ESG: Effective and Appropriate Implementation the Key to Success

ESG factors are becoming critical to investment decisions all over the world. With its history of innovation and creativity, private capital is perfectly placed to ensure ESG is not just a box-ticking exercise

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Founded in 2001, **Capstone Partners** is a leading independent placement agent focused on raising capital for private equity, credit, real assets, and infrastructure firms from around the world.

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ESG has emerged as fundamental underwriting criteria for investors in both public and private markets. The challenge for sponsors and investors alike will be ensuring that performance against ESG objectives aligns with substantive impact, rather than regulatory recordkeeping. ESG has been making headlines for several years and has been widely adopted among European GPs and LPs. Although North America and Asia have lagged in the adoption of ESG principles, the ubiquity of these factors in recent client fundraising due diligence and the results of a Capstone Partners ESG LP survey show that implementation is accelerating in all regions.

Interestingly, the E, S, or G focus varies by region. The European market is most focused on environmental considerations, North America on social aspects (particularly as it relates to diversity and equity), and Asia on governance (unsurprising given the emerging market characteristics of the region and the large number of venture capital managers).

Our ESG survey revealed that 39% of US LPs focus on the ESG metrics of the management company, compared with just 3% of European LPs. By comparison, 64% of European LPs are focused on how GPs integrate ESG considerations into their investment process. ESG initiatives are easiest to implement and measure at the GP level. Nearly one-fifth (19%) of European LPs are looking at specific ESG metrics, in contrast to just 4% in North America and 9% in Asia.

The Skeptic Supertanker Is Turning

In the US, sponsor reactions to ESG implementation have been mixed. Many initially believed that ESG was a 'topic of the day' that would pass once we got through COVID and the politically charged environment of the past 18 months. Many GPs were concerned that ESG would become another check-the-box exercise, creating overhead costs that were detached from underlying benefits. While the results of studies related to ESG's impact on returns do vary, there is no question that the concept of good stewardship of our environment, developing a more diverse and fairly compensated workforce, and responsible governance are all descriptors of world-class organizations, and should be drivers of greater innovation within the private asset industry.

That said, it will take some deep, creative thought and hard work to leverage ESG principles into an asset. It will also take time, which means all constituents need to set realistic expectations on the pace of change – unrealistic expectations can drive poor decisions that may end up being counterproductive in the longer term.

It's a recipe for failure when ESG becomes a 'one size fits all' concept, whereby sponsors push to get the right answers to their ESG questionnaire, achieving paper victories rather than real-world ESG successes. One of the great attributes of the private capital asset class is that it encompasses a broad range of investment strategies and companies across most sectors of the economy. Unlike valuation or marketing guidelines, it would be virtually impossible to create a set of standard, detailed ESG requirements that can be applied to service, manufacturing, distribution, technology, and real asset strategies. Beyond the obvious differences in potential environmental impact, these industries also vary greatly in terms of regulatory/governance requirements and the profile of available employee and management talent. However, the difficulty of finding a standard ESG application cannot be an excuse for not implementing policies – those who fail to do so will likely find their LP base dwindling.

The EU has started to get tough and implement a series of policy measures aimed at using the financial sector to reorientate capital toward a more sustainable economy. The recently introduced Sustainable Finance Disclosure Regulation (SFDR) requires asset owners across Europe to provide specific disclosures relating to the ESG impact of investment decisions. Implementing this piece of legislation is going to be challenging for many GPs, but will improve transparency and reduce the risk of greenwashing. The new rules will also put pressure on GPs outside of Europe who want to market their funds in Europe, as they risk losing access to that capital.

A Call to ESG Action

The call to action is for managers (and service providers) to proactively define and implement an ESG policy that reflects the profile of both their investment organization and the underlying portfolio companies. The policy should be reflective of how responsible ESG can have a positive impact on these businesses. It should have measurable KPIs that track progress toward a longer-term goal. The policy should not be a path of least resistance, but should push people outside of their comfort zones and challenge them to find creative ways to meet the pre-determined goals.

Inevitably, people will have different interpretations and definitions of the environmental, social, and governance aspects of their businesses, which is fine. By proactively developing a policy, a manager can demonstrate to potential investors their commitment to ESG and, more importantly, develop world-class businesses that drive better returns.

We work daily with our clients to identify best practices and available resources to help them think through these issues. We do not have all the answers, but in adopting ESG, and as it is evaluated in more and varied situations, the nuances of effective, tailored, and relevant implementation will become better understood. It is incumbent on our industry to create responsible ESG outcomes, not merely sophisticated diligence scorecards. Our industry excels at creating both. Let's ensure we focus on making an impact on what really matters.

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