Privcap/ Report

This report is based on a recent Privcap webinar:

Reporting ESG:

Challenges and Opportunities for Private Equity GPs

- **An expert discussion for investor relations professionals**

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> –Ignacio Sarria, New Mountain Capital

This report is based on an edited transcript of a recent Privcap podcast.
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Privcap: Why are institutional investors demanding more and better information about ESG in the portfolio?

Ignacio Sarria, New Mountain Capital: Especially over the last five years, we see this every day, every week. LPs and institutional investors—like pension funds, insurance companies and family offices—are requesting more and more ESG information. If you look at the trend, this started with public equities. Public equities were the first ones to be in the headlines about their companies polluting, or what their companies were doing in emerging markets. Activists among their larger shareholders were reaching out to the managers and saying, “Hey, can you please explain?”

It’s the same thing in private markets. We see LPs that are asking about ESG because their underlying pensioners, clients and principals also want to know where the money is being deployed, and how the money is being invested. It’s not only about showing returns, but showing how you make the returns. It used to be about driving top-line growth, about whether too much leverage was being used. And now it’s about ESG. They ask, “What about the environment? What about social, what about governance?” Every year, the bar is becoming higher, which is good news for the industry. New Mountain just raised a flagship fund last year at $9.6 billion. Seventy percent of the LPs investing in that fund had a specific ESG DDQ request. That’s pretty high.

Meghan McAlpine, SS&C Intralinks: It started with regulations in Europe. There is also growing interest from the SEC. But LPs increasingly are applying ESG factors as part of their investment process. Particularly in this post-COVID world, more people are focused on economic and social impact and ESG has become even more elevated. In the past, I think it was merely a check-the-box type of exercise, or maybe a niche strategy in the investor’s toolkit. But it's definitely become more mainstream. There are also more tools out there to measure the impact of ESG on an investor's portfolio, so lot of LPs are taking advantage of that and looking to get more transparency from their fund managers. There’s definitely a push from fund managers as well. The largest fund managers are committed to ESG and are advocating for ESG. There's a push from both sides.

Meg Lentz, Malk Partners: There has been a broad evolution around ESG, moving on from just exclusionary screening—you know, don't invest in certain industries—to something more nuanced. How are companies impacting various stakeholders, the employees, communities, the environment, customers, suppliers? COVID this past year has accelerated a lot of the belief around ESG. LPs and GPs together are trying to figure out what the best practices are. Many are turning to advisors like Malk to help them tease that out. There definitely is a growing recognition that ESG

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is moving from check-the-box to creating value and mitigating risk through strong ESG practices.

Privcap: Ignacio, what will be the biggest pain points as the industry figures out how to adopt ESG principles?

Sarria: I remember 10 years ago in conferences and webinars like this one, part of the conversation was around "Climate change, is it real? Is it worth it?" So, we had to focus on the "why." And it was very political, not just in the U.S., but in Europe and everywhere. Now, the good news is that at least the discussion is more around "how."

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The top two topics for our investors are environment and climate change, and DEI ([Diversity, Equity and Inclusion). Five years ago, the number-one priority was climate change. But now, it's diversity and inclusion, which I think is good news because it makes people the top priority. It is also good because private equity firms that don't do heavy industrial can't opt out by saying they can't address the "E" in ESG. All portfolio companies have people, so maybe we can use that to open up the discussion.

Investors are saying, "Show me KPIs." They want to see data so they can track progress. It used to be that when GPs presented case studies, there was a bit of cherry picking, showing stories about specific companies. But now, the LPs want to see data across the portfolio regardless of industries, and they want to see it year on year.

There is now the question of which data to share, because GPs sometimes complain that they put together lots of data and ask, "Do investors use this data or not? What is the key data?"

McAlpine: The biggest pain point right now is how to measure the effects of ESG. That's a little bit up in the air. Previously, it was about qualitative information and sharing case studies, like Ignacio said. But now, many firms are trying to figure out if ESG has a measurable impact on the portfolio, and that's what the LPs are looking to get as well. But measurements are getting better. Given that the industry is focused on this, that's a positive thing.

