ESG Integration

The Next Big Imperative for Private Equity Firms

March 2021

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EY
Building a better working world

Background

The past year has been a landmark year in the history of mankind with the COVID-19 pandemic overpowering the might of multi-trillion economies and years of science and research. The pandemic also exposed the fragility and vulnerabilities of our current business and economic systems. In India, the pandemic pushed the country into recession for the first time with a steep contraction of about 24%. It has also made us rethink our current models of growth and the need to build in greater resilience and sustainability.

While we continue to battle the pandemic, there are greater challenges of biodiversity loss and climate change, waiting in the wings, which would not only paralyze our economies but pose existential threat to businesses. To prepare for these larger challenges we not only need to adapt to the new normal but also build back better at an unprecedented speed.

Currently, the world is at the cusp of a fundamental shift which will reshape financing. UN Principles of Responsible Investment now has 3,805[1] signatories varying from asset owners, investment managers and service providers with total Assets Under Management (AUM) of US$ 100 trillion[2]. This includes 9 Indian signatories with 6 of them joining in 2020[3]. The climate risk and opportunity guidelines promoted by Task Force for Climate Related Disclosures now has 1,800+ supporters across 78 countries[4]. This includes 36 supporters from India out of which 24 joined in 2020 and 2021[5]. The growth and adoption of such investor led initiatives on self-regulation around ESG practices is fast becoming the new norm required by General Partners (GPs), Limited Partners (LPs), peers, and the industry to stay competitive.

1. https://www.unpri.org/signatories/signatory-resources/signatory-directory
2. https://www.unpri.org/annual-report-2020/how-we-work/building-our-effectiveness/enhance-our-global-footprint#:~:text=The%20collective%20AUM%20represented%20by,investors%20and%20337%20service%20providers).
3. https://www.unpri.org/signatories/signatory-resources/signatory-directory
4. https://www.fsb-tcfd.org/support-tcfd/
5. https://www.fsb-tcfd.org/supporters/

Building Back Better In The New Normal

ESG Building Blocks

How do you influence the environment and what ability do you have to mitigate risks that could cause it harm?	What relationships do you have with other businesses and communities and what is your attitude towards equality, diversity and human rights?	How do you manage your internal affairs to ensure accurate and transparent accounting method and the avoidance of conflicts of interests and illegal practices?
Environmental	**Social**	**Governance**
Climate change	Equality & diversity	Management structure & Compensation
Pollution	Human rights	Accounting and Auditing Standards
Resource Management	Supply Chain Management	Board Leadership, Diversity and Independence
Water Usage	Community Relations	Succession Management
Energy Efficiency	Data Protection and Privacy	Shareholders rights
Clean Energy Technologies	Product Safety and Liability	Corruption & Bribery
Biodiversity		Risk Tolerance

ESG investing is fast emerging as a tool to build resilience and mitigate risks across investments. Coupled with non-financial reporting, it has helped investors unearth hidden risks in environmental and social aspects which were earlier not considered through conventional mechanisms.

1 Improved risk management and better performance

Investments in non-ESG funds are increasingly perceived as riskier. According to CDP (earlier known as the Carbon Disclosure Project), a global sustainability disclosure platform, **60 Indian companies disclosed that climate risks would have a financial impact of US$ 98 billion**[6]. On the other hand, ESG indices *(such as S&P BSE 100 ESG India Index and MSCI India ESG Leaders Index)* and ESG funds have been outperforming most of the conventional peers.

6. CDP India Annual Report 2020 (1 USD = INR 72.57 on 17th March 2021)

2 Syncing with Investor Interests

General Partners (GP) and Limited Partners (LP) are increasingly considering ESG factors. In certain cases, investors work with the investees to create sustainable value for the company. A case in point is the investment of Leading Global PE fund in one of the largest Chinese infant formula manufacturer, a year after the manufacturer faced the melamine milk scandal. This **ESG focused approach** of the PE, to create social value, enabled it to generate **2.3x returns** on its 5-year investment.[7]

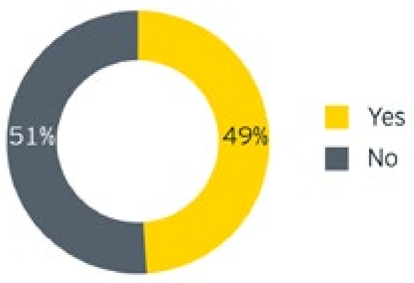
3 Growing ESG Urgency

According to EY's Global Private Equity Survey 2021, over two-thirds of investors point towards looking at ESG risks and opportunities very seriously for their investment decisions. This comes as a result of growing stakeholder focus on ESG.

