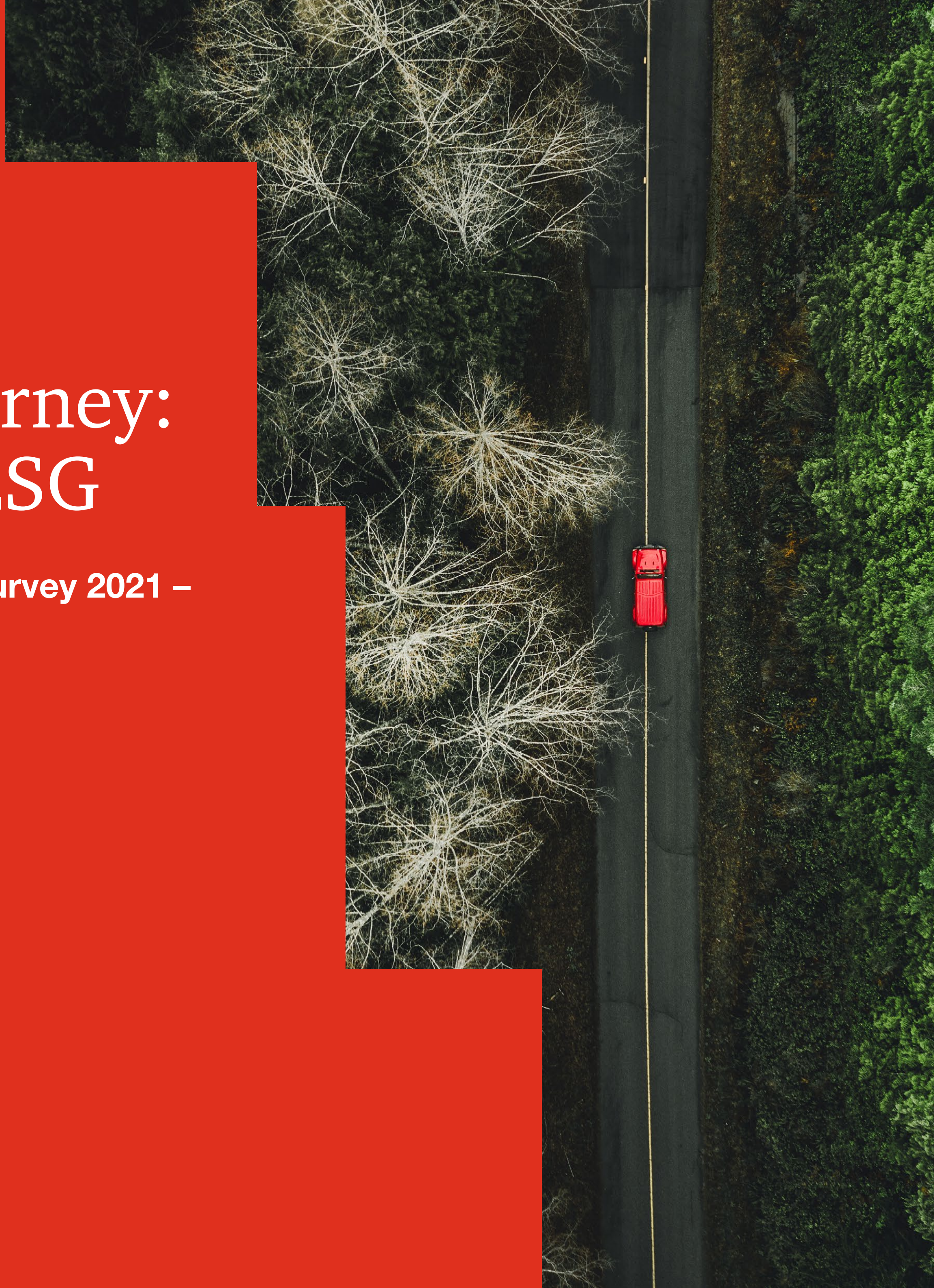
Private equity's ESG journey: Thinking ahead about ESG

Global Private Equity Responsible Investment Survey 2021 – Africa View



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Introduction

Multiple crises over the past 18 months have delivered a stark wake-up call to the world. If we're going to reduce the likelihood of further pandemics, respond to the risks of climate change, build a more equitable society and still generate growth, it's clear that we'll have to create more sustainable economies and social and environmental systems.

