

Sustainability in private equity

From box-ticking exercise
to the heart of value creation

The private equity industry has finally stepped onto the unstoppable train that is the sustainability movement. There is rarely any debate nowadays as to whether environmental, social and governance (ESG) considerations can be powerful drivers of value creation. The key challenge lies in execution.

In this white paper, we shed light on how sustainability practices of private equity managers are evaluated using our assessment framework. In addition, we hope this paper can be a useful resource for private equity managers who have only recently embarked on their own sustainability journey and are now looking for guidance. We are doing this not only because we believe the influence of the private equity industry, which has enjoyed tremendous growth in the past decades, can be channelled into addressing systemic challenges facing global communities. We are also a firm believer that properly incorporating ESG considerations ultimately delivers strong financial returns for investors, in a long-term sustainable manner.

Sustainability is now mainstream in the private equity industry

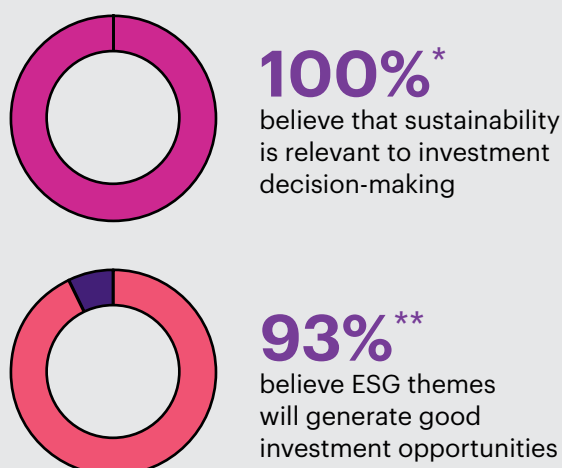
In a survey of 117 private equity managers, 100% of respondents believe that sustainability is relevant to investment decision-making (*Figure 1*)¹. In another 2020 survey of over 50 private equity managers, over nine in 10 respondents (93%) believe that focusing on ESG themes will generate good investment opportunities².

The Principles for Responsible Investment (PRI) investor network reports that the number of private equity and venture capital firms among its signatories has quadrupled over the past five years, to a total of 1,090 today³.

But private equity has had a mixed history of engaging with ESG considerations. The “G” has been important from the get-go, by design. In 1989, Michael Jensen, co-winner of the 1990 Nobel Prize in Economics, published a highly influential Harvard Business Review article, addressing, at the time, a new and untested form of ownership that has since come to be known as private equity⁴. This new model, Jensen argued, would effectively resolve a key governance weakness of public companies – the conflict between owners and managers over the control and use of corporate

resources. On the other hand, the story is very different for “E” and “S”. Environmental and social considerations in the private equity “playbook” have been virtually non-existent for most of the industry’s not very long history.

Figure 1: Sustainability is now mainstream



Source: *LGT Capital Partners; **ERM

¹ESG and the SDGs: Insights from private equity managers, LGT Capital Partners, 2020.

²Eyes on the prize: unlocking the ESG premium in private markets, ERM, 2020.

³Private Equity Should Take the Lead in Sustainability, Robert G. Eccles et al. Harvard Business Review, July-August 2022.

⁴Eclipse of the public corporation, Michael C. Jensen, Harvard Business Review, September-October 1989.



Private equity is well-positioned to take the lead in sustainability

Despite a tepid pace of adoption until recently, we believe the private equity model offers a couple of critical advantages in advancing sustainability.

Long investment horizon

While private equity is far from immune from short-termism, the average holding period for portfolio companies is around five to six years⁵. That allows private-equity-owned companies to operate on a longer time horizon than most publicly traded companies, whose executives often feel compelled to manage the business to meet quarterly guidance. An adequately long time frame is often required to realise ESG objectives such as reducing greenhouse gas emissions and for the benefits of successful sustainability initiatives to be reflected in the financial value of the business.