Lentz: There's definitely not a standard out there yet. LPs are asking for different types of data and GPS are struggling with the question of what the right data is. One consideration to layer on top of that is how to make this not just a reporting exercise to please LPs, but how do we make this accretive to the investment process and to each portfolio company? There is a lot of focus around tailoring the ESG issues you're paying attention to, and to the metrics you're trying to collect about the company so that it is accretive to the operational plan and your investment thesis.

Privcap: What do the LP data requests look like today by way of a split between portfolio-wide data and company-specific information?

Lentz: You really need to balance portfolio-wide measurement—like DEI and climate change—against company-specific metrics that are most material to that business. LPs are really looking to roll up all that data, but you need to think about the most material ESG issues and metrics to be tracking for each company so that they can run their businesses better and use that data in day-to-day decisions.

Sarria: Every LP is different. There are some very sophisticated, savvy investors with regard to ESG who want very detailed information around how, for example, many of the companies are carbon-neutral. But we also see requests around diversity, gender and equal payment. We see questions about labor standards. For the GPs, these are not easy tasks because it's not one size fits all. You try to gather as much information as you can without making your life miserable. There are so many different frameworks that you can use.

Let me give you one example of what we've been doing at New Mountain Capital since 2008. Every year, we put together what we call our "social

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dashboard," which tracks the number of new jobs created by our portfolio companies. Let's say we buy Company A, and there are 1,000 jobs. By year-end, we look at how many jobs at the company have been created after 12 months, net of any job losses. We track that every year until we exit that particular company. We also track the average employee pay. We look at how much we pay, from the CEO to the lowest-paid junior analyst in that company. We do an average of how much we pay and benchmark that against the U.S. national individual income. We send this dashboard to the LPs. Some of them love it, others don't care.

Privcap: Meghan, from your observations, what do LPs want to know around diversity and inclusion?

McAlpine: We're definitely seeing more of a focus on data and social impact. In the past, ESG was focusing on climate change, carbon footprint. Those metrics were synonymous with ESG. Now, there's much more of a focus on the "S" [in ESG]. DEI is becoming extremely important to LPs. We're seeing LPs ask specific questions, getting down to the portfolio company level on how that company is operating and how they're addressing concerns, whether it be around equity or inclusion. We see them looking for more concrete data and KPIs, as opposed to general qualitative information. Similar to Ignacio's dashboard, they want to see differences year over year at the portfolio company level.

Lentz: The requests have gotten a little bit more robust than just gender across the full firm or across the full workforce. It's starting to get more specific around the executive team or the management team, and using that as a signal around promotion rates. We're seeing more interest in board-level diversity data. The first piece was gender, but now there's more interest in racial or ethnic representation. GPs are starting to get more nuanced in asking their portfolio companies to track the recruiting process, the recruiting pipeline. They want to see job levels and roles broken down across locations, and using that data to drive change and implement better diversity and inclusion programs and initiatives. I'm seeing a lot of progress there, both at the LP level and at the GP level.

Privcap: Where is the industry with regard to ESG reporting standards?

Sarria: Right now, there is no specific standard. By the way, you don't have to disclose ESG information. I think it's good to disclose it because I'm a big believer in it. There are two ways to look at ESG: risks and opportunities, red flags and what I call green flags. We see more focus on the value, the opportunities—the green flags—more so than the red flags.

If you're looking for a specific format, you could look at the UNPRI, which gives you guidance around the DDQ. ILPA and the AIC have also offered guidance. But there is no specific requirement, for example, for reporting the ABCs around financials. But these will come. The SEC and European regulators are trying to fight greenwashing. You have to be careful what you say and what you disclose.

In our case, we use SASB and we find it very useful. They have 77 subsectors. Every time we do a deal—whether it be services, packaging, consumer—we go to the key questions of SASB, which gives us a sense of the right KPIs to report to our investors.