Businesses all over the world are adapting, shifting environmental, social and governance (ESG) issues from the periphery of strategic concern toward the centre. They're acknowledging ESG as a driver of value creation and urgently developing a proactive ESG mindset. PwC's latest *Global Private Equity Responsible Investment Survey* demonstrates that private equity (PE) is on this same journey and is well-placed to provide leadership, thanks to decades of experience prioritising a strategic, long-term, activist approach to value creation. Having seen the view on the global outlook, we now want to take you deeper into the results from an African perspective.

PE firms that put ESG at the heart of their business strategy will be the game changers in the new sustainable economy. And just as there will be leaders, there will also be laggards. Those firms that fail to embrace ESG will risk significant value erosion.

The Global Private Equity Responsible Investment Survey explores the views of general partners and limited partners in responsible investment among global private equity firms.

Context and methodology

This year, ten PE firms from five countries across Africa responded to the survey. Globally, 209 firms from 35 countries or territories responded (compared with 162 in 2019). Of these, 198 respondents were general partners and 41 were limited partners (compared to 145 and 38, respectively, in 2019). Some respondents were both general and limited partners. The vast majority (81%) came from Europe, with 5% from Africa.

Our survey shows how PE firms are adopting sustainable investing. In particular, it explains:

- that firms are entering a new age of ESG maturity
- why ESG is becoming key to value creation
- what is driving enduring business success

Explaining "Sustainability" and "ESG"

Sustainability refers to the long term viability of a company and, for example, discovering ways to decouple growth and success from negative impact. Achieving this involves deeper strategic embedding within an organisation, as opposed to the more compliance-driven environmental management and/or corporate social investment (CSI) programmes. In other words, sustainability used in this context describes an organisation's ability to thrive through a comprehensive and forward-looking focus on environmental, social and governance (ESG) factors. The specific ESG factors relevant for each company or organisation will depend on the context in which it operates, and the correct identification and responsible management of such issues will directly impact the sustainability of the business. In the case of a Private Equity firm, it is important that the specific ESG factors impacting the underlying portfolio be carefully considered in the performance and sustainability of the firm.

Key findings

There's an increased recognition among leaders of the value creation opportunities that arise from aligning a business with the transition to sustainability, and there's acknowledgement that ESG is a lever for transformation, alongside other levers such as digitisation and internationalisation. The UN's Principles for Responsible Investing (PRI) 2021–24 Strategy also makes it clear that topics including climate and human rights will become ever more important for investors, especially in the context of the post-pandemic recovery.

Consideration of ESG factors is no longer simply to mitigate potential risks. Aligning with global sentiments, the key drivers for ESG and responsible investment (RI) activity for African respondents were value creation, corporate values, and value protection and risk management. For African PE firms, there is more internal motivation based on operational efficiency gains from ESG considerations than investor pressures, as felt globally. This could be attributed to the stark realities faced by African companies, such as social vulnerability and inequality. Thus, PE firms are preempting market pressures they may feel in the future and taking it upon themselves to drive the ESG agenda.

This is also evidenced by the continual consideration of ESG matters at a board level, with more than half of the surveyed companies formally considering them as part of every board meeting agenda, and all African respondents considering these issues at least once a year, compared to 56% of global respondents. In contrast, vetting potential investments based on ESG considerations is still less prominent in Africa than globally. Most African companies also only rely on qualitative ESG findings to systematically inform investment decisions, rather than quantitative information.

ESG issues have been integrated into the majority of African companies' overall business development strategies, with specific key performance indicators (KPIs) being tracked and reviewed to measure the performance of the underlying portfolio. One of the standardised measures used to track ESG impacts are the United Nations Sustainable Development Goals (SDGs). More than half of the African respondents have prioritised SDGs at a fund or portfolio company level. Similarly, half have adopted a proactive approach to systematically monitor and report portfolio and company activities and performance against relevant SDGs, although most do not use SDG aligned KPIs to report the impact of their portfolios.

