, she chose to integrate Amundi's equity platform, first as an investment specialist and then as an equity analyst on the mining and metals sector. Between 2014 and 2016, Viviane was ranked among the top 3 European buy side analysts in her sector by Extel. Viviane holds a degree in Finance from Paris 1 and an MBA from INSEAD. She is also a CFA (Chartered Financial Analyst) charterholder.

Introduction

Despite a relatively modest share of global financial markets[1], the Private Equity industry has acquired a considerable economic and social weight. In a recent paper, Eccles et al.[2] were expecting that it would hold assets amounting to about 11 trillion$ in 2026 and employ 20 million people in their portfolio companies.

As a consequence, **Private Equity firms have a decisive impact on how the global economy addresses the key challenge of climate change** and more generally is managed in a responsible manner.

At the same time, according to Elliot[3] in an admittedly blunt and provocative statement, "the industry has gained the reputation of being greedy, stingy and immoral, for laying off workers and to lack diversity", illustrating a series of criticisms that need to be addressed. The study is reporting a proportion of only 19% of women in PE firms, and even though it may have slightly increased since, these firms' structure remains highly unbalanced in terms of gender. As a result, **"the marriage of PE with sustainability does not come naturally"**.

However, **these perceptions need to be investigated and confronted with actual observations**, which is not an easy task as the topic of how responsible investing practices are addressed by Private equity investors is relatively recent and has not been widely covered by academic research. One reason is that the industry's high financial performance image has historically been associated with **limited transparency**. Moreover, it is likely that academic studies mainly reflect the situation in the US, which dominates the PE industry, and to underestimate trends in other continents.

Our paper aims at distinguishing myths from realities. It is articulated as follows:

- In the first section, we wonder whether the combination between Private equity and responsible investing is a natural or a contradictory combination.
- In the second section, we investigate the reasons for which Private Equity investors engage in responsible investing, analyzing the impact of cultural factors, of regulatory trends, pressure from LPs as well as return and risk considerations,

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[1] Overall, private capital markets make up about 5% of global financial markets. As an illustration, Comparing Public and Private Markets - Apollo Academy mentions a figure of USD 13 trn for global private capital, compared with a USD 130 trillion global fixed income outstanding and a total market cap of USD 101 trillion for global equity markets (based on BIS data as of 2022 and 2023 Q2)

[2] Eccles R. G., Shandal V., Young D. § Montgomery B. (2022), Private Equity Should Take the Lead in Sustainability, Harvard Business Review, July-August 2022, https://hbr.org/2022/07/private-equity-should-take-the-lead-in-sustainability reference

[3] Elliot K. N. (2019), Fordham University," Problems and Possibilities of Private Equity and Environmental Sustainability", Student Thesis, Elliot%20Pb%20Possibilities%20PE%20and%20environmental%20sustainability%202019.pdf

concluding by observations on where these investors are currently positioned in their responsible investing journey.

- In the third section, we look at their implementation strategies, from exclusion to investment in solutions and engagement, with a specific focus on investing through externally-managed funds.
- We follow up in the fourth section with the identification of remaining challenges, ranging from data to reporting and fee issues.
- A few key messages are then summarized in conclusion.

Section 1- PE and responsible investing

A natural combination?

First, **its investment horizon seems to fit well with the long horizon over which a responsible investing approach is expected to bear fruit**, as possibilities for PE investors to divest are much more limited than those of investors in public markets. A typical holding period for investee companies is around 5 years, significantly higher than the average measure in the case of public investments.

Responsible investing also contributes to PE investors' objective to maximize the value of companies upon exit. If the invested company's future prospects are hindered by environmental or social risks, or if its governance is inefficient, its value will clearly be negatively affected. This justifies PE investors' integration of ESG considerations in the management of these companies. According to a recent survey[4], value creation has even become the main driver for ESG activity in PE.

> ***"Value creation has become the main driver of ESG in Private Equity"***
>
> *Market survey*

In this perspective, **PE investors can exercise a tighter control of portfolio companies** from an ownership and governance standpoint. As they have one or several representatives in the board of these companies, they have a stronger capacity and incentive to influence change within these companies. This is the case in particular of environmental issues, which PE investors can incite firms in their portfolio to better take into account. Eccles[5] adds more broadly that "PE investors have access to any information they want about financial and sustainability performance". Moreover, according to some academic studies[6][7], "private market capital is better suited to address societal challenges[8]".

It can also be stressed that governance, one of the three pillars in ESG investing, is an essential component of PE as, according to GPs we interviewed, "**PE is about governance**", and "Governance is key as you must have accountable leadership first to get the rest right". A PE manager's essential role, when investing in a company, is indeed to set up a strategic plan to accompany its growth and this is highly dependent on having the appropriate governance. PE investors share their expertise in offering an effective

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[4] Pwc Global Private equity Responsible Investment Survey 2023, Generating Upside from ESG Opportunities for Private Equity
[5] See note 2
[6] Gompers, P., Gornall W., Kaplan S. N. § Strebulaev I. A. (2020). How do venture capitalists make decisions? Journal of Financial Economics 135 (2020) 169-190 et al.
[7] Gupta D., Kopytov A. § Starmans J. (2022), The Pace of Change: Socially Responsible Investing in Private Markets, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3896511
[8] Jeffers J., Lyu T. § Posenau K. (2022) et al., The risk and Return of Impact Investing Funds, available at https://dx.doi.org/10.2139/ssrn.3949530

business model and are able to integrate non-financial aspects that they view as essential for the long-term business success of the firms they hold. In that, their influence on portfolio companies is definitely stronger than that of investors in public markets.

One may then wonder whether such influence is favorable from a sustainability standpoint.

Academic research tends to underline a positive impact of PE on growth through its benefits in relieving financial constraints and providing managerial expertise to portfolio companies **:** according to one paper, target firms increase their sales by 50% on average compared to matched control firms[9] in the years following the buy-out.

Moreover, through its focus on economic activities with high potential growth, **PE is also shown to have a positive impact on sustainable innovation**, in particular in fostering new business opportunities in environment. As an illustration, according to an IFC report[10], venture capitalists are more likely to develop green funds in order to "open new markets", i.e. to stir innovation in the field.

PE investors do actually appear to contribute to the necessary move to sustainability. In its analysis of the electricity generation industry[11], a recent paper reveals that "new entrants, particularly PE investors and foreign corporations, have played a crucial role in adopting new technologies and improving the efficiency of electricity generation, suggesting that competitive pressures and capital availability… are driving the industry's evolution towards sustainability and innovation".

This observation may not apply to all sectors, and additional growth brought by PE investors to their portfolio companies does not necessarily lead to positive outcomes for society. Markarian et al. (2023)[12] gives the example of higher education deals that have led to higher tuition fees, and of investments in nursing home leading to higher mortality rates.

