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# The Business Case For ESG Impact Awareness In Private Equity

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There's no question that the world is currently in flux. We're in the midst of a global pandemic and the game for the foreseeable future is that of adaptability. How quickly one can pivot and their tolerance for risk determines their outcomes. It is within this context that funds focused on Environmental, Social, and Governance (ESG) strategies have outperformed their traditional counterparts. ESG impacts matter, especially to the market.

Why? Because ESG investing requires a closer look at social metrics, environmental factors and governance structures. Private Equity firms that consider ESG investment strategies go beyond simple marketing claims. They're not messing around. They evaluate the details behind everything from supply chains to employee retention to local community engagement strategies. It's the equivalent of inspecting a house before you buy it. These PE firms care about their portfolio impacts and want to resolve them... Plus, both their investors and their assets know it.

The ESG focused approach enables greater resiliency within firms because they know the full extent of their vulnerabilities and opportunities. This makes ESG investment increasingly attractive. It's the safer and more informed bet. It also feels good. Especially during a global crisis. As a result, ESG awareness and evaluation is rapidly growing in its importance to stakeholders involved in PE investments.

## ESG Translates Into Informed Risk

A critique of using ESG to inform investment strategies is that the standards shift, especially depending on the location or scale of a company. The criteria for meeting sustainability standards in Europe do not necessarily align with standards in the United States, and a performance measure may place greater weight on one metric versus another. As a result, firms that engage in ESG analysis must be flexible and consider multiple data points.

Here at Tablecloth, for example, we take a framework-agnostic approach by first assessing each client's portfolio, then developing an ESG data model specific to the interests of their fund. Every portfolio is unique based on different investment themes, sectors, geographic locations, and more. The impact data we capture needs to be properly contextualized within the bigger picture. By engaging with our clients, we're able to determine how they truly wish to make an impact through their investments, and what data is most relevant to tracking those goals. This deeper understanding means we can shift to cover multiple reporting frameworks relevant to those needs.

Despite the variation across frameworks, the introspection required of ESG analysis is recognized more and more for its ability to identify risks and assess the overall health of a company. Risks associated with ESG include factors such as supply chain collapse, natural disasters, regulatory bans, labor safety standards, or data insecurities.

## Knowledge Is Power... and Profitable

The quantitative and qualitative data that comes from evaluating ESG risks informs businesses on how they can adapt to achieve better internal results, as well as facilitate smooth working relationships with external partners. Although it is rooted in global concerns, focusing on ESG can be a self-serving practice for businesses. It provides an opportunity for profit and added value. Specifically, a 2019 report from McKinsey identifies five areas in which ESG strategies can directly link to value creation: top-line growth; cost reduction; reduced regulatory and legal intervention; greater employee attraction, retention and performance; and investment optimization.

Ultimately, the insight into the value added from ESG performance provides businesses an advantage over their competitors. Top-line growth can be achieved through access to new sustainably focused markets, as well as access to consumers that are in search of ESG products that are not yet available. For example, a 2020 study by IBM found that 57 percent of consumers would change their purchasing habits to avoid having a negative environmental impact. Seventy-one percent of consumers indicated that traceability of a purchase is so important to them that they would pay more for that information. Firms that understand their supply chains through an ESG lens have the power to understand their story relative to consumer demands and adapt.

Employees are also becoming more mindful of a company's ESG culture. Key findings from a Marsh and McLennan 2019 study on the relationship between ESG performance and workforce sentiment found that the companies with the highest employee satisfaction and attractiveness also had higher ESG scores than their competitors. Higher scoring employers were also found to have lower carbon emission intensity, a greater focus on monitoring employee satisfaction and greater board diversity. At the time of the study, Millennials and Gen-Z generations made up 52 percent of the workforce. As that proportion increases, so too will the importance of ESG metrics.

But added value isn't just about pleasing consumers and employees. Regulators and investors are also increasingly seeking ESG indicators when assessing performance. A 2020 Sustainable Investment Survey by Pitchbook indicated that 95 percent of LPs surveyed were either already evaluating ESG risk factors or increasing their focus on ESG risk factors in 2021. Additionally, the Board of the International Organization of Securities Commissions (IOSCO) is currently soliciting feedback on a set of recommendations for ESG Ratings and Data Providers that would address some of the aforementioned reporting inconsistencies for 95 percent of the world's securities markets. Standardization of ESG metrics is on its way.

### Taking Control of Your ESG Impact Story

The demand for greater transparency in ESG business practices is coming from all sides with varying degrees of oversight. Getting ahead of these demands means getting a hold of the big data behind your investments. ESG data analysis looks at both historic practices as well as the future direction of a firm, whether the goal is to stabilize growth or maximize it to a global scale. By acquiring information about ESG metrics now, firms have an opportunity to control their own narrative and shape their story before it gets told for them.

Most businesses are still in a discovery phase when it comes to ESG – they are learning how to speak the language and how to align the values of their firm with their impact story. ESG performance evaluation is valuable for assessing risk—*and* it's profitable. It's not going anywhere.

For those who are generally new to ESG investment, now is the best time to educate yourself and learn to identify the ways in which you can modify your portfolio or work with shareholders to address ESG related needs and reduce impacts.