Environmental considerations

Over the past 18 months, the business world and most global governments made a stronger connection to the existential risks posed by climate change. Increasingly, the financial services sector is taking action, and that is reflected in PE firms' concerns about climate risk. In 2019, the vast majority of PE firms said they were concerned about climate risks in their portfolio. But most appeared to be slow off the mark in addressing the issue.

The following are environmental factors considered material by African PE firms when making investment decisions:

1. Management of environmental impacts, including waste management, water use, energy use, land use and air emissions
2. Compliance with existing and emerging environmental / carbon regulation
3. Biodiversity (including deforestation)

Those environmental factors considered material by African PE companies are consistent with their global peers. However, climate risk receives less consideration in Africa, and is rather replaced by biodiversity and deforestation concerns.

Have PE companies implemented measures to address the top environmental concerns in Africa? The following is the situation as it stands:

1 Management of environmental impacts, including waste management, water use, energy use, land use and air emissions

Mitigation measures implemented

2 Climate Risk

Half have already implemented mitigation measures, a third more plan to do so in the next year

3 Resource use, circular economy, plastic footprint and eco-design

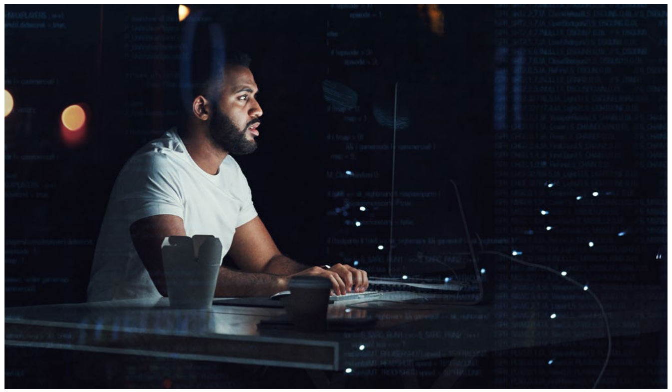
More than half already implemented mitigation measures, with some more planning to do so in the next year

4 Compliance with existing and emerging environmental / carbon regulation

70% have already implemented mitigation measures, with the rest planning to do so in the next year.

While climate risks are one of the top concerns for African PE companies, only half of the respondents have already implemented mitigation measures. Some (40%) consider climate risks in their due diligence processes, but most have not taken steps to understand or mitigate their portfolio's exposure to climate risks yet, although they plan to do so in the next year.

The reality, however, is that evaluating the climate risk of a portfolio is complicated. The UN PRI's guidance, published last year, aims to address some of the challenges in the implementation of the recommendations of the Task Force on Climate Related Financial Disclosures (TCFD), in particular the challenges around the knowledge, data, constrained resources and scale of addressing climate risk for whole portfolios. In addition, PE firms have to evaluate a variety of available third-party tools and methodologies. As governments around the world start to take more aggressive action on climate change, and as institutional investors and other limited partners increasingly factor climate risk into their own investment decisions, PE companies will need a greater level of knowledge and sophistication to chart the right course. Even if African governments do not legislate climate action in the short term, the implication of such legislation by large trading partners, and the subsequent negative effect of inaction, must be considered when developing and internalising an appropriate strategy.



Social considerations

Social factors considered material when making PE investment decisions for African PE firms:

1 Human rights and labour, including risk of modern slavery in supply chains

2 Occupational health & safety

3 Employee engagement, development and training

The past five years have seen a new resolve on the part of business to improve diversity and inclusion within the workplace, particularly in terms of gender equality. Indeed, 77% of survey respondents globally say that diversity is a core value and integral to their culture. A majority already believe that diverse teams generate business benefits—notably in the field of innovation. Improving diversity and inclusion throughout the sector is becoming a higher priority in a globalised workforce where firms compete for a new generation of talent that views diversity as the expected norm, not the exception, and where more diverse teams and boards can deliver greater success.

For African respondents diversity is one of the top three social concerns, with almost all having set diversity targets for gender or ethnicity and race.