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[9] Fracassi C., Previtero A. § Sheen A. (2021), Barbarians at the Store? Private Equity, Products, and Consumers, Journal of Finance, available at https://dx.doi.org/10.2139/ssrn.2911387

[10] IFC (2018), Private Equity and Venture Capital's Role in Catalyzing Sustainable Investment, Input paper for the G-20 Sustainable Finance Study Group

[11] Aleksandar Andonov § Joshua Rauh, The Shifting Finance of Electricity Generation, Stanford University Graduate School of Business Research Paper, July 2024, The Shifting Finance of Electricity Generation by Aleksandar Andonov, Joshua D. Rauh : SSRN

[12] Markarian G., Rakotobe C. § Semionov A. (2023), HEC – University of Lausanne, "ESG in the Top 100 US Private Equity Firms", https://dx.doi.org/10.2139/ssrn.4503661

Another highly discussed issue is whether PE investors genuinely invest in the long term, or are overly submitted to short-term pressure. Lerner et al.[13] have addressed this ongoing debate around the actual horizon of private equity. More precisely, they studied whether leveraged buyouts (LBOs) relieve managers from short-term pressures from public shareholders, or whether LBO funds themselves sacrifice long-term growth to boost short-term performance. Examining one form of long-run activity, namely, investments in innovation as measured by patenting activity, and based on 472 LBO transactions, they found no evidence that LBOs sacrifice long-term investments and showed that LBO firm patents become more concentrated in important areas of companies' innovative portfolios.

The authors found no evidence that LBOs sacrifice long-term investments

Academic Survey

It appears overall that PE's natural focus on governance makes its role very useful on this essential pillar of ESG, and that it has a positive impact on innovation, and particularly in the industries that are the most important for climate transition.

[13] Josh Lerner, Morten Sorensen, Per Stromberg, Private Equity and Long-Run Investment: The Case of Innovation, the Journal of Finance, March 2011, Private Equity and Long‐Run Investment: The Case of Innovation - LERNER - 2011 - The Journal of Finance - Wiley Online Library

Section 2- Why should PE investors engage in RI?

Cultural factors: the US/Europe gap

As noted in our recent study[14], **culture can be a key driver of investors' move to sustainable policies**, and some societies have a stronger sensitivity than others to this topic. As stated by a GP we interviewed, "As a Scandinavian company, we want to be open and transparent and pay the appropriate taxes[15]", and this GP has defined a Statement of Purpose, committing to "align all investment decisions in support of the UN SDGs as well as ownership actions to drive the development of portfolio companies in this direction". Europe does actually appear as significantly more advanced in terms of responsible investing, both generally and in the specific case of PE. According to a recent survey[16], 74% of LPs in Europe have implemented ESG initiatives at least two years ago, whereas 53% of LPs in North America have not implemented ESG initiatives in their investment strategy or at their corporate level. Likewise, according to another report[17], despite its dominance in the PE sector overall, the US continues to lag Europe in ESG fundraising and assets under management.

Investors observe that US managers tend to be cautious in terms of content of management agreements and side letters in their discussions with LPs, probably for fear of potential litigation. Confirming this, Markarian et al. report in their above-mentioned study that US PE firms have relatively low ESG scores, with a smaller proportion of firms with positive E and G scores compared with their S score, another illustration of the priority given by US investors to the Social rather than to the Environmental pillar, and in particular to the Diversity and Inclusion theme. Moreover, regarding investors' motivation to look at ESG considerations, risk mitigation, and in particular the avoidance of negative publicity, is dominant in the US according to a recent survey[18], whereas the majority of European investors appear driven by the desire to improve ESG performance. As reported in the same survey, 70% of PE investors in Europe would agree that ESG considerations influence valuation premiums, against just 38% in the US.

As a result of US investors' dominance in the PE sector, a number of academic studies we mention are likely to be biased towards US behaviors and to hide increasing ESG preoccupations in Europe.

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[14] See note 4
[15] See EQT Annual and Sustainability Report 2023
[16] Capstone ESG Priority Survey 2024, Capstone Partners, June 2024
[17] ESG in Alternatives 2024, Preqin report
[18] ILPA, Bain and Company 2022, Limited Partners and Private Equity Firms Embrace ESG

However, according to an interviewed institution, whereas about a quarter of LPs in the US clearly express their opposition to responsible investing that particularly prevails in certain States, the rest of the US market is either supportive or neutral about it and is making progress. Most investors there are collecting ESG data, producing sustainability reports and integrating climate risk in their analysis, but this tends to happen behind the scene. GPs also do tend to look at all forms of risk even though they are usually shy about it in their communication.

> ***"Whereas about a quarter of LPs in the US clearly express their opposition to responsible investing that particularly prevails in certain States, the rest of the US market is either supportive or neutral about it and is making progress."***
>
> *An interviewed pension fund*

Meanwhile, the Asian landscape is complex and highly fragmented, with key markets in China, Japan, Hong Kong and Singapore more advanced than others. According to a Bain report[19], half of GPs that were interviewed expressed their intention to increase their ESG efforts, and Asian investors overall tend to look towards European frameworks to shape their ESG approach, illustrating both the leading role of Europe on the topic and the pragmatic attitude that prevails on Asia.

Intensifying investor demand

Another important element is **pressure from LPs** as an increasing proportion of institutional investors want to invest responsibly – according to Eccles et al., 90% of LPs factor ESG in their investment process - and are expecting their GPs to act accordingly. This is particularly the case in Europe where investors tend to be very favorable to the integration of sustainability. For Zaccone[20], "most PE firms integrate ESG factors in their investment strategies because investors and other stakeholders pay increasing attention to them". There is a risk for GPs that would not follow this route to see LPs keeping on hold positions in their funds and refusing to increase them.

In addition, portfolio companies are themselves incited to integrate responsible investment considerations that are important to their employees, customers and stakeholders, **in response to social expectations.** As an illustration of pressure from stakeholders, an Australian pension fund offers sustainable growth options, and these investment solutions focus on the climate and medical care themes to which its members, many of them are employees of the healthcare sector, are particularly sensitive.

GPs embarking in a RI approach may do so as a way of differentiating themselves and to **foster their brand recognition**, thereby helping raise funds. Competitive pressure is also driving progress in responsible investing and many investors have to follow this

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[19] Asian-Pacific Private Equity Report 2024, Bain and Company, March 2024

[20] M.C. Zaccone and Matteo Pedrini, ESG Factor Integration into Private Equity, MDPI, July 2020, https://www.mdpi.com/2071-1050/12/14/5725

route when their peers do. According to the above-mentioned survey[21], the top three benefits PE investors expect from ESG are brand enhancement, risk mitigation and competitive differentiation.