Control-oriented approach and greater access to information

Private equity firms are often well-placed to exert significant influence, if not outright control, over their portfolio companies. This can include encouraging for stronger sustainability practices. Private markets are often accused of not providing the same level of transparency as public markets do. The reality, we would argue, is a little bit more nuanced than it appears. This claim is correct in the sense that for a member of the general public, there is less information regarding a privately owned company than a publicly listed one. However, as a controlling shareholder, a private equity firm typically enjoys access to any information it wants, including sustainability related, while investors of listed companies only get to see what companies opt to disclose in financial reports and what regulations dictate. This information advantage, coupled with its control-oriented ownership model, can put private equity firms in a powerful position to drive changes in corporate behaviours.

⁵Prolonged Private Equity Holding Periods: Six Years Is the New Normal, Joenvaara et al, The Journal of Alternative Investments Summer 2022

▶▶ The evolution of sustainability practices in private equity firms

For over two decades, WTW has been active in recommending private equity funds to its clients and investing in those funds on behalf of its discretionary clients. We observed first-hand how managers have shifted their views on the importance of sustainability (Figure 2).

Stage 1 | Disbeliever

Not that long ago, it was not uncommon for private equity firms to view many ESG considerations as unnecessary distractions from generating return potential. Private equity investors and managers, like most of the other participants in the investment industry, had not developed ways to effectively capture and integrate ESG information as part of their return-generating theses. In fact, some managers even argued that considerations of ESG issues could damage return prospect, based on anecdotal evidence of underperformance of impact focused mandates. There was little attempt to greenwash, a practice involved with making unsubstantiated or exaggerated claims about sustainability credentials⁶, as there was no perceived reward in doing so.

Stage 2 | Compliance driven

As regulators around the world recognised various systemwide challenges in the sustainability space, private equity firms were obliged to comply with regulations addressing those challenges. Still, there was a lack of genuine understanding as to why ESG information mattered with respect to financial returns, and ESG compliance was viewed largely as a regulatory burden and a box-ticking exercise.

Stage 3 | Fund-raising driven

Meanwhile the sustainability movement continued to forge ahead. Expectations were growing. Providers of capital, such as end savers and institutional asset owners that represent large pools of end savers, increasingly demanded their asset managers take sustainability more seriously. Some private equity firms started to see sustainability as a specialist product that could appeal to a minority of investors and in response launched funds with specific impact objectives. Outside those specialist mandates, private equity firms started building up sustainability know-how, typically starting in the investor relations department. As ESG topics assumed a more prominent position on investors' agenda, so too did the risk of greenwashing.

Figure 2: How sustainability practices in private equity firms evolve over time



⁶In the literal sense, "greenwashing" refers to making unsubstantiated or exaggerated claims about environmental credentials, but the phrase is nowadays often extended to cover the broader ESG spectrum.

Stage 4 | Risk mitigation

Then, a breakthrough occurred: a rising number of private equity firms started to regard ESG considerations as materially relevant to investment decision making. This journey normally started with firms viewing ESG information from the lens of risk mitigation. Negative screening became a standard practice. At this point the integration of ESG issues was primarily focused on the pre-investment period and managers were prepared to walk away from deals in which ESG risks were deemed too great.

Stage 5 | Value creation

Today's high-conviction managers took another substantial leap forward by unequivocally embracing sustainability throughout the entire investment process: pre- and post-investment period. Consequently, ESG information has effectively become a core driver of value creation and an overarching framework that can inform the strategic thinking of the entire firm. Within our current private equity portfolios, all managers we partner with have reached at least stage 4, with a number of them indeed achieving stage 5. We are actively working with all our managers, encouraging them to adopt best practices.

That is not to say that scepticism has completely disappeared. The way the industry is wired is that until there is consistent data establishing a positive and decisive link between ESG considerations and financial returns, there will likely always be cynicism among some investors.

Albeit mostly outside the private equity industry, growing evidence of the financial impact of ESG factors and stewardship has started to emerge⁷. And as the market increasingly incorporates externalities, both negative and positive, in its pricing of financial assets, underpinned by a sustainable investment evolution, we expect more evidence to arise over the long term.

⁷Sustainable investment, show me the evidence, WTW, 2018





WTW private equity sustainability assessment and engagement framework

At WTW we believe that properly incorporating sustainability considerations, including both risks and opportunities, is central to successful long-term investment outcomes. This foundational belief spurred the development of a structured and disciplined process for integrating ESG considerations into our manager research decisions.