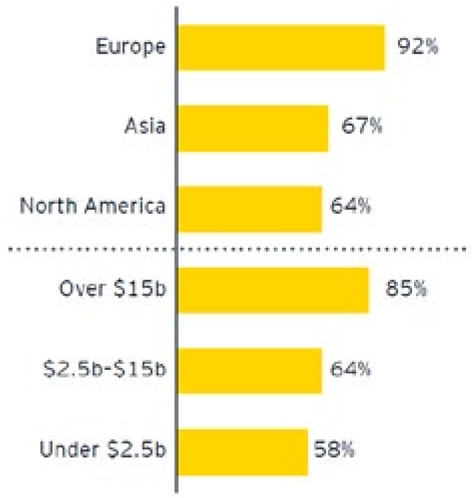
4 Increased regulations

In 2020, EU recently released the EU Taxonomy for Sustainable Finance which was followed up with the UK Government mandating TCFD aligned disclosures. Recently, the **Indian Government also joined the International Platform for Sustainable Finance** (ISPF) which promotes development of sustainable finance regulations to encourage private capital mobilization for environmentally sustainable investments.

Do you invest in ESG products?



Who has an ESG policy?



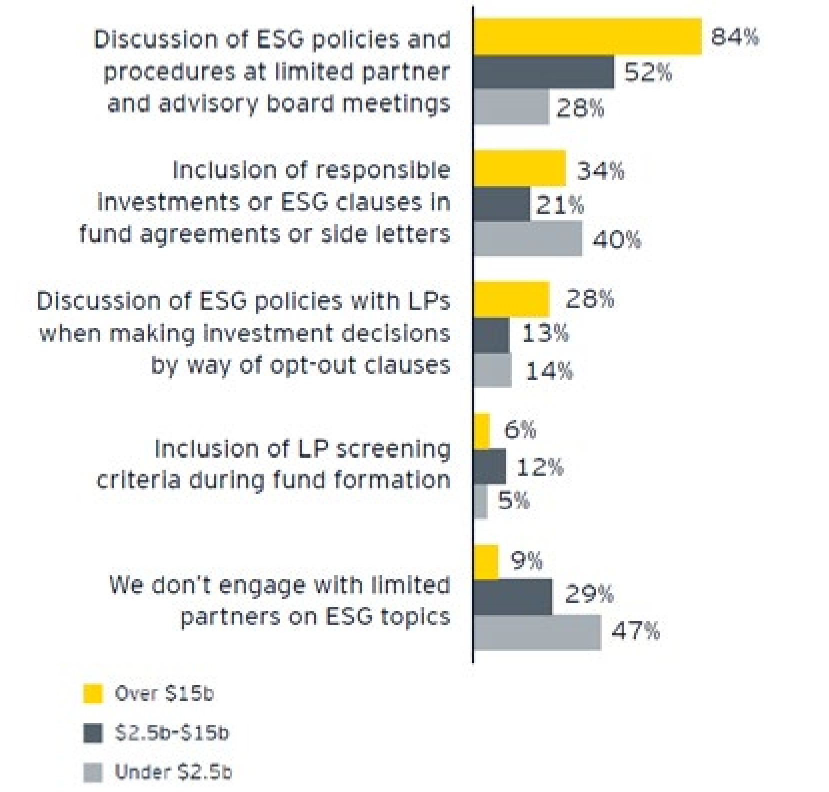
7. https://www.blackpeakgroup.com/2020/06/private-equity-and-esg/

What are the components of an ESG Policy?

How seriously are ESG risks and opportunities contemplated in the investment decision making process?