Another factor mentioned by certain major institutional investors[22] is that the risk of externalities may reduce a company's **ability to attract talent,** as young professionals are particularly keen to see their employer embrace responsible values. According to one GP, **"being focused on extra-financial elements is a factor of attraction of talented individuals"**.

A sustainability expert is also mentioning **pressure coming from banks** that require information on environmental or social indicators from firms asking for loans, thereby inciting them to improve their focus on ESG.

An evolving regulatory environment

As sustainability regulation is currently far lighter in the case of private assets, regulation has not been such a driver of RI integration as for public assets. According to experts, this is one reason for the Private Equity sector's lag on responsible investment issues over the recent years, relative to the banking, insurance or pension fund sectors that have been submitted to increasing regulatory constraints. **However, this has started to change,** especially in Europe where Sustainable Finance Disclosure Regulation (SFDR) has already had significant impacts in terms of disclosure and in setting standards, leading some GPs to launch Article 8 or Article 9 funds, the latter category applying to products with a primary sustainable investment objective. As an illustration, one of the leading French GPs we interviewed, is currently launching a fund on the decarbonization of the industry in which all firms will be committed to engage in a low-carbon strategy, including "brown to green"; this fund will be categorized as Article 9, with the integration of best practices and appropriate criteria.

Moreover, the Corporate Sustainability Reporting Directive (CSRD) EU directive that entered into force in January 2023 requires companies to publish regular reports on the social and environmental risks they face, and how their activities impact people and the environment. Reports will be published for the first time in 2025 for financial year 2024, and the first companies to report will be those previously targeted by the Non-Financial Reporting Directive (NFRD), excluding any national transposition. Companies in the scope will be required to report standardized and audited sustainability data in accordance with the European Sustainability Reporting Standards (ESRS) developed by the European Financial Reporting Advisory Group (EFRAG), an independent body. Initially applicable to large listed companies, **CSRD will expand its scope one year later to a broader set of large companies as well as listed SMEs** along with new ESRS. According to some estimates by regulatory experts, the number of companies in scope could reach more than 49000, against just about 2000 in the initial phase. Companies in scope will

[21] See note 8
[22] See GIC Annual Report https://www.gic.com.sg/how-we-invest/investing-sustainably/

have to publish detailed, audited information on environmental, social and governance issues and within sustainability reporting, undertakings will have to disclose their transition plan or report on the non-existence of such a plan. According to a major consultant, this obligation to define a transition plan over the long term will be a key driver of companies' increased ESG integration.

Another impactful directive is Corporate Sustainability Due Diligence Directive (CS3D) that, as currently proposed, will set obligations for large companies (with more than 1000 employees and EUR 450 million turnover) regarding actual and potential adverse impacts on human rights and the environment. They will have to adopt a Paris-aligned climate transition plan including emission reduction objectives if climate change is a principal risk for, or a principal risk of, that company's operations.

"This obligation to define a transition plan over the long term will be a key driver of companies' increased ESG integration."

A major global consultant

The ESG regulatory landscape is highly fragmented In Asia, but key markets there have seen significant developments in recent years[23]. Singapore has a flexible, incentive-based framework, including a set of measures for companies to achieve ESG goals. All listed companies will have to provide climate-related disclosures aligned with ISSB standards from 2025, but large non-listed companies[24] will also have to comply by 2027. In Hong Kong, HKMA, the Monetary Authority, has released a policy manual on climate-risk management, encouraging scenario analysis and stress testing.

"Regulation should be seen as a carrot to move ahead rather than a stick."

An interviewed GP

As a result of this evolving environment, especially in Europe, PE investors that have been able to consider themselves less affected by regulatory change now urgently need to change stance. Interviewed GPs actually confirm that the regulatory wave that has recently accelerated in Europe has influenced their approach. One of them mentioned that "regulation should be seen as a carrot to move ahead, rather than a stick", although admitting that it may appear as a strong constraint for companies that are lagging behind.

Impact on return and risk

Now is responsible investing adding to or detracting performance? And is it favorable to risk management?

[23] ESG Investments: The Asia-Pacific Regulatory Perspective, Morgan-Lewis, July 2024
[24] With annual revenues above 1bn$ and total assets above 500M$

As underlined in our previous study[25], the answer is related to investors' beliefs. An Australian pension fund we interviewed has a strong conviction, shared at board level, that responsible investing and performance go hand in hand. Going even further, a major European utilities company has recently merged its Financial and Impact activities within a common department as a proof of its belief that performance should include non-financial as well as financial elements.

"Responsible investing and performance go hand in hand"

An Australian pension fund

The debate on the impact of RI integration on risk and return remains open, but **investors increasingly perceive**, as mentioned by Crifo et al.[26], **that RI integration improves long-term returns,** although it is is difficult to specifically attribute value creation to the integration of ESG-related factors. GPs in particular base their conviction that, as claimed by one of them, "we see ESG and returns as mutually reinforcing[27]" on examples of companies in their portfolio. Another one provides two illustrations of the link between responsible investing and return, through the positive impact of reduced energy consumption on total costs and the fact that "more diverse boards create more value". The latter belief is supported by a study by Carter et al.[28] underlining significant positive relationships between the fraction of women or minorities on the board and firm value. They are convinced as well that "in order to create long-term value and ensure that the companies they support thrive, it is essential to take into account sustainable growth**" and that extra-financial criteria need to be integrated in corporate analysis.** This GP believes that organizations perform better when they foster an inclusive environment where differences are valued, supported and respected.

This debate looks particularly acute for LPs as studies have shown that **there is a very wide dispersion of returns within the universe of PE funds**, and GPs with the highest reputation in terms of financial performance, often based in the US, are rarely those that strongly focus on responsible investment. Zara[29] has conducted a survey to analyze the link between ESG integration and PE firms' performance and concluded that ESG-integrated PE funds do not perform better than their non-ESG counterparts in terms of Sharpe ratio. However, when these funds are introduced in a duly diversified portfolio,

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[25] Institutional investors' approaches to responsible investing | Amundi Research Center

[26] Crifo P., Forget V. (2012), "Think global, invest responsible: why the private equity industry goes green", HAL open science, hal-00672034f

[27] Cited in Eccles R., Lennehag T. § Nornholm N. (2020), EQT: Private Equity with a Purpose, Journal of Corporate Finance, Volume 32, Number 3, Summer 2020

[28] Carter D. A. Carter, Simkins B. J. § Simpson G. (2003), "Corporate Governance, Board Diversity and Firm Value", The Financial Review,38 (2003) 33-53