In evaluating the sustainability practices of a private equity manager, we use a **six-dimensional framework** to assess the overall commitment to sustainability and the sophistication of ESG integration (*Figure 3*). The key is to pinpoint clear evidence that ESG integration has gained collective buy-in and become institutionalised, supported by a clearly defined governance structure and a fit-for-purpose resourcing model.

Figure 3: **How WTW assesses sustainability credentials of a private equity manager**

<p>1. Overall commitment to sustainability</p> <ul style="list-style-type: none"> • An evolving sustainability policy that reflects collective beliefs on why sustainability matters and details how ESG considerations are embedded in the entire private equity investment cycle including deal origination, due diligence, deal structuring, portfolio management and exit • Demonstration of commitment to industry standards/guidelines/best-practice frameworks and evidence of actionable learnings from participating in these initiatives • Evidence of contractual commitments related to sustainability (e.g., in side letters or limited partner agreements) 	<p>2. Sustainability resources</p> <ul style="list-style-type: none"> • A clear governance structure outlining sustainability oversight responsibilities within the organisation • Evidence of senior leadership buy-in and involvement, supported by dedicated ESG specialists and/or third-party consultants • Evidence of regular and firm-wide efforts to provide sustainability training, assistance and external resources to investment and operational teams as well as portfolio companies
<p>3. ESG integration: pre investment</p> <ul style="list-style-type: none"> • Evidence of in-depth and consistently conducted ESG due diligence, led either internally by the manager itself or assisted by external ESG consultants • Documentation in investment memos of materiality-based assessment of ESG risks and opportunities and evidence of material ESG findings influencing investment decisions, including pricing decisions and downside protection structuring, and ESG objectives and milestones as part of the value creation plan 	<p>4. ESG integration: post investment</p> <ul style="list-style-type: none"> • Embedding of a sustainability action plan in the portfolio management and value creation process • Evidence of incorporating ESG responsibilities in leadership roles at portfolio companies, including remuneration measures related to sustainability • Evidence of ongoing monitoring and management of ESG considerations at portfolio companies
<p>5. Reporting</p> <ul style="list-style-type: none"> • Qualitative and quantitative updates on ESG considerations/KPIs featured in regular communications, ideally quarterly • Established disclosure framework in action to material ESG incidents • Reporting on engagements with portfolio companies, including the entity engaged with; the objectives/topic and rationale of the engagement; actions taken; outcomes and next steps 	<p>6. Sustainability impact</p> <ul style="list-style-type: none"> • A transparent approach to measure, assess and report impacts of investment holdings on the wider environment and society • Evidence of decreasing carbon footprint and other environmental improvements, at portfolio companies and at the private equity business • Evidence of aligning portfolio companies and the private equity business with net-zero goals • Evidence of increasing diversity and other societal improvements, at portfolio companies and at the private equity business

When it comes to the **commitment to sustainability**, two attributes separate the leaders from the crowd, in our view. Beyond actions such as developing a sustainability policy or committing to an industry initiative which are certainly important in their own right, an effective **culture** that actively cultivates and incentivises sustainable value-creation opportunities throughout the organisation is imperative to reap the full accreted value from ESG integration. Sustainability principles, policies and the commitment to meet them are set by the leadership. But it is the culture that transmits them through the firm and to clients. Evaluating the culture of a firm is no easy task. It involves assessing many soft factors that are often subjective and open to interpretation.

WTW has developed a systematic culture assessment framework⁸ centred around client value proposition, employee value proposition as well as the quality of the firm's leaderships in developing and evolving the firm's vision, values and direction.

The other differentiating factor is clear evidence that the manager is "**walking the talk**", including managing and disclosing sustainability performance of its own (in addition to that of its portfolio companies) and progress on the impact front, environmental as well as inclusion and diversity practices.

⁸Measuring culture in asset managers, WTW, 2018

We believe that best-practice ESG integration encompasses the entire life cycle of private equity investing, from shaping opportunity set and forming investment strategy, through deal origination and due diligence, to portfolio company value creation during ownership stage and exit. Resources need to be in place to support the identification, measurement and management of material ESG information, ideally encompassed in a data driven approach.

