Measurement and reporting: vital for ESG value creation in private equity

Regulators across jurisdictions are moving towards mandatory sustainability reporting for large and listed corporates. At Adamantem, we believe this trend towards increasing accountability through transparency of ESG outcomes is just as critical for private equity investors looking to drive sustainable value creation through ESG integration

Sustainability reporting requirements on the rise for large and listed corporates

Although most of the world was focused on international climate change commitments in November 2021, one of the most significant announcements to come out of COP 26 was the formation of the International Sustainability Standards Board (ISSB), tasked with developing “standards that result in a high-quality, comprehensive global baseline of sustainability disclosures focused on the needs of investors and the financial markets[1]”. With an existing proliferation of ESG reporting standards across the world (see Figure 1) causing a lack of consistent and comparable reporting in a format relevant to the financial markets, investors welcomed this development.

Figure 1: Number of ESG reporting provisions by regions, 2020

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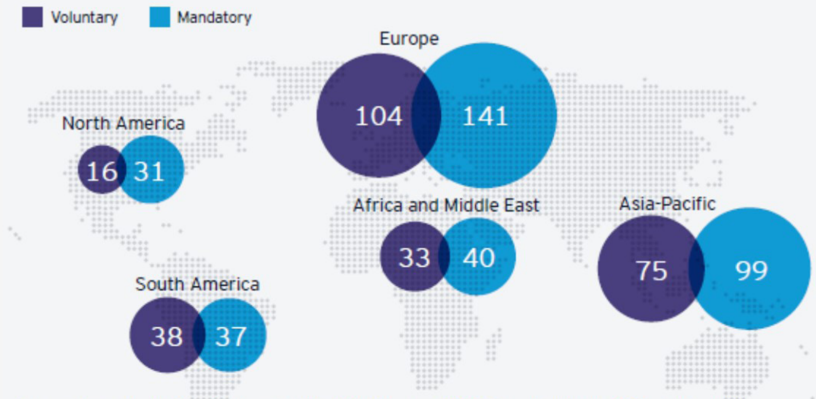


Source:The Future of Sustainability Reporting Standards, EY and Oxford Analytics, June 2021

The ISSB standards will build on the work of a number of existing reporting initiatives[2], with the goal of becoming the “global standard setter for sustainability disclosures for the financial markets[3]”. Two prototype standards for climate and general disclosure requirements have already been released[4], and are currently open for consultation until July 2022 with the aim of release towards the end of the year. It is expected that standards relating to other key ESG areas will follow swiftly.

In a significant development, in March 2022 it was announced that the ISSB and the Global Reporting Initiative – the leading global standard-setter for multi-stakeholder focused sustainability reporting – will coordinate their standard setting activities, ensuring sustainability information will meet the needs of both the capital markets and other stakeholders in a consistent and comparable way.

While it will be up to individual jurisdictional authorities to decide whether ISSB reporting will be mandatory, momentum for mandatory sustainability reporting is building:

- From April this year, over 1,300 of the UK’s largest companies and financial institutions will be required to disclose climate-related risks and opportunities in line with the Task Force on Climate-related Financial Disclosures (TCFD)[5].
- New Zealand has also announced mandatory TCFD reporting for large financial institutions from 2023[6].
- In the past month, the U.S. Securities and Exchange Commission set out its proposed rules requiring climate-related disclosures in registration statements and annual reports[7].
- The proposed Corporate Sustainability Reporting Directive in Europe will extend the scope of the existing Non Financial Reporting Directive meaning a greater number of companies required to disclose environmental, social and employee-related matters such as anti-bribery, corruption and human rights performance[8].

Although Australia has not yet made moves to mandate ESG disclosures, APRA[9] and ASIC[10] are increasingly focused on climate risk reporting.

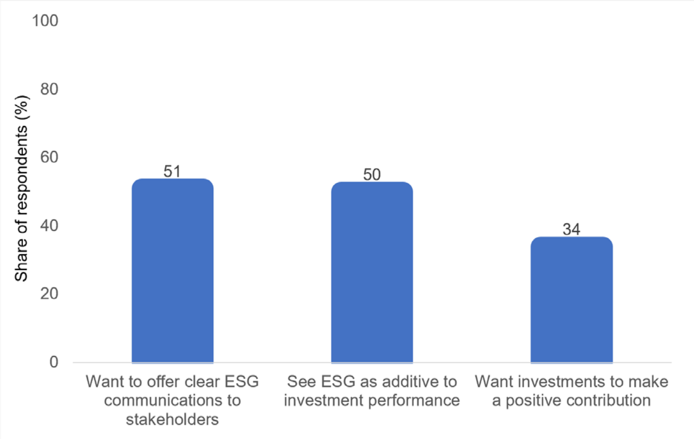
What does this mean for private equity?

An ability to demonstrate ESG outcomes and value creation

In the longer term, there is likely to be increased pressure from investors, lenders, customers and regulators for private companies to improve their sustainability credentials and reporting in line with these international frameworks.

In the meantime, however, private equity firms with a commitment to responsible investing can look to them for guidance on how to demonstrate their ESG performance and its contribution to value creation. In a recent Bain & Company and Institutional Limited Partners Association survey[11] of 100 limited partner organisations, the top reasons cited for ESG integration were that it is viewed as additive to investment performance and that it enables clear ESG communications to stakeholders.