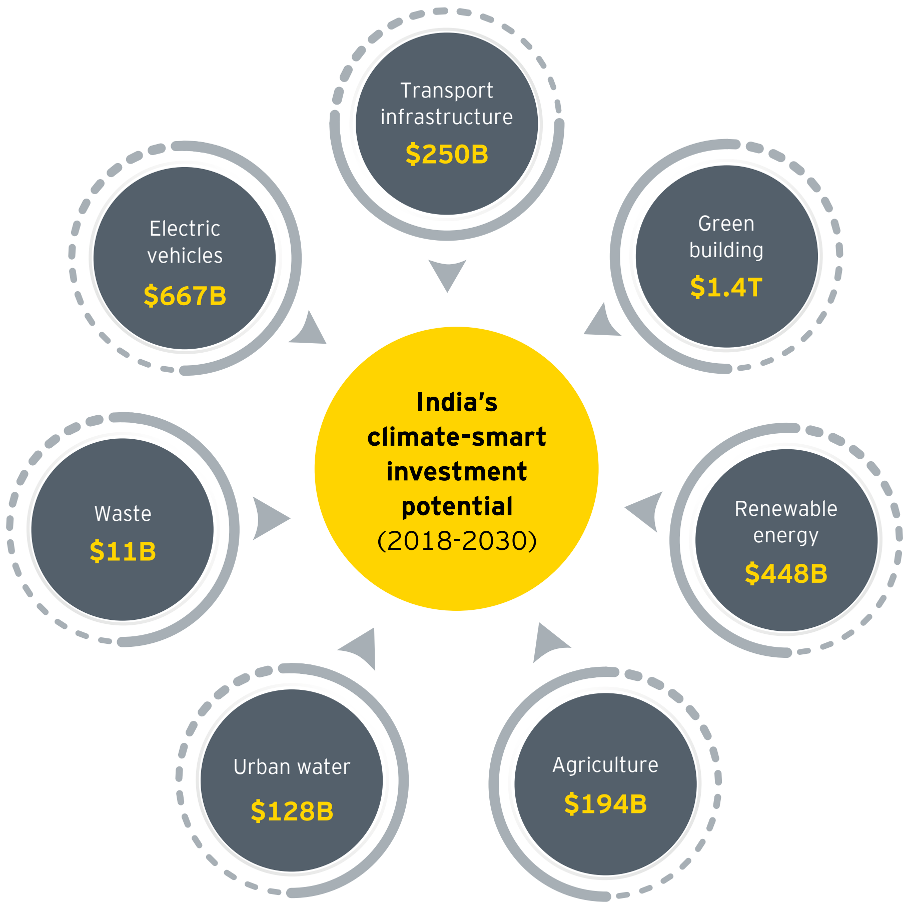
What are the top ESG risks you include in your decision making?

How are you engaging with limited partners on ESG topics?



Source: EY 2021 Global Private Equity Survey

ESG focused investing also brings with it the advantage of greater access to investors who look at ESG as a **strategic opportunity**. Sound ESG practices have also led to lower cost of capital in certain cases. It also allows investors to look at scenarios through a sustainability lens and make profits while creating positive impact. For example, an International Finance Corporation (IFC) report suggests that India has a US$ 3.1 trillion climate investment opportunity by 2030.



US$ 1.4 trillion in Green Buildings as 70% of buildings required by 2030 are yet to be built

US$ 667 billion for electrifying all new vehicles by 2030

US$ 448 billion in renewable energy; another report suggests that additional USD 500 billion may be required to meet the revised target of 450 GW of clean energy by 2030

US$ 250 billion in transport infrastructure to achieve a modal shift from private to public transport

Source: Climate Investment Opportunities in South Asia, IFC

Working Towards ESG

The business case for sustainable finance has materialized at an extremely crucial time when the costs of inaction have proved to be far more. The pull of opportunity and push of risk are converging to force the sector into action, yet there is still a lot to be done, not only to address climate change but also promote wider sustainable growth.

Risk

The financial sector must understand sustainability risks, which are risks arising from the failure to embrace any of the SDGs, and/or the risks arising in the transition to achieving them and thus a sustainable future (for climate risk these would be physical and transition risk). This is so that capital can be allocated to manage the risks, and to pursue the opportunities and returns brought along by the transition to a sustainable future.

Returns

Financial services will have a critical role to play in accelerating the transition to a sustainable future, which will create commercial opportunities for firms well placed to take advantage of structural shifts. It will be important for companies to position themselves relative to their peers to identify opportunities and assess the readiness for transition.