One of the key challenges is **tackling greenwashing**. We have wide-reach conversations on sustainability not only with an ESG specialist or head of investor relation but also across due diligence meetings, whether with the leadership, deal-sourcing function or members of investment and/or operational teams. Inconsistencies across these conversations can be indicators of unsubstantiated or even erroneous claims about sustainability credentials. As always, concrete evidence is sought to back any claim in order to help minimise the risk of greenwashing. Some best-practice examples include:

- Clear documentation of assessment of relevant ESG information in investment memos of all deals
- ESG specialist(s) working alongside investment teams, given decision-making rights at the investment committee meeting
- Integration of ESG targets into individual incentive structures, at both the firm and portfolio company level
- Focusing on *additionality* when it comes to impact; evidence of a clear chain of events involving manager actions that result in tangible outcomes, validated by reference calls, as opposed to being a free rider on corporate actions that would occur anyway.



It is often underappreciated that greenwashing risks exist not only at the investment manager level but also at the portfolio company level. In this regard, our preference is for private equity managers to be thoughtful about having the engagement and disclosure process in place to validate the ESG-related claims made by the investee companies.

We acknowledge that in the world of private equity, sustainability best practices are still emerging and rapidly developing.

Within the universe of private equity managers we partner with, there is a varying degree of sustainability maturity and aspirations, depending on factors such as stakeholder priorities, market context, scale/resources,

and core competencies. The assessment framework we outline above is hence best viewed as a facilitator of constructive dialogue and an enabler of further progress towards stronger practice. While we do have certain minimum requirements in place to screen out managers not managing sustainability properly, we see great value in working along with our managers to contribute to the “rising sustainability tide” of the entire investment industry.

Before we move on to the next subject, we present you two case studies. In *Figure 4*, we show a European mid-market firm actively pursuing excellence in ESG integration. The case study in *Figure 5* is an example of WTW working closely with a private equity manager, having successfully resulted in tangible and material outcomes.

Figure 4: Sustainability best-practice case study

This is a mid-market private equity firm specialising in TMT, service and industrial growth investments within Western Europe. It has been a Principles for Responsible Investment (PRI) signatory since 2012. Its responsible investment policy is thoughtful and comprehensive, and one of the early movers in the industry in adopting Taskforce on Climate-related Financial Disclosures (TCFD) for climate reporting.



ESG initiatives

Numerous ESG initiatives are embedded throughout its investment process, pre- and post-investment. Its dedicated Head of ESG oversees the entire integration process and is hands-on in terms of conducting annual ESG review and providing comprehensive feedback to portfolio companies on ESG improvements. The manager is also committed to delivering positive impact within and even beyond its holding period.



Climate change

With regards to climate change, the manager supports the Science Based Targets initiative, and is targeting Scope 1 and 2 compliance by 2030 and all portfolio companies adopting science-based targets by 2040. There is clear evidence of identifying climate-related risks and opportunities within the due diligence process, covering those related to both climate transition and the physical impact aspect. The manager is also conducting climate change scenario analysis for all portfolio companies as part of onboarding, leveraging a tool that it developed alongside PwC’s Sustainability Team.



Inclusion and diversity




The manager is dedicated to improving inclusion and diversity (I&D) both at the firm and portfolio company level. It formalised its I&D policy in 2019 and recently formed an I&D council, a team composed of representatives from select portfolio companies to advance I&D. It is also in the process of developing a toolkit, a resource of best practices available for portfolio companies. Within its portfolio companies, the manager looks into reporting on gender pay gap, ethnicity pay gap and other relevant I&D metrics. 35% of its portfolio company executives are female, with a target of 50% over time. At the firm level, women represent 48% of the total workforce.



This is a sample representation of our work with an investment manager. Outcomes will vary and there is no guarantee of similar results.