[29] Zara C. (2019), "Does Sustainability Affect Private Equity Asset Class? First Findings", University Bocconi, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3152973

results in terms of Treynor ratio[30] - see Box 1 for the difference between Sharpe and Treynor ratios - turn in favor of ESG funds, due to their lower level of weighted average correlation and lower weighted total risk compared with their non-ESG counterparts. In other words, ESG-integrated PE funds tend to be less risky and more diversifying than their non-ESG counterparts. This is a particularly insightful conclusion for investors looking to build an efficient portfolio including PE, which may also support many investors' belief that **responsible investment practices are a risk management tool** and that **ESG issues, beyond the enhancement of value creation, broaden risk management.**

A recent study[31] tends to confirm this statement. It shows that PE firms experiencing environmental and social incidents in their portfolio companies are less likely to raise a subsequent fund and that the subsequent funds are smaller. **Not paying enough attention to ESG issues may therefore be risky for PE firms' business potential.**

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[30] *The Sharpe ratio measures the ratio between the expected or actual return of a portfolio, after subtracting the risk-free rate, and its standard deviation, according to the following formula:*

$$\mathrm{SR} = \frac{(r_x - R_F)}{SD}$$

where:

r_x = Expected or actual return on investment of investment

R_F = Risk-free investment's return

SD = Standard deviation of r_x

The Treynor ratio is also a measure of the risk-adjusted return of a portfolio, but it differs in that it is the portfolio equity beta which is subtracted from the portfolio return, according to the following formula:

$$\textbf{Treynor Ratio} = \frac{r_i - r_f}{\beta_i}$$

r_i = Portfolio's return

r_f = risk free rate

β_i = Portfolio's beta

Given that Private equity funds display equity-like risk, and despite its disadvantage of being backward-looking and subject to estimates of portfolio beta, it is probably more appropriate to evaluate their performance according to the Treynor ratio.

[31] T. Duevski, C.i Rastogi, T. Yao, ESG Incidents and Fundraising in Private Equity, November 2023, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4641071

However, investors are often chasing the best performers in the industry, and as these face strong investor demand for their funds, they enjoy a strong negotiating power, leading LPs to have to accept lower ESG standards from these GPs. According to one interviewed pension fund, "we have to choose our battles; we already have to negotiate fees, reporting format…, and we cannot sacrifice on returns due to our fiduciary duty". This implies that even though European GPs are on average much better rated in terms of ESG than their US counterparts, the latter may still be significantly represented in investors' portfolios.

"We have to choose our battles,… and we cannot

sacrifice on returns due to our fiduciary duty"

A European pension fund

Where do PE firms stand in their responsible investing journey?

Despite all these arguments, Markarian et al.[32] report that ESG practices of the top 100 US PE firms significantly lag behind those of publicly traded industrial firms**, illustrating the fact that the PE industry in this country is currently lagging in the sustainability journey.** 58% of GPs interviewed in this study disclose zero information about their ESG practices (except for some "boilerplate language"), and "two thirds of those that disclose have sparsely populated and uninformative ESG information". Likewise, only 15% of firms are signatories into high quality ESG frameworks such as the TCFD, Carbon Neutral Protocol Certification and SASB. Moreover, **companies predominantly share positive information on ESG and often neglect to communicate negative news.**

Such lag is understandable as PE investors tend to focus their investments on small and medium-size firms which have less resources, and sometimes a more limited awareness, to implement a responsible investing strategy. The same study by Markarian et al. shows that larger firms do better as the higher the number of employees, the better the environmental performance, whereas firms that have a buy-out strategy tend to be ESG outperformers and independent funds are more likely than captive funds to develop responsible practices as a differentiating tool to attract investors. According to a GP, it still remains difficult to obtain carbon data, particularly regarding Scope 3 emissions, from midcaps, whose climate engagements remain limited while few of them address the issue of biodiversity. Confirming this observation, Eccles[33] states that "until recently, ESG in PE was a box-ticking exercise at best", although ESG leaders are now becoming more sophisticated in integrating ESG factors.

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[32] Markarian G., Rakotobe C. § Semionov A. (2023), HEC – University of Lausanne, "ESG in the Top 100 US Private Equity Firms", https://dx.doi.org/10.2139/ssrn.4503661

[33] Eccles R. G., Shandal V., Young D. § Montgomery B. (2022), Private Equity Should Take the Lead in Sustainability, Harvard Business Review, July-August 2022, https://hbr.org/2022/07/private-equity-should-take-the-lead-in-sustainability reference

However, progress is definitely occurring and ESG has become a core due diligence criterion in private equity over the last decade. According to a 2022 survey of more than 100 LPs conducted by the Institutional Limited Partners Association (ILPA) and Bain & Co.[34], 70% of LPs have integrated ESG considerations in their private equity investment policy to mitigate ESG risks and/or to take advantage of ESG opportunities. The same CFA Institute report mentions another survey conducted by PWC (2022) showing that more than 40% surveyed GPs adopt ESG considerations when selecting and managing their investments.

In a recent paper, Abraham et al.[35] reveal an increasing trend in ESG disclosures over the past 20 years, with social topics becoming as important as environmental ones recently. Interestingly, they also confirm that more ESG disclosures by PE firms are associated with better environmental, social and governance at the portfolio company level and that the demand for ESG information from fund investors is a significant determinant of PE firms' ESG disclosures. PE investors are therefore encouraging and accompanying increased disclosure trends at portfolio firm level as, according to an interviewed GP, there has clearly been an increase in sustainability preoccupations by investee firms. **This is needed in particular when firms wish to be referenced as product or service providers or when they participate in due diligence processes.** Firms are showing increased maturity on the topic, in particular regarding the definition of their ESG governance, business ethics (in topics such as GDPR or cybersecurity) and the formalization of policies, such as human resources. However, some GPs consider that the environmental topic remains a bit underdeveloped, due in particular to difficulties in accessing data, while they anticipate that **biodiversity will be the next emerging point of attention.**

Finally, one should stress again the heterogeneity of the Private equity market that, according to a regulation expert we interviewed, can be segmented between ESG champions, ESG laggards, and in between a number of "bipolar" actors who selectively integrate ESG considerations on a case-by-case basis, depending on investors' requests. Significant divergences may also be observed between different categories of investors, with pension funds significantly more focused on ESG than high net worth individuals for instance.

[34] https://rpc.cfainstitute.org/-/media/documents/article/rf-brief/economics-of-private-equity.pdf

[35] Abraham J. K., Olbert M. and Vasvari F. P., ESG Disclosures in the Private Equity Industry, London Business School, July 2024, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4265171

Section 3 - Responsible investing implementation

PE investors survey underline that it is becoming standard for PE firms to consider ESG factors when sourcing opportunities, carrying out due diligence, forming post-acquisition plans and deciding on deal terms. Let us review different forms of such implementation in investors' portfolios.