Figure 2: Top reasons why LPs incorporate ESG



Source: https://www.bain.com./insights/limited-partners-and-private-equity-firms-embrace-esg/

General Partners that can measure and report on their sustainability outcomes in line with internationally recognised frameworks designed for financial markets will be better able to communicate the impact of their ESG programs to investors and demonstrate their contribution to overall investment performance. At the same time, their portfolio companies will be able to use the same reporting to communicate their environmental and social impacts to their stakeholders, using transparency to build relationships of trust with employees, customers, suppliers and local communities as part of creating long-term sustainable businesses.

Those firms that are measuring and reporting sustainability outcomes will also have a better ability to assess whether their ESG integration approach is in fact achieving the desired outcomes – informing a cycle of continuous improvement that is not possible in the absence of data.

A need for the rights skills and capabilities

General Partners, and the management teams and Boards of their portfolio companies, will need to continually evolve their skills, capabilities and perspectives in order to adapt and respond to these reporting trends as well as capitalise on the value of the underlying data.

Investment in tools and resources to collect the relevant information across portfolios will be required. More important, however, will be:

- the mindset within the General Partner and the portfolio company management teams to understand which ESG issues need to be monitored and measured. This will need to be coupled with the skillset to analyse this data from both a sustainability and an investment perspective, and to use it to create meaningful change within a business in a way which both drives outstanding financial returns while delivering positive social and environmental impacts; and
- Boards with strong governance foundations with a broader set of skills and capabilities to guide portfolio companies through the rapidly evolving ESG landscape. For example, a recent Deloitte report cited a need for directors to have “deeper knowledge of the environment, sustainability and climate change domain including as it relates to social licence to operate, workforce management and organisational culture issues[12]”.

ESG skills on public market Boards are scarce. The 2021 Sustainability Report[13] found that while 71 of the largest 100 global public companies now have a board overseeing sustainability, only 17% of the directors serving on those committees had relevant ESG or sustainability training or experience. However, private equity firms with dedicated internal ESG resources can leverage those resources to build ESG capability in investment teams (who sit on portfolio company Boards) and portfolio company executives, making them well placed to create future fit Boards and management teams.

The Adamantem response

Transparency: Building a culture and practice of transparency and high ethical standards to build relationships of trust with all stakeholders

This concept of transparency is one of Adamantem's three pillars of responsible investing. Through this lens we incorporate measurement and reporting into our approach to creating long term value and sustainable businesses.

We have always integrated ESG reporting into our regular Board and other portfolio company reporting processes. However, this year, we commenced the rollout of our proprietary "ESG Outcomes Reporting Framework" to our Fund II portfolio companies. This framework enables portfolio companies to report on over 25 sustainability metrics on an annual basis across our three focus areas for responsible investing: Environmental Sustainability, Participation and Transparency. The framework is aligned to the Ten Principles of the UN Global Compact and has been designed with reference to the Global Reporting Initiative Standards[14]. This will allow us to monitor and report on the sustainability performance of our portfolio companies during our hold period, and more clearly articulate the contributions made to positive social and environmental impacts. As international sustainability standards converge in the capital markets, we will be able to use this data upon exit to better articulate and quantify the value this has created.

We also report to our investors on our responsible investing progress in our annual Responsible Investing Report. For the first time in 2021, we made this report publicly available as a sign of our commitment to transparency and as a way of sharing our learnings with the broader investment industry.

1 https://www.ifrs.org/groups/international-sustainability-standards-board/issb-frequently-asked-questions/
2 For example the Climate Disclosures Standards Board, the Task Force for Climate-related Financial Disclosures, the Value Reporting Foundation's Integrated Reporting Framework and SASB Standards and the World Economic Forum's Stakeholder Capitalism Metrics
3 https://www.ifrs.org/groups/international-sustainability-standards-board/issb-frequently-asked-questions/
4 https://www.ifrs.org/groups/technical-readiness-working-group/#resources
5 https://www.gov.uk/government/news/uk-to-enshrine-mandatory-climate-disclosures-for-largest-companies-in-law
6 https://environment.govt.nz/what-government-is-doing/areas-of-work/climate-change/mandatory-climate-related-financial-disclosures/
7 U.S Securities and Exchange Commission Factsheet 'Enhancement and Standardization of Climate Related Disclosures' Release no. 33-11042, 21 March 2022
8 https://ec.europa.eu/commission/presscorner/detail/en/qanda_21_1806
9 https://www.apra.gov.au/news-and-publications/apra-finalises-prudential-guidance-on-managing-financial-risks-of-climate
10 https://asic.gov.au/about-asic/news-centre/find-a-media-release/2021-releases/21-349mr-asic-welcomes-new-international-sustainability-standards-board-and-updated-climate-related-disclosure-guidance/
11 https://www.bain.com/insights/limited-partners-and-private-equity-firms-embrace-esg/
12 Bold Moves in the Boardroom: Skills and Capabilities Fit for the Future, Deloitte, February 2022
13 https://www.boardreport.org/the-sustainability-board-report-2021
14 Through the use of the "Linking the SDGs and the GRI Standards", it is possible to link the GRI reporting indicators to Sustainable Development Goals

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