Reporting

To understand the risks and investment opportunities stemming from transition pathways, the financial sector will need to improve the quality and quantity of reporting. This will require investment in data, information and mechanisms needed for sustainability-related financial and non-financial disclosures as well as promoting global alignment of disclosures through the use of common frameworks (such as the TCFD framework in the case of climate change).

Global Coor-dination

The transition to a sustainable future cannot be addressed in isolation and globally coordinated efforts will be required to overcome the barriers to investment in both developed and emerging economies. Policy and regulation will be important coordinators of these efforts enabling capital flows to finance the transition and for commercial opportunities are to be realised on a global scale.

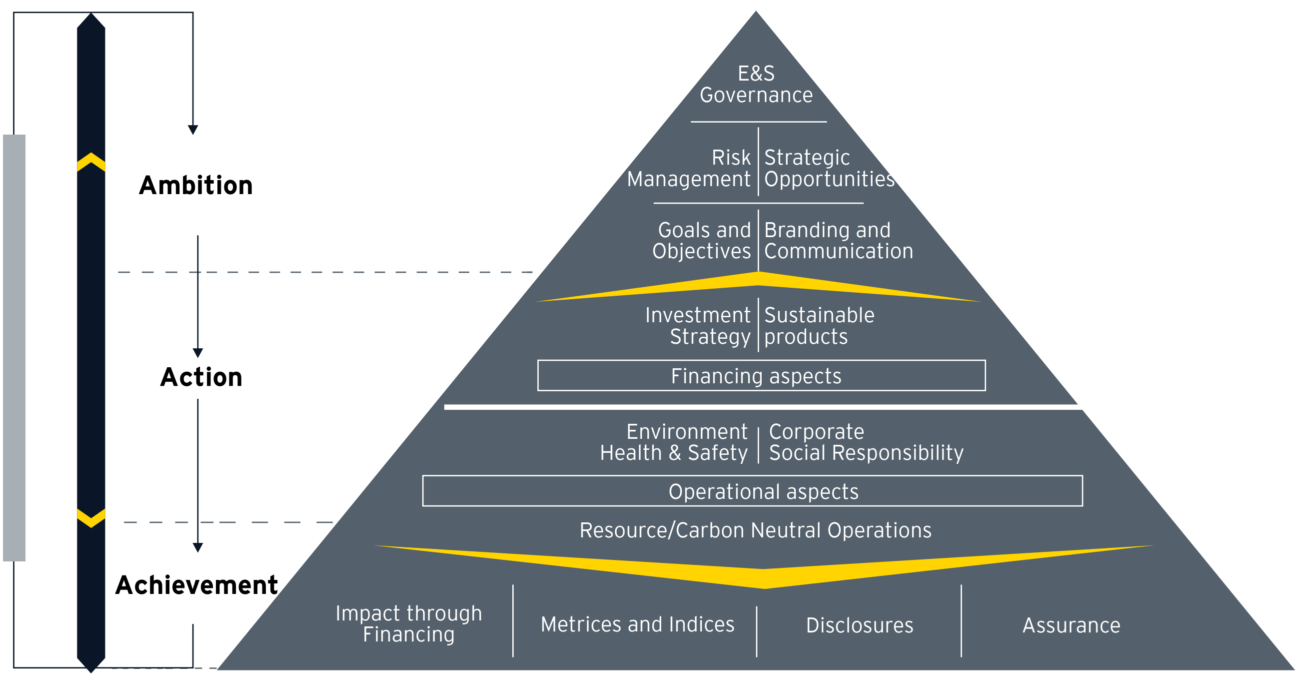
Products & Services

Opportunities for institutions exist primarily in the introduction of new products and services and the improvement of reputation through the focus on purpose and long term value. To harness these opportunities, key stakeholders need to take account of growing sustainability demands and requirements.

How Can EY Help?

As private equity firms integrate ESG risks and opportunities into their decision-making, EY can provide support throughout the entire investment life cycle, capturing efficiencies and driving the most value for our clients. EY can advise private equity funds during acquisition and exit due diligence, which can be delivered alongside financial due diligence engagements. We tailor our ESG strategy services to the portfolio company as the fund seeks to generate a strong return to investors.