Exclusion policies

As already observed in the general case of responsible investing approaches, **a number of PE investors decide to apply an exclusion policy or negative screening,** and typical exclusions apply to coal, tobacco or controversial weapons. Many GPs have engaged themselves not to invest in companies whose products, services or practices cause environmental and social harm, and where there is no path to transform the business into a positive contributor to society [36] ". Specific exclusions may concern animal maltreatment, controversial weapons, exploited labour, fossil fuels, gambling... For LPs that have defined an exclusion policy and invest in Private equity through funds, such exclusions need to be included in management agreements, but ensuring, through full transparency, that all its indirect holdings respect such exclusion policy may be difficult. According to an LP, there is a risk that exclusion policies lead to an eviction effect and that Private equity investors focus on activities that are green "*ab initio*", whereas, as already stressed in our previous study, in order for climate transition to occur, **it is key to accompany brown activities in their transition process.**

"There is a risk that exclusion policies lead to an eviction effect"

A large European corporate

Thematic investing

Private Equity is also a particularly appropriate investment approach to thematic investing, as it looks to identifying sources of future growth and, unlike traditional equity investing, has no benchmark and far less diversification constraints. Thematic investing can take the form of direct holdings in order in particular to "find innovative solutions towards net zero" or to "catalyse solutions for hydrogen transport and storage", quoting a major South Asian investor.

Thematic investing may also be implemented through specialized funds. One illustration is the already-mentioned Article 9 decarbonization strategy being launched by a GP under SFDR Article 9 EU classification, as a proof of the purity of the concept. In the management of its impact fund, a leading global GP claims to focus its investments in selected themes, such as climate, well-being, security, and to generally **invest in firms proposing solutions to address UN SDGs**. According to a an already-mentioned recent survey[37], **30% of interviewed PE investors have set up a dedicated pool of capital for**

[36] See ESG at Bridgepoint, January 2024
[37] See note 23

impact or ESG-focused investments in Europe, compared with 15% of investors in Asia or North America.

Investing in funds, particularly in the thematic area, can be a convenient way for institutional investors to invest in Private Equity. In this case, LPs take a close look to the fund's thesis (what are its objectives, are they linked to certain SDGs for instance?). **They also integrate RI criteria in their selection of GPs and expect GPs to publicly report on their ESG efforts.** A Dutch pension fund has established a scoring methodology of their PE managers and conducted an analysis of how they stand with respect to Paris alignment. Responsible investment considerations can also be integrated in side letters that a number of GPs accept to sign to take into account specific guidelines from LPs. LPs also need to check in their manager selection process that the toolkits that GPs claim to be using are actually integrated, and to ask for examples of applications. The
Like many engaged LPs, the Amundi multi-management team at Amundi Alternative and Real Assets has a specific ESG process with an ESG questionnaire, an annual survey , KPIs data collection and GPs are today better organized to respond to such demands. The following box summarizes a few criteria used this team on how to integrate ESG considerations in selecting GPs.

Box 1: Some criteria used by the multimanagement team at ARA to identify well integrated ESG practices amongst GPs, by Viviane Ting

GP's resources and organization in responsible investing

- *Has the GP expressed its beliefs and conviction regarding responsible investing? Has it set specific objectives (such as net zero, at what horizon?)*
- *Are responsible investing issues addressed at Board level, how frequently? Is a Board member specifically in charge?*
- *Are ESG criteria integrated in managers' remuneration and according to what scheme?*
- *Is there a RI team, what are its size and reporting line? How does it work with other teams in the GP's organization? How is it trained?*
- *Does it also rely external resources, such as consultants (for instance for CO2 accounting), databases…?*
- *Participation in charters and peer groups (UN PRIs…)*

Investment decision process

- *At due diligence stage:*
  - *How is the ESG evaluation process of target companies objectivized? Is there a rating system, is it internal or external, and how is homogeneity of ratings setting ensured?*
  - *How are decisions taken and how are ESG criteria integrated? Who has the final say in the case of conflict between financial and non-financial criteria?*
- *During the life of the investment:*

What is the engagement process to ensure progress on ESG issues? In particular, is there an ESG roadmap and is it regularly monitored? Is there a tool to monitor success or failure in commitments taken?

Compliance with investors' requirements

- *Is the GP able to comply with LP's exclusion policy, in particular regarding:*
  - *Respect of Oslo and Ottawa conventions on controversial weapons*
  - *Other exclusions, such as tobacco, coal, unconventional oil…*
- *What tools are used to ensure transparency on funds?*
- *Does reporting include non-financial indicators? Can it be adapted to specific investor requests?*

From due diligence to onboarding, holding and exit

"During the investment phase, these expectations should be expressed in the form of KPIs"

A GP

Responsible investment must be integrated at the different stages of the PE investment process, from due diligence to onboarding, through the holding period and upon exit.

GPs that integrate responsible investing in their approach already include these considerations in their due diligence phase before investment, and expect the management of target companies to share the same values. During the investment phase, a GP[38] recommends that these expectations be expressed in the form of KPIs, distinguishing:

- **Absolute requirements**: adherence to global standards, adherence to UN Global Compact, communication of a sustainability-related policy, material from strategic board discussion on sustainability, share materiality assessment …
- **Core elements**: ethics and ant-corruption, diversity, employee engagement, GHG emissions, water usage, waste to landfill …
- **Portfolio companies specific KPIs**, depending on sector and company.

Target companies should adopt a Responsible investment framework, with clearly stated goals and priority themes adapted to their specificities and generally related to UN SDGs, such as resource efficiency, changing demographics….

Another GP has produced a "Sustainability Onboarding Guide[39]" for its portfolio companies, that defines in particular its ESG priorities, as well as a "Brief for Third-Party ESG Due Diligence Assessments" including the identification of "two to three concrete risks that the portfolio company considers to be most material". As it would be illusory to pursue all goals at the same time, it also states that its focus during the 12 months following an acquisition should it be on governance, climate and compliance.

Portfolio companies' progress along the set objectives should then be measured and monitored on a regular basis along the different KPIs that have been defined. In this respect, PE investors can be helped in establishing such lists of KPIs by the Invest Europe ESG KPI report, resulting from a collaboration with national associations involved in the European data cooperative. Within climate, typical KPIs are related to CO2 emissions targets. Within social considerations, they can aim at board diversity: for instance, a global GP has set a goal of at least 30% diverse board membership for its controlled companies.