Figure 5: **Sustainability engagement case study**

<p>Background</p>	 <p>During the due diligence of a mid-market pan-European buyout manager, we identified several areas for improvement as it relates to its sustainability practices, following our assessment framework and understanding of the manager’s specific context</p>
<p>Engagement</p>	 <p>Having decided to make the investment, we set up a follow-up feedback call with the manager to discuss industry best practices and tangible next steps that it could take to continue advancing on its own sustainability journey</p>
<p>Outcome</p>	 <p>The manager has agreed to implement a number of ESG initiatives at the firm following our engagement:</p> <ul style="list-style-type: none"> • Arranging sustainability training for all employees • Signed up to the Institutional Limited Partners Association (ILPA) ESG Data Convergence initiative • Exploring verification of carbon reductions plans at the firm and portfolio companies through the Science Based Target Initiative (SBTi) • Commitment to improve the diversity of the team and portfolio companies • A side letter making these commitments contractual

This is a sample representation of our work with an investment manager. Outcomes will vary and there is no guarantee of similar results.



Addressing challenges in data collection and reporting

A challenge that repeatedly emerges from our conversations with institutional asset owners and private equity managers is the lack of a consistent ESG data collection and reporting framework.

This creates challenges for private equity managers when it comes to evaluating the link between ESG information and financial performance, disclosing ESG performance to their investors and other stakeholders, as well as tracking the progress on sustainability goals of their portfolio companies. A lack of consistency and comparability also makes it very difficult for investors in private equity to benchmark ESG performance across different funds⁹.

With a huge array of reporting standards, frameworks and guidelines, participants in the private equity industry are understandably overwhelmed.

Deciphering the alphabet soup in the sustainability space requires dedicated resources, a non-trivial ask particularly for boutique managers that have not yet reached scale. For that reason, in *Figure 6* we provide a quick-start guide to a selection of frameworks and initiatives that in our view matter the most to the world of private equity, leveraging our multiyear experience of navigating the space.

That list, however, is still too long. The need for the convergence of standards is abundantly clear. And notable steps have been taken. In the public market space, the [International Sustainability Standards Board](#) (ISSB) was launched in late 2021 to deliver a global baseline of sustainability-related (including climate) disclosure standards, consolidating the work of several previous efforts into a single body.

In private markets, the [ESG Data Convergence Initiative](#) is among the most coordinated attempt to bring a standardised set of ESG metrics and mechanism for comparative reporting to the industry. Within a few months after its launch in September 2021, more than 230 leading private equity firms and investors representing more than \$24 trillion USD in assets had committed to the initiative, including WTW. Its participating firms agreed to report on a core



set of ESG metrics across six categories, including greenhouse gas emissions, renewable energy, board diversity, work-related injuries, net new hires, and employee engagement. These data points will be collected at the same time of the year, using the same technical definitions, and normalised with a standard set of financial data points such as revenue and enterprise value. They will also be reviewed year on year and evolve as the industry continues to make progress on arriving at a set of meaningful and comparable ESG data from private companies. We encourage all private equity managers we partner with to join this initiative. Many of them have already done so.

Even with standardised reporting, challenges remain in collecting, and in some cases estimating certain metrics from portfolio companies.

For example, board diversity and net new hires are relatively straightforward to record. Greenhouse gas emissions, on the other hand, are a lot harder to measure accurately. For private equity firms who do not have sufficient in-house resources to address this challenge internally, trusted third-party data providers can be brought in to fill the knowledge gap. Our private equity team has spent a significant amount of time vetting numerous ESG data providers and made a short list of our preferred ones available to our managers. We hope our efforts contribute to them building a disciplined and data-driven sustainability process.