Lentz: With any sort of data collection process, you have to first see what you get, and then you can start using it, analyzing it and benchmarking it and setting goals. LPs are still very early in this process. The ultimate goal is to show aggregated metrics across the portfolio, and ideally showing returns tying that back to stronger ESG performance. But we are still at the stage of encouraging GPs to start building out systems to collect that data and starting to do that analysis and setting benchmarks.

McAlpine: We recently sent out a survey to GPs asking them if LP demand for more data and standardized reporting is among the top challenges that they're currently facing. Forty percent of them agreed. We further asked them if they had a strategy to address LP ESG reporting demands, and 45 percent either disagreed or were neutral. So, a lot of GPS are still figuring out what their reporting should look like for ESG.

There are no widely used standards in place today. Obviously, there are some frameworks that people are using, like UNPRI and SASB. ESG reporting standards will eventually emerge. ILPA will likely help drive that process. Internally, at SS&C Interlinks, we want to be part of the drive for standardization in the industry. Particularly with ESG, we have included ESG reporting metrics directly into our InvestorVision

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portal, and we're looking to continue to develop that as standards emerge. But, until there are standards in place, it's important for GPs to have a well-defined ESG strategy in place and to provide as much transparency as possible to their LPs, using the frameworks that are out there.

Lentz: When we're talking about standards and different required disclosures, it's helpful to take a step back and define whether these standards are going to be company-specific ESG issues or more fund-level disclosures around a firm's processes around risk identification and due diligence—more qualitative, programmatic disclosures. There is still an open question around what form the disclosures will take. Maybe we'll have both.

For most of the clients we work with, UNPRI is still the standard ESG reporting framework. Then, you have SASB and GRI, which are more issue focused.

Privcap: Who within the private equity firm should deal with ESG? Is this purely an IR function? Do you need a dedicated ESG person or resource?

Sarria: Every year, Coller Capital does an ESG survey where they ask the question, "Do you have dedicated ESG resources?" In 2020, over 50 percent of the GPs said they have a dedicated ESG person, which is good news. It used to be that ESG was mostly staffed part-time. They also asked which members of the team live with ESG. It started with investor relations and business development, but now it's moving to operating partners. Then, the last question was, "Who do they report to?" Two-thirds responded that the ESG team reports directly to the managing partner or to the CEO.

Privcap: Ignacio, can you talk more about your "green flag" approach to identifying ESG issues?

Sarria: We say "green flag" because green is also the color of a U.S. dollar. If you do things the proper way, you can make more money. A green flag means that if you improve the company from an ESG point of view, that company is going to be more valuable when you exit.

It would be great if could buy a company and, five years later, when selling, can show the ESG impact on returns. But this is not easy. We're trying to see how we can assess this. If we paid eight or nine

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times, but because of ESG improvements—a more efficient production technique, a better workforce—maybe instead of selling for eight or nine times, we can sell it for 10 or 11 times. Maybe we saved money on energy or packaging. If we track that, we'll be able to show an impact not just from leverage and top-line growth and margin expansion, but from ESG. That's what the green flag approach is all about.

McAlpine: Previously, ESG was definitely more about risk mitigation and making sure something wasn't going to negatively impact the portfolio. It's moved to a discussion about value creation. Before, if a fund manager was focused on ESG, there may have been the thought that you would be sacrificing performance or giving up returns. There is much more of a belief now that you can add value by investing more sustainably. The industry is still figuring out how to measure that impact, but LPs definitely are in favor of it.

Privcap: After a deal is done, do you provide an SDG (Sustainability Development Goal) report?

Sarria: We could be talking for hours about sustainability development goals, as defined by the United Nations, in 17 in different areas. That's something that we look at, but in our experience, it's really hard to track the SDGs, which are more focused on countries and NGOs.

Privcap: How is the SEC looking at ESG, and how can GPs avoid potential pitfalls in the future?