Finally, **the notion of engagement,** which we identified in our previous paper[40] as a key element in institutions' responsible investment approach, **intrinsically lies at the core of PE investing,** as PE's objective is precisely to directly influence portfolio companies' policies. As stated by Crifo[41], **"**engagement appears a necessity to be consistently a socially responsible PE investor". As a result, surveys report that ESG engagement is viewed by most PE investors as consistent with their overall efforts to generate returns for their clients.

[38] Indahl R., Jacobsen H. G., Summa Equity (2019), Private Equity 4.0: Using ESG to Create More Value with Less Risk, Journal of Applied Corporate Finance, Volume 31, Number 2, Spring 2019
[39] Sustainability Onboarding Guide for Bridgepoint-backed Companies, Bridgepoint, January 2024
[40] Institutional investors' approaches to responsible investing | Amundi Research Center
[41] See note 15

Different priorities between investors

As already mentioned, **any PE investor will focus on governance in its due diligence process**, with business ethics, compliance with regulation, anti-bribery and corruption policies natural topics to address, while cybersecurity is increasingly viewed as a key issue as well. More specifically, one of our interviewed GPs ensure that one Board member in portfolio companies is in charge of ESG and then acts as a facilitator on these topics, illustrating the fact that sustainability must be a strategic priority for portfolio companies. According to them, "setting the right governance first is a key success factor".

On climate, priorities are set in terms of measurement and of reduction of emissions. Some companies also take net zero commitments. According to Invest Europe[42], this is the case of 12% of portfolio companies in Private Equity funds, the figure rising to 20% in the case of buyouts. RI-focused GPs also subscribe to SBTI, which implies that all their investee companies will need to be engaged in a low-carbon target. As an illustration, a GP reports that 50% of its portfolio companies have a net zero trajectory validated by SBTI and that it has set a 100% target for 2030.

A GP reports that 50% of its portfolio companies have a net zero trajectory validated by SBTI and that it has set a 100% target for 2030.

Social criteria typically include health and safety, human rights, diversity, absenteeism and staff turnover.

Investors' specific focus within ESG is naturally reflected in this process. For instance, an LP we interviewed has a strong focus on the S pillar, and particularly on health and safety at work, in line with the company's overall objective of zero labor accidents. Its other main priority is on climate, following its 2050 Net zero objective that it pushes its GPs to adopt as well. Its interest in governance is also illustrated by the Chart of Good Practice that it requires its employees exercising Board responsibilities to adhere to.

An LP we interviewed has a strong focus on the S pillar, and particularly on health and safety at work, in line with the company's overall objective of zero labor accidents.

The following Box presents Amundi's approach to responsible investing as an illustration.

[42] Invest Europe (2024), Private Equity at Work report, https://www.investeurope.eu/research/private-equity-at-work

Box 2: Integrating ESG in Private Equity: an illustration with Amundi's approach

Interview with Lorna Lucet, Senior ESG Analyst in charge of Private Equity at Amundi

1. ***How do you intervene during the due diligence process when analyzing a potential target? What are the key ESG criteria you look at this stage?***

The first step in due diligence is always the same: identification of matters that are material for the company, based on several elements: international or sectoral standards (SASB), ESG research published by Amundi, thematic studies and our professional judgment. Material subjects will not be the same for a company in the automobile sector which must respond to major challenges on decarbonization or the circular economy and a consulting company which must rather concentrate on social subjects, such as talent attraction and retention, well-being at work, etc.

At Amundi PEF MidCap, we have developed a proprietary ESG rating tool that allows us to evaluate the company during the due diligence phase and throughout our ownership. This tool takes into account material issues for the company, sectoral or national benchmarks on certain subjects (absenteeism, accident frequency and severity rate, percentage of women - both in management positions and in total workforce-, etc.) and best practices identified in our portfolio. This rating is essential in our process as it makes it possible to objectify the rating of investments and to harmonize practices between ESG analysts.

2. ***And what is your role in the decision process? What happens in the case of a disagreement with the Investment team?***

The ESG team has a seat on the Investment Committee and presents the results of the ESG due diligence and the final rating. When we launch a fund, each target holding must obtain a minimum ESG score. According to our proprietary methodology, rating must be equal to or above E within an A to G range -A being the best rating and G a company excluded for reasons of non-compliance with Amundi's Responsible Investment policy.

In addition, and in this we distinguish ourselves from many peers, the ESG team has a veto right in the Investment Committee that it can exercise at any time, even when financial, legal, social, fiscal and strategic analysis has not detected any blocking issue. This guarantees that ESG subjects are taken into account in the decision process at the same level as financial characteristics.

3. ***And how do you intervene during the investment life?***

At Amundi PEF MidCap, we are active minority shareholders and we negotiate to sit on the Supervisory Board of our holdings because we want to be part of the decision-making. Our mission in ESG is to ensure that the company has responded 1/ to its legal obligations (gender equality index, GDPR, CSRD) and 2/ to its material challenges.

Thanks to due diligence, we are able to identify strengths and areas for improvement in these companies. We then work with them to build an ESG roadmap that materializes in actions, quantified objectives and deadlines.

We then monitor the progress made quarterly and annually through dedicated meetings with the people in charge of ESG and with the Supervisory Board of our companies, as it is essential that their governance bodies be accountable and guarantee the success of this roadmap. Then, in the event of failure or delay without relevant justification, we begin an escalation process: limitation or downgrading of the ESG rating on one or more criteria, questions to the Supervisory Board, early exit being the last step (always having in mind the best interest of our clients).

4. Can you provide an illustration of a positive ESG transformation that was fostered by your intervention as a private equity investor?

As a Board member, we have the ability to influence companies and to accompany them on how they approach sustainability. Very often, they need our help to structure their CSR strategy. For one our investees[1] , we first incorporated CSR criteria into the variable remuneration of the CEO and in 2023, we helped them dedicate 15% of the variable compensation to 29 CSR objectives. Having CSR criteria in the variable compensation reinforces management's commitment to the company's social & environmental missions that It integrates into day-to-day management and strategic decisions. We also helped the company identify and hierarchize the most material ESG topics in order to set up a CSR roadmap with specific and quantitative ambitions, including on how to meet CSRD requirements. In four years, we have seen this investee going from the status of a company willing to work on sustainability to that of implementing dedicated actions of energy reductions or circular economy in order to reduce the negative impacts of its activities and to reinvent its business model.

5. Turning to broader market issues, according to you, how does sustainability fit within the risk/return map? And if you believe that sustainability does not detract financial performance, how do you convince investment professionals that this is the case?

A number of meta-studies have demonstrated that there is a correlation between CSR performance and company valuation. At Amundi PEF-MidCap we are convinced that implementing a CSR strategy increases the valuation of the stake when we sell it, due to several factors: compliance with growing CSR regulation, reduction of legal risks, anticipation of future economic risks and development of new solutions allowing an increase in corporate sales and margins.