⁹How private equity can converge on ESG data, Lorenna Buck et al, BCG

Figure 6: Navigating the alphabet soup

	Acronym	Stands for	Comments
	EUT	European Union Taxonomy	The EU Taxonomy regulation and the Sustainable Finance Disclosure Regulation (SFDR) are cornerstones of the EU's Sustainable Finance Strategy. The European Commission has created an EU Taxonomy Compass to provide guidance on which activities are EUT eligible. SFDR created the Article 6, 8 and 9 classifications for funds which indicates the level of integration of sustainability in a fund.
	iCI	Initiative Climat International	A global community of private equity firms and investors that seek to better understand and manage the risks associated with climate change. In March 2022, it launched a new standard that sets out a consistent approach to greenhouse gas emissions disclosure across the private equity sector.
	IFC	International Finance Corporation	IFC has been at the forefront of impact investing in emerging markets for decades. It developed the Operating Principles for Impact Management , which are now followed by over 140 privately and publicly owned funds and institutions.
	IIGCC	Institutional Investors Group on Climate Change	A European membership body for investors collaboration on climate change with more than 375 members representing over €51 trillion in assets. Its mission is to support and enable the investment community in driving significant and real progress by 2030 towards a net zero future. In Feb 2022, it launched its first net zero guidance for private equity , to which WTW has given input.
	ILPA	Institutional Limited Partners Association	An association for institutional limited partners in private equity with over 500 members representing over \$2 trillion. A great source of educational materials, resources, and toolkits that help navigate the ESG learning curve for the private equity industry participants and a leader of important initiatives such as ESG Data Convergence initiative and Diversity in Action .
	IMP	Impact Management Platform	A collaborative initiative to build and further global consensus on how to measure, assess and report impacts of investments on people and the environment, increasingly adopted by the private equity community.
	PCAF	Partnership for Carbon Accounting Financials	An industry-led partnership to facilitate transparency and accountability of the financial industry to the Paris Agreement. PCAF developed the Global GHG Accounting and Reporting Standard for the Financial Industry . The partnership is open-access and free-of-charge. Organisations can join PCAF for free and get access and tools.
	PRI	Principles for Responsible Investment	The largest international network of investors promoting sustainability principles, backed by United Nations. As of March 2022, more than 4,800 signatories, including over 1,000 from the private equity industry, from over 80 countries representing approximately US\$100 trillion, have signed up to PRI. An incredibly rich source of practical tools that guide private equity firms (and other type of investment organisations) to integrate ESG including “ A GP’s guide to integrating ESG factors in private equity ”, “ A guide on climate change for private equity investors ” and “ TCFD for private equity general partners ”. Many of the private equity firms we back are PRI signatories.
	SASB	Sustainability Accounting Standards Board	A non-profit organisation active in developing sustainability accounting standards. The materiality map it developed covers 77 industries and identifies the material ESG issues that are likely to impact the financial performance of a company, a very useful tool for private equity ESG due diligence. From August 2022, as part of the efforts to consolidate sustainability accounting standards, the SASB Standards became a resource of the International Financial Reporting Standards (IFRS) Foundation under the newly formed International Sustainability Standards Board (ISSB) .
	SBTi	Science Based Targets initiative	A coalition set up to help companies set emission reduction targets in line with climate science and Paris Agreement goals, backed by more 1,000 companies as of 2022. The initiative defines and promotes best practice in science-based target setting and independently assesses and approves companies’ targets. In November 2021, it issued a guidance for the private equity sector to set up science-based emission reduction targets.
	TCFD	Task Force on Climate-Related Financial Disclosures	Created to develop consistent climate-related financial risk disclosures for use by corporations and investors in providing information to stakeholders. Regulators around the world have increasingly encouraged, and in some cases mandated, market participants to follow TCFD. Institutional asset owners responded by requiring asset managers to make disclosures on the regular basis following the recommendations of TCFD.
	UN SDGs	United Nations Sustainable Development Goals	A collection of 17 interlinked global goals designed to be a “blueprint to achieve a better and more sustainable future for all”, a useful set of universally acknowledged impact objectives with growing adoption among private equity managers and investors.



In conclusion, an action list for managers

In a relatively short span of time, sustainability has moved from a topic of limited perceived relevance to a core pillar of value creation in the private equity industry.

Many private equity firms are well underway with the integration of ESG information in their investment processes. For those who aspire to maximising the competitive edge that a sophisticated sustainability program can offer, here are ten actions we invite you to consider taking. We firmly believe private equity managers that ground sustainability in their strategy and focus on value creation will ultimately deliver strong financial returns for their investors, in a long-term sustainable manner.