Have measures been implemented to address the top social concerns in Africa? The situation as it stands:

1 Occupational health & safety

All have already implemented mitigation measures

2 Diversity, inclusion and equal treatment

Most have already implemented mitigation measures with the rest planning to do so in the next year

3 Employee engagement, development and training

All have already implemented mitigation measures

Since social issues such as unemployment, poverty and the need for a *Just Transition* are critical in Africa, it is reassuring that most are receiving attention, either already or in the next year. Notable exceptions are 'engagement with local communities' and 'the future of work such as automation'. With the global focus on Net Zero and the accompanying change in investment direction, proper consideration of a Just Transition also becomes an imperative. Such factors will become critical in moving towards a low-carbon world without leaving communities behind. Local communities must have a voice in the transition narrative, and the role that technology will play whilst protecting jobs and livelihoods will need to be carefully balanced with the goal of decarbonising the economy.

Governance considerations

Governance factors considered material when making PE investment decisions for African PE firms:

1. Compliance with ESG regulation
2. Prevention of bribery and corruption
3. Governance of sustainability / ESG risks and opportunities

Prevention of bribery and corruption has long been a top governance concern for business. Interestingly, the other material issues all relate to the future of sustainable business. The connection to ‘compliance with ESG regulation’ and ‘governance of ESG risks and opportunities’ is obvious. However, as PE firms address business ethics, as well as corporate values and culture, they will increasingly do so through the lens of responsible investing or ESG strategy. Their outlook and approach will also be shaped by the diverse and innovative talent of their workforce. Ultimately, the governance of both firms and portfolio companies will determine whether the value creation strategies that are being shaped to meet the challenges of our changing world will be sustainable.

Have measures been implemented to address the top governance concerns in Africa?

1 Prevention of bribery and corruption

All have already implemented mitigation measures

None All

2 Compliance with ESG regulation

Most have already implemented mitigation measures with the rest planning to do so in the next year

None All

3 Governance of sustainability / ESG risks and opportunities

Most have already implemented mitigation measures with the rest planning to do so in the next year

None All

African respondents are not currently focussing on addressing cyber security or emerging technologies. They must ensure that technological gains are not disregarded in prioritising pressing concerns, which could result in African PE firms being left behind in terms of digitisation.

Conclusion

While great strides to address sustainability are being made by PE firms in Africa, and often of their own volition, more still remains to be done to ensure Africa's continued growth and development in a new economy. From PwC's point of view, the following are the top steps:

Set a strategy, both as a company and as an investor:

ESG issues will reshape the global economy in the coming years and affect the investment performance of PE firms, and more broadly, the entire financial services sector. Furthermore, these issues are interconnected. It is crucial for PE firms to incorporate responsible investing and ESG matters into their general business strategy and no longer consider it as a side concern or specialist offering. It is important for African firms to consider how key ESG issues - such as climate risk, Net Zero (and the balance with the need for a Just Transition), diversity and emerging technologies - will have an overarching influence on firms and their investment portfolios. Understanding both the big picture and specific portfolio, ESG risks and opportunities will help shape a strategy that should deliver sustainable value creation.

Set a clear road map and target for transformative value creation:

PE firms should approach responsible investing and ESG in the same way they would other strategic issues with direct impact on their investment returns. At the portfolio level, PE firms should engage with their portfolio companies' management teams to truly embed ESG matters into their transformation and value creation plans.

When assessing new investment opportunities, PE firms should not look at the ESG risks only during diligence, but should start thinking about the value creation opportunities from early on and integrate those into the business plan. Fundamentally, leaders should ascertain whether there is an opportunity to align the business with the sustainable transition. This could form part of the investment thesis and truly unlock potential sustainable value creation or hinder growth and block access to finance. Conversely, if addressed properly, they can drive value creation across the spectrum.

Build a team equipped to navigate the journey:

Paradigm shifts require a rethink of accepted ways of doing things, to ensure resilience. An understanding of ESG issues will be a fundamental necessity for successful private equity investors. Operational training is essential for investment teams if they are to prepare quickly and build literacy on the subject matter.

Firms also need to recruit the right talent to deliver on sustainable value creation goals. This involves hiring individuals with sustainable business expertise and, in general, hiring more diverse teams in terms of gender, ethnicity and age, as well as socioeconomic background and qualifications. The good news is that the firms that demonstrate a commitment to ESG will likely be best placed to attract and retain such sought-after talent.

Contacts

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