However, much of the ESG analysis is predictive, designed to limit future negative trends and adapt to a changing world. It is difficult for a company to modify its business model on the basis of hypotheses on its impact of economic and societal trends over the next 10, 20 or 30 years on its future valuation when for many actors the horizon is rather limited to 2 to 5 years!

6. How do you perceive the data challenge in Private equity? Is data quality improving, and what are the main gaps?

The issue of data is crucial, and whereas a large number of data providers provide information on listed companies, this is not the case for Private Equity which mainly concerns small and medium-size companies that are not yet subject to CSR reporting obligations. Direct access to investees and the possibility of conducting interviews are key in the due diligence phase to assessing the maturity, credibility and desire of the company to work on these subjects. At Amundi PEF-MidCap, 80 to 90% of our portfolio will have to comply with the CSRD by 2026, which will likely reshuffle the cards in terms of data. We will then have greater access to data as well as better data structuring and comparability to evaluate the performance of companies.

7. Companies will be subject to increasing regulatory constraints, in particular with the widening of the CSRD scope. Do you believe they are getting ready for this challenge.? And in what way do you help them prepare themselves?

The CSRD will be a revolution for our SMEs and ETIs: not only will they have to respond to it – with a mandatory audit – but they will also have to structure, identify and monitor the indicators year after year for the sake of transparency. This will force companies to question their business model and evaluate it using not only financial but also ESG criteria, imagining how it could be affected by such major trends as climate change, biodiversity loss, work flexibility, search for social justice, etc. All topics that often appear secondary to companies essentially focused on growth and financial profitability. Some of these firms are getting prepared, though, having already completed their double materiality matrix, anticipating an audit in 2025 before the formal 2026 deadline and by initiating a global reflection. Others take longer to be convinced…

8. You are an ESG expert dedicated to private assets activities. What makes an ESG approach specific on these asset classes?

I see two specificities of ESG in PE:

• the proximity we have with our investees: The engagement between investors and investees can then be done on a much more regular, sometimes daily, basis while engaging with a listed company is far less intense, with yearly or at best quarter contacts.

• our capacity to influence them due to our presence on their Supervisory Board and our contribution to the definition of their strategy, whereas voting rights in listed companies represent a much more diluted form of influence. Such presence allows us to express our strategic views every quarter and gives us privileged access to information.

9. Most experts consider that the Private equity industry is lagging in terms of ESG integration. Do you agree? Do you think it is catching up?

The companies that are most visible on ESG are large listed companies as they are subject to regulatory obligations. In addition, many have made it a marketing argument and have well-established communication. This does not mean that SMEs and ETIs do nothing! They do not form a homogeneous mass, some are well ahead and others well behind. Many of them have in common the need to better take ESG issues into account when evaluating the sustainability of their business model – just like listed companies – and the need to better articulate their ESG convictions and to objectivize them through consolidated facts and figures, things that large companies know how to do better. In the last four years, SMID companies made a lot of progress, especially in the structuration of the approach : they appointed CSR Directors, have integrated CSR issues in the governance bodies and even in the variable remuneration of the CEO for some of them, launched a roadmap, etc. The work needs now to be objectified and this is what the CSRD will allow to do!

10. More specifically, how would you characterize Amundi’s approach to ESG in Private Equity?

I would underline three of our current strengths at Amundi PEF MidCap:

• Our veto right which guarantees ESG to be a real counter-power

• Our proprietary tools: we are constantly developing new tools such as our proprietary rating or our engagement tracking tool. They ensure our independence from external suppliers and the translation of our vision of ESG into figures and objective actions.

• Broadly-shared accountability: we are convinced that ESG cannot be a topic for experts only and must be supported by the entire management team. This is why we always form management/ESG pairs to ensure that our portfolio managers are able to raise these issues with their investees. To do this, we put a strong emphasis on training, through the development of proprietary internal training courses, allowing us to meet our teams’ needs as closely as possible.

Section 4 - Remaining challenges

Data and resources

In general, investors report that **there is still difficulty in finding information on ESG issues in portfolio companies and lack of a comprehensive way to measure them**. Establishing a carbon account in particular requires multiple sources and data needs to be verified by independent external providers. However, investors are making efforts in this area. A major Asian sovereign has invested in sustainability data and analytics platforms that have developed solutions to address the challenge of private assets data. One of these platforms is a global leader in business sustainability ratings for global supply chains that helps to drive transparency on sustainability performance[43]. A Dutch pension fund sends annual data requests to its GPs and is observing progress on emissions data, at least regarding Scope 1 and 2 emissions, although overall data remains insufficient for them, for instance on gender pay gap data within the social pillar. According to one interviewee, **data is definitely improving with regulation,** and GPs have become more disciplined about gathering ESG data, setting a number of KPIs, such as water usage, carbon emissions… The next step is the publication of auditable carbon data.

A Dutch pension fund sends annual data requests to its GPs and is observing progress on emissions data

Defining the most appropriate metrics for non-financial indicators is also a challenge, all the more so as it is difficult to apply the same ones to different types of companies and assets. In this respect, GPs have a role to play in helping companies choose their methodologies, for instance on CO2 footprint calculations, and establish platforms regrouping the data they have collected. They may also support companies in selecting specialized advisors, for instance on carbon accounting. A group of GPs and LPs launched the ESG Data Convergence Initiative in September 2021, agreeing in particular to report on a core set of ESG metrics drawn from existing frameworks[44].

Embedding responsible investing within the overall organization

Accountability for responsible investing must be taken at the highest level of the institution, at Board and Investment committee level, based on a genuine belief. Its implementation may actually incur additional costs and constraints, at least in a first stage, and ESG specialists must convince their Private Equity colleagues in charge of closing the deals and of managing portfolio companies.

[43] See GIC Annual Report https://www.gic.com.sg/how-we-invest/investing-sustainably/
44 https://www.esgdc.org/

In terms of organization, most investors that have identified responsible investing as one of their core values have set a Sustainability team but, as stated in our previous report, they declare at the same time that this team should not guide all aspects of responsible investing and that **sustainability knowledge should be shared all over the company and embedded in its overall approach.** According to our multi-management business line within Amundi Alternative and Real Assets, "as an indirect investor in a market that is not necessarily the most transparent, our ESG assessment puts a strong focus on the Governance pillar. ESG must be embraced at the top of an organization to ensure effective engagement and necessary investments. ESG is not just ticking boxes, it comes with costs and needs the endorsement of all parties in the ecosystem. Building awareness, having appropriate training programs, pushing for diversity, are some key success factors that will lead the team to higher standards."

"ESG is not just ticking boxes, it comes with costs and needs the endorsement of all parties in the ecosystem."