- 1** To achieve **organisational buy-in**, start at the very top. Leadership at the highest level is responsible for creating and communicating a strategic vision and driving a cultural re-set that respects sustainability as an unequivocally important driver of value creation
- 2** Develop a **sustainability policy** that details the current and future state of ESG integration within the firm. Make it as concrete as possible, including quantifiable and trackable sustainability ambitions and commitments
- 3** Back the sustainability development plan with appropriate **resourcing**, including setting up a clear governance structure overseeing the efforts and considering creating “sustainability champion” roles and/or bringing in dedicated sustainability specialists
- 4** Make systematic and regular **sustainability training** available to all members of investment and operational teams, as well as portfolio company management
- 5** **Integrate ESG** throughout the entire investment process, including (1) regularly re-evaluating investment strategy and opportunity set reflecting evolving sustainability themes (2) equipping investment team with the tools/frameworks in identifying material ESG risks/opportunities during diligence and (3) embedding ESG action plans in ongoing portfolio management/value creation
- 6** Be disciplined about **gathering ESG data**. Upgrade capabilities of internal reporting at portfolio companies to facilitate reporting ESG metrics that ideally can be aggregated at the fund level and disclosed to fund investors
- 7** **Climate**: build knowledge with respect to climate change related risks (physical and transition) and opportunities (mitigation and adaption solutions); acquire capabilities in collecting emissions data and consider adopting TCFD framework; consider committing to net-zero goals and develop and implement action plan in line with net-zero commitment
- 8** **Inclusion and diversity (I&D)**: consider developing and adopting a diversity policy that embeds target setting at the firm as well as portfolio companies; collect and track I&D metrics across the firm and portfolio companies and promote measure to help improve I&D over time
- 9** **Collaborate with the industry**: consider adopting industry standards (e.g., become a signatory of UNPRI) and joining forces with other private equity firms and investors in addressing system-wide challenges such as lack of standardisation of ESG reporting (e.g., join the ESG Data Convergence initiative)
- 10** Embrace **agility**. Acknowledge that sustainability conversations are constantly evolving, and new tools, services and solutions are frequently emerging. Don't settle; best-in-class is not a static concept

Appendix:

A deeper dive into Asia-Pacific's sustainable private equity landscape

Sustainable investment considerations within Asia-Pacific's private equity space are relatively nascent but growing. According to Bain's 2022 survey of Asia-Pacific private equity managers, nearly 40% of said managers have already embedded ESG considerations into their overall fund strategy for value creation.

This figure is set to grow in the coming years; 57% of Asia-Pacific private equity managers plan to increase their focus on sustainability significantly in the coming 3 to 5 years, as compared to 41% in 2020 and 30% in 2019¹⁰.

Compared to Western counterparts however, Asia-Pacific's private equity managers are still a bit of a ways behind, as they are still in the process of building up internal sustainable investment expertise and resources. Many are well aware of driving mechanics behind the global megatrend of sustainability, but fewer have made substantial commitments to sustainability goals or are actively integrating ESG considerations into their investment processes.

One of the key challenges currently impeding further and faster growth of sustainability in Asia-Pacific (not just unique to private equity, but any asset class) is the lack

of a single, unifying governing body on sustainability matters. The heterogeneity within the region – differing economic statuses and social norms/expectations – makes it particularly challenging to align all countries under the same umbrella. With differing sustainability disclosures, taxonomies, and standards across funds and regions, it is difficult for investors to (a) compare ESG performance across funds and (b) track ESG performance and progress against their own goals. To this end, note that upcoming international efforts to align taxonomy (e.g. EU and China's collaboration on Common Ground Taxonomy) and disclosure requirements (e.g. the IFRS' International Sustainability Standards Board) should alleviate this challenge. With such efforts aligning a wide spectrum of investors internationally, it is crucial that the "principle of proportionality" is considered (i.e. it is more challenging for developing economies to report on more esoteric metrics such as Scope 3 emissions). Apart from partaking in these international efforts, it is also important for Asia-Pacific's private equity managers to consider joining the ESG Data Convergence Initiative, as mentioned prior.

Another challenge hampering the growth of sustainability within Asia-Pacific's private equity space is the relative immaturity of the market. According to Bain, in 2021, growth deals comprised 59% of Asia-Pacific's deal value, and were the dominant deal type in four of the region's six major markets. And with growth deals, it is typical that

¹⁰Asia-Pacific Private Equity Report 2022, Bain & Company



an investor is a minority shareholder. With <50% stake in a company, it is relatively more difficult for a minority shareholder (vs. a buyout manager with controlling stake) to advocate for sustainability to be incorporated into the company's practices.