McAlpine: The SEC has taken more of an interest in ESG. Similar to Europe, regulations are coming to the U.S., and fines will likely emerge sooner rather than later. You need to make sure you have some sort of reporting framework in place. You need to be as transparent as possible so that you're ahead of the game. You need to address ESG issues that might come up with the LPs instead of trying to hide them, which would actually make things worse.

Lentz: With the SEC starting to launch inquiries into different private equity firms around their ESG disclosures and claims, it really just comes down to making sure you're doing what you say you're doing. When you have an ESG policy, make sure that you are able to show evidence of consistent implementation, and examples of how you've done that. That's what we advise our clients. We'll see what regulations come out, but in the meantime, the main philosophy should be to make sure you're doing what you're say you're doing.

Sarria: In Europe, we have the Sustainable Financial Disclosure Regulations, which say that if you are launching a fund, you need to state clearly in the PPM what you are doing from an ESG point of view. If you are an ESG fund or an impact fund, what are your commitments? You know, are we getting to a point where there's a policeman enforcing rules, and is that good or bad? We'll see how things evolve. Overall, I think it's positive. The regulators are looking out for greenwashing, which exists. At some point, there will be bad actors in ESG. You need a level of transparency so that, in five years, an investor would be able to say, "Hey, you said you'd be doing A, B, and C, and you didn't do it."

You don't want GPs to avoid ESG because they're afraid of misleading investors. They just need to state on a best-efforts basis what they're going to do. And, if you don't do it, investors can tell the regulator. But this is the same with financial disclosures. It's good for the industry. I'm positive on all these trends.

Privcap: Meghan, how should ESG information be dealt with during fundraising?

McAlpine: Disclosure is key. It's no longer an option and it's really become critical, especially in this competitive fundraising environment. It can be tremendously helpful for GPs to clearly articulate their position on ESG and their strategy. This can really give them an advantage in the competitive fundraising market. It can be a differentiator. I've spoken to LPs who have explicitly said that they will not invest in a fund manager due to ESG issues, or due to a lack of transparency on those issues.

Privcap: A question about real estate: if a private equity real estate firm is outsourcing much of their property operations, how do they report on ESG issues when they don't have their hands directly on the assets?

Lentz: Are they are using one consistent property management firm? Do they have many partners? Generally, when outsourcing property operations or management, what we see real estate firms do-

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ing is building that relationship with the property management company and expressing interest in ESG issues—maybe building that into the contract or setting that requirement from the beginning. It's about saying that there are the issues we care about, getting them on board and then having a consistent data-tracking and collection mechanism and having them provide that back to you. That does become much more difficult when you have a variety of different property management firms. It becomes a lot easier when you do have a consistent relationship. It should become more of a partnership.

Privcap: What advice do you have for a GP who is worried that when they report their initial ESG metrics, the numbers aren't going to look very good? For example, maybe they'll have to report that the diversity at several of their boards is zero.

McAlpine: That could be true across the industry in general. I don't think this would be a big surprise to LPs. But I think the bigger focus should be on what the plans are to change things in the future. GPs should be up front and transparent with LPs on their strategy going forward. How you're going to address a weakness in DEI is extremely important.

Lentz: I agree. LPs are not expecting perfection. They want to see improvements. But that requires having a plan in place, initiatives to drive improvements and drive changes. Tracking data is one thing, and it's a useful tool, obviously. But your ESG program should be broad and include operational initiatives. How are you driving change at your portfolio companies and in your own GP operations to show improvements over time? It can't just be about collecting data.

Sarria: I'm very optimistic. We are all learning. Every firm, even the largest ones, understands that the whole thing is evolving. For many GPs, you can download an ESG report from their websites. There are so many best practices out there, but I see that as a positive. It makes sense to listen to the LPs and see what other GPs are doing. In the private equity asset class, we have strong governance versus public equities. I know there are many negative headlines about private equity about ESG and diversity. But I think we can be a good case study five, 10 or 15 years from now.

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