Amundi Alternative and Real Assets

We generally observe a **split of responsibilities within Sustainability**. An interviewed GP has identified experts dedicated to a "Portfolio management and value creation" pillar and others to "Reporting, risk, reporting and communication". Likewise, at a large LP, where ESG specialists are integrated in the PE team, one of them has a broad role, organizing due diligences, developing strategies, policies and regulations, whereas the other person is in charge of data collection and analysis.

Another GP has a team of 8 ESG professionals working on Private equity and Private debt that has been developing **different areas of excellence to progress on various ESG themes**: one team member is particularly in charge of climate issues, one of the definition of sustainability strategies, one of compliance and risk management…

At a third one, the split in terms of responsibilities is defined along product lines, with partners in charge of coordinating the ESG methodology respectively within the Mid-Cap, the Small-Cap and the Real Estate Investment teams.

Investors can also join forces with their peers in order to push certain topics, and this is all the more natural as co-investing is a frequently adopted approach to Private equity investing and, as already mentioned, investors that adopt this approach tend to co-invest with institutions that have similar objectives. However, while resources can be strengthened by joining peers, it is important for reasons of efficiency to avoid spending time on initiatives that have a limited return on investment.

One GP also works with a number of service providers and proposes a combination of Big 4 companies and of more specialized and local ones as such providers to portfolio companies.

Overall, some investors complain that the coexistence of many different frameworks (SBTI, NZ AM, EDVCI…) that would need to be better coordinated, complexifies the PE investment environment.

Managing potential conflicts

There is also a risk that ESG considerations are left aside in case of economic difficulties, and GPs admit that these can be delayed in the occurrence of a major operational issue. However, they add that the risk of major disagreements with firms' management on these issues is limited by the fact that sustainability issues are addressed before investing. Likewise, there may be disagreement with other shareholders but the risk of conflicts can be contained if GPs are majority, or at least very significant minority shareholders, and work with co-investors that share similar preoccupations.

The issue of fees

One may wonder whether there is not an intrinsic contradiction between GPs claiming a responsible investing approach while levying high fees that are typically attached to Private Equity funds. High PE fees are indeed considered a big issue in the Netherlands, leading large Dutch LPs to put pressure on managers and to **work on impact-linked carried interest schemes**. However, they also admit that such pressure is less efficient when investing in the top-quartile managers, which are more reluctant to compromise on their own conditions. This is probably a challenge for the industry which can be resolved through **increased simplicity and transparency on fee schemes**, as well as through a proof that fees are fully justified by the final performance delivered to investors. It implies setting remuneration schemes that are consistent with the risk taken when investing in private equity vehicles and their long investment horizon.

The reporting challenge

Even as both PE firms and LPs have embraced ESG integration, ESG reporting is seen as problematic, as reported in the above-mentioned ILPA and Bain § Co. report[45]. In response to rising demand for ESG data from institutional investors, ESG frameworks and ratings providers have proliferated, but lack of standardization of ESG reporting is a difficulty. Every GP also tends to define its bespoke set of KPIs, leaving LPs without standardized, comparable data to assess the ESG performance of their PE portfolios.

In response, the above-mentioned ESG Data Convergence Initiative has agreed on six issues - Scopes 1 and 2 GHG emissions, renewable energy, board diversity, work-related injuries, net new hires and employee engagement - as well as KPIs for each[46]. In its reportings, one GP provides aggregated and detailed data regarding the E, S and G

[45] https://rpc.cfainstitute.org/-/media/documents/article/rf-brief/economics-of-private-equity.pdf
[46] According to Invest Europe, 70% of portfolio companies have anti-bribery and corruption policies, as well as initiatives to manage cybersecurity risks. Invest Europe also supports the industry with its EG reporting guidelines

pillars and their components, such as carbon footprint, staff turnover or governance diversity.

The rapid uptake of the ESG Data Convergence initiative indicates that the industry is ready to meet this challenge[47]. However the challenge often falls on portfolio companies that are not well equipped to produce such reporting. GPs may help in this by setting up their reporting system and asking portfolio companies to format their reporting along these guidelines. A number of GPs organize regular calls, webinars and conferences with their portfolio companies to increase firms' awareness and support them in the production of their reporting.

A number of GPs organize regular calls, webinars and conferences with their portfolio companies to increase firms' awareness and support them in the production of their reporting.

However, adopting a more transparent reporting does not always produce the desired outcome. As an illustration, Campbell et al.[48] find a significant negative relation between the discussion of environmental topics and an adviser's fundraising ability, primarily attributable to environmental disclosures with a negative tone. In other words, it can be positive to report on environmental issues, but it may hurt you if you mainly report on negative information. Moreover, the study shows that investors respond differently to ESG information depending on their political orientation: they react more in anti-ESG or more Republican-leaning US States. This is another illustration of the influence of cultural factors on the approach to RI, that we reported in our previous study.

[47] In Europe as well, Invest Europe's ESG KPI report is the results of collaboration with national associations involved in the European data cooperative

[48] Campbell J., Davidson O., Mason P. § Utke S. (2024), ESG Disclosures in Private Equity Fund Prospectuses and Fundraising Outcomes, ESG%20in%20Private%20Equity/Academic%20Papers/ESGDisclosuresinPrivateEquity.pdf

Conclusion

Due to their growing size and impact on the global economy and to the levers they hold to implement responsible investment, through their direct involvement in defining strategy in their investee companies, private markets have an essential role to play in the development of ESG. The PE industry has generally lagged behind other segments in the financial sector, but it is currently catching up. Increased regulatory, particularly in Europe, as well as LPs' pressure, are playing a role in this trend, but GPs should also be aware that if the PE industry does not embrace sustainability, it will face a number of risks. In particular, its social legitimacy will increasingly come under attack, and it may no longer be able to deliver its historically high returns if it fails to fulfill its potential to help solve, rather than exacerbate, E, S and G problems.

Beyond broad statements of purpose and communication, responsible investing in PE is now getting into the hard part, and very concrete issues have to be faced. Improvement in data quality and increased homogeneity of tools and methodologies are important challenges. PE investors have a role to play in this respect by contributing to building and feeding databases that could be widely used. Investment processes should also be strengthened, with clear rating and engagement processes, as well as through the formalization of the importance of ESG in the governance of portfolio firms. We have shown in particular that successful implementation of responsible investing requires that it be widely shared within investors' organization instead of being reserved to specialists, as it has broad implications in terms of setting strategy, managing risk, producing reportings…

Other important issues will need to be addressed. How to deal with the potential mismatch between the long horizon over which certain sustainability strategies are expected to pay off and the shorter horizon of holding an investee company? How to integrate ESG in GPs' remuneration schemes? The examples we have provided in this paper can guide investors in answering these questions.

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