At the same time, there are also some key drivers encouraging the growth of sustainability amongst Asia-Pacific's private equity managers. First and foremost is the growth of climate technology sectors in the region; according to Bain, investments in climate technology rose 230% in 2021, following a 106% jump in 2020. Private equity managers are usually best placed to invest in new and upcoming technologies, given their ability to add value to such companies and not place pressure on short-term returns, as their public counterparts may.

When it comes to combatting climate change, the balance between interests in Asia is particularly interesting. On one hand, there have been incredible measures being taken by Asian economies when it comes to a low/zero-carbon energy transition. For example, it is estimated that more than 50% of electricity could be produced from renewables in Asia-Pacific by 2050¹¹. Of the top 10 countries in terms of energy transition investments, Asian countries (China, Japan, India, South Korea) comprise 42% of the world's total investments, with China by and large ranking first at US\$266 billion of investments, or 35% of the world's total¹². China's market is especially strong when it comes to renewable energy, leading the charge in producing renewable energy and making electric vehicles. On the other hand, Asia-Pacific accounts for >50% of the world's carbon emissions, with three APAC countries comprising the world's top 5 largest emitters

(China, India, and Japan). Further, at COP26, India made a last-minute push (supported by other emerging economies such as China) to soften coal language from "phasing it out" to "phasing it down". Clearly, while opportunities in climate technology abound in Asia, there are many challenges still at work that PE managers and other investors alike must navigate through.

Nonetheless, climate technology, such as climate adaptation and mitigation solutions, present new and exciting opportunities for Asia-Pacific private equity managers.

For instance, carbon capture and storage ("CCS") is picking up momentum in Asia-Pacific. Recently, six Korean energy companies have announced collaboration with Malaysia's Petroliaam Nasional Berhad to launch Asia-Pacific's first CCS hub project, whereby carbon captured in South Korea will be transferred to Malaysia for storage¹³. Private players, such as Exxon Mobil and Mitsubishi, are also planning to build CCS plants across Asia-Pacific.

There are other reasons compelling asset managers in Asia-Pacific to pay more attention to sustainability, private equity managers included. First and foremost is government action, largely related to environmental concerns and climate change. In the past few years, many major economies across Asia-Pacific have committed to net zero emissions and have also taken the initial steps to make these commitments a reality, as summarised in *Figure 7* below.

Figure 7: Asia-Pacific's commitment to net zero emissions

	Mainland China	Hong Kong	South Korea	Japan	Singapore
Paris Agreement Signatory	Yes	Yes (via Mainland China's agreement)	Yes	Yes	Yes
Net Carbon Neutral Target	2060 – government pledge	2050 – government pledge	2050 – government pledge	2050 – government pledge	Second half of 2050 – government pledge
Interim 2030 Target	Peak emissions before 2030; Over 65% reduction in emissions intensity of economy (below 2005 levels)	Reduce carbon emissions intensity by 65-70% (2005 as base), absolute carbon emission reduction of 26-36%, 3.3 to 3.8 tonnes per capita by 2030 – was set in 2017	Absolute emissions 40% below 2018 levels – updated in Dec 2021	46-50% absolute emissions reduction from 2013 levels	Peak emissions at 65 million tonnes around 2030

¹¹Asia's power production to be renewable-reliant by 2050, AA Energy

¹²Ranked: The Top 10 Countries by Energy Transition Investment, Visual Capitalist

¹³6 Korean firms join cross-border carbon capture storage project, The Korea Herald



Further mechanisms beyond medium and long-term commitments include carbon taxes, carbon emissions trading schemes (e.g. China's national emissions trading scheme), and green finance regulation – which are also expected to grow over the coming years.

Secondly, investors in the region are increasingly demanding that their private equity managers commit to and integrate sustainability considerations in their funds. While this is partially driven by regulatory changes on the horizon, some institutional investors in Asia-Pacific, such as family offices, are also driven by their personal missions and convictions.

While there are undoubtedly great challenges hindering the growth of sustainability in Asia-Pacific's private equity markets, it is also apparent that private equity managers are well placed to take advantage of opportunities in the region, such as climate technology.

With increasing regional regulation and investor demands for ESG incorporation and sustainability disclosures on the horizon, there will more than likely be rippling effects on the policies and practices of Asia-Pacific's private equity managers.

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