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ESG-impact in private markets

Due to changing societal and scientific insights, increasing regulatory pressure, stricter government oversight, and court rulings, aspects such as climate, working conditions, and governance are becoming increasingly important preconditions for investment policy. Also with regard to investments in private markets.

By Nicole Batist, Marc Keijzer and John van Scheijndel

For institutional investors, realizing ESG impact, alongside risk and return, may well become a third foundation of their investment strategy. Direct investments in private markets—including private equity, private debt, and infrastructure—can effectively implement their own ESG policy. However, because such investments are often illiquid, it is frequently particularly difficult to exit prematurely. The question is what options investors have to steer the private market manager's policy if their own ESG objectives are not met.

Various forms of ESG investing There are various forms of ESG investing, such as company exclusion, engagement, and thematic investing. Here, we limit ourselves to ESG impact investing, where the objective of the investment policy is actively aimed at achieving a positive impact on society, for example in the areas of healthcare, education, nutrition, or the environment (CO2 reduction). Figure 1 shows that ESG impact investing in private markets had a global volume of $100 billion in 2022 and is growing strongly.

Investment policy of institutional investors There is increasing attention to ESG factors in the investment policy of institutional investors, who endorse the OECD Guidelines and/or the UN Global Principles. Some parties go a step further by creating significantly more room for ESG impact investments in their investment policy, with multiple SDGs as a spearhead.

In particular, the somewhat larger institutional investors have a separate allocation to private markets in their strategic portfolio. The importance of this investment class can rise to well over 30% of their investment portfolio. Figure 2 shows that realized financial returns from impact investing in private markets need not lag behind and that, in addition, the realized impact is in line with expectations.

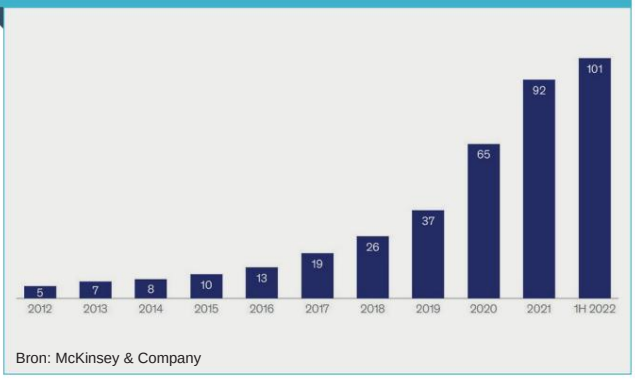
Investing in private markets offers a particularly effective way to implement one's own ESG impact policy. It is important that the institutional investor clearly defines which impact objectives must be achieved. This also places high demands on the selection process and requires specific knowledge of a project and/or industry.

Private market managers have access to firsthand information flows and deploy combined instruments such as capital injections, expertise, and executive management to realize significant value appreciation for the portfolio company. These instruments can also be effectively utilized to achieve ESG impact.

Changing investment landscape due to ESG regulations Due to increasing ESG regulations, such as the Sustainable Finance Disclosure Regulation, de Taxonomy Regulation, MIFID II, de CSRD and associated Regulatory Technical Due to standards, and recently the firm action by various regulators and court rulings, it is becoming more important to have substantiated ESG information and to report, and to ensure that statements are factually correct. Misleading ESG statements can result in substantial fines and reputational damage. For instance, the SEC recently fined Goldman Sachs Asset Management $4 million, and a major ESG investigation by Bafin and the SEC was launched at DWS Group, followed by a joint consumer claim. The fact that managing ESG risks is also a key priority for DNB is evident from the announcement that it will assess a large number of pension funds on their management of ESG risks, which are both quantitative and qualitative in nature.

After all, investments can decline sharply in value in the interim and become stranded assets as a result of onset climate change, changing consumer preferences, or increasing ESG regulations.

FIGURE 1: POWER DEVELOPMENT WITH ESG FOCUS (IN $ MILLION)



Bron: McKinsey & Company

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When investing in private markets can at excellent effective execution be given to the own ESG impact policy.

Control mechanisms

For the aforementioned reasons, institutional investors have an interest in having continuous insight into ESG performance, partly given the fact that a poorly performing manager cannot easily be held liable for damages . Having adequate control mechanisms for this type of investment is important for all parties in order to properly manage mutual expectations.

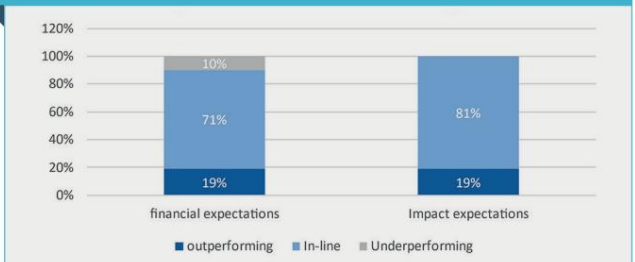
To properly determine the appropriate control mechanisms, a thorough operational, financial, and legal due diligence investigation must first take place, which cannot be limited to a one-off box-ticking exercise. Subsequently, the information will need to be interpreted, verified, and validated with the necessary rigor by specialists. With the introduction of the Corporate Sustainability Due Diligence Directive, parties will be required to establish due diligence processes in order to continue investigating human rights violations and environmental damage in their value chain and to take measures to mitigate and prevent negative effects. In this way, parties in the investment chain are strongly encouraged to cooperate. The outcomes of the due diligence investigation can serve as a basis for scenario analyses regarding ESG risks and appropriate contractual agreements. For instance, parties should include concrete future ESG objectives and obligations (KPIs) in the investment documentation, alongside the required baseline assessment.

Because measuring the progress of ESG impact is difficult and institutional where investors are limited in their ability to conduct their own research into the materiality of available data, the IRIS+ developed by the GIIN can methodology2 can be a useful tool. IRIS+ offers tools to translate SDGs into concrete objectives and measurement indicators, but experience shows that even with these tools, formulating and measuring impact objectives remains difficult. In addition, agreements can be made regarding transparency and the frequency of information flows, including the possibility of having information independently verified by the portfolio companies, thereby preventing asymmetrical information flows.

The inclusion of withdrawal rights, allowing for early exit from the investment at a pre-agreed price mechanism, and the inclusion of restrictions regarding future drawdown obligations can also be useful steering mechanisms. Furthermore, consideration could be given to including excuse rights or opt-out rights, whereby participation in a capital call round is not required if the portfolio company's policy does not (or no longer) comply with its own ESG policy.

Finally, consideration could be given to incentives, such as linking a deferred portion of the carried interest to agreed ESG objectives and including conditions to ensure a responsible exit.

FIGURE 2: FINANCIAL RETURNS AND IMPACT-PERFORMANCE IN RELATION TO GOALS AND EXPECTATIONS



Source: GIIN, Impact Investing Decision-Marking Insights on Financial Performance. The graph shows that 71% of respondents indicated that financial expectations were met, and that according to 19%, financial expectations were exceeded in a positive way. Only 10% indicated underperformance. The graph also shows that 81% of respondents felt that impact expectations were met; according to 19%, the impact was better than expected.

1 Certain LP's in Henderson PFI Secondary Fund II LLP (a firm) v Henderson PFI Secondary Fund II LP (a firm) & Others [2012] EWHC 3259

2 IRIS+ System | Standards | IRIS+ System (thegiin.org)



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ESG impact investments in private markets can make a positive contribution to the transformation of the real economy.

Historical data are not always available, making it difficult to measure ESG impact.

Continuously conducting due diligence, performing scenario analyses, and agreeing on appropriate contractual terms are becoming increasingly important.