EY delivers value to its clients through the ‘Sustainable by Design’ Framework which has been adapted specifically for the finance sector in form of the ‘3A ESG Framework’ which revolves around 14 core elements of **Ambition, Action and Achievement.**



Source: EY research

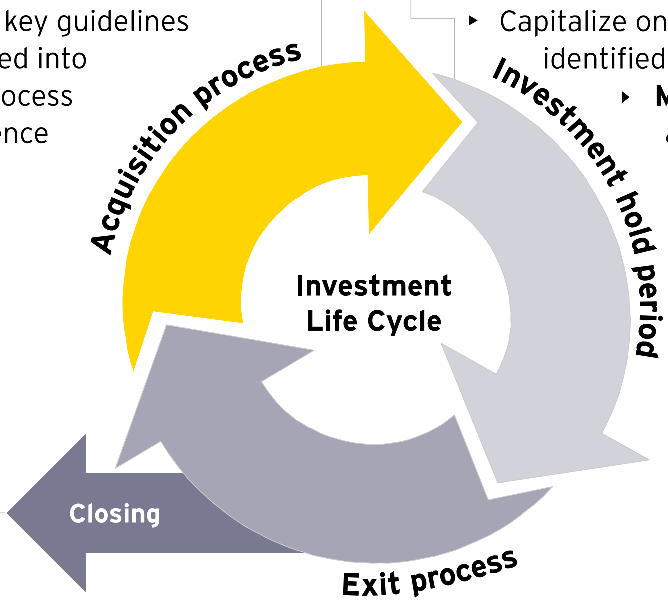
With EY's 3A ESG Framework as the foundation, we can support clients in the PE sector to deliver a range of services across the value chain.

ESG strategy

- Identify best suited **investment strategy** and objectives
- Support in developing **new ESG / SDG / sustainability aligned funds**
- Develop **ESG policy,** internal capacity and conduct scenario mapping basis relevant stakeholders
  - Materiality assessments
  - Reporting and governance
  - Develop ESG Dashboard
- Identification of **ESG indicators and impact objectives /** parameters
- Identify ESG risks and opportunities in the areas / sectors that the fund would address
  - Develop **implementation strategy** and key guidelines to be integrated into investment process and due diligence

Due diligence & Investment: buy-side

- Develop a **decision making toolkit**
- Current state assessments / **screening** based on the ESG parameters / **high level ESG risks**
- Safety performance management
- Climate risk assessment, **scenario modeling and climate stress testing Non-financial performance reporting** advisory (across Integrated Reporting, TCFD, UN-PRI, UNEP-FI Principles of Responsible Investment)
- Assurance on non-financial performance parameters (such as GRI and IIRC)
- **Periodic due diligence checks,** outcome measurement and valuation
- Capitalize on risks and opportunities identified during acquisition process
  - **Measures** to mitigate risks and optimize opportunities
    - Periodic monitoring of measures
  - **ESG benchmarking and market scan**



Impact Evaluation: sell-side

- Support value capture of the company from an ESG perspective
- Present the impact delivered through the investment and expected in future
- Impact of approaches adopted to mitigate risks and identify opportunities

Why EY?

EY Sustainable Finance

Leading Initiatives

EPIC: build out of non-financial metrics including innovation and human capital.

Long Term Value: Helping companies understand and articulate how they generate shareholder value.

WEF ESG 'scorecard' - IBC Long-term Prosperity Project: Proposal recommending a common set of universal ESG metrics / disclosures on non-financial factors.

UNEP FI: EY supports the working groups for Positive Impact Finance.

Thought Leadership

EY on Carbon Neutrality

Protecting the planet for future generations is an important issue for EY people and becoming carbon neutral this year is a real step forward on the EY sustainability journey. As an organization that spans more than 150 countries with varying views and ambitions on climate change, we recognize this is no easy feat. However, with over 284,000 EY people who are dedicated to our purpose of building a better working world, EY has a once-in-a-lifetime opportunity to take immediate action to create sustainable, inclusive growth for generations to come.

Carmine Di Sibio, EY Global Chairman and CEO, January 2020

We are the brand you can trust, with the numbers to prove it

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150+ **countries**

700+ **offices**

EY is among **India's Top 50** and among the best in Professional Services by **Great Places to Work** in 2017. **Best Companies to work for 2018.**

World's **Most Attractive professional services employer** for 2017

Amongst **Working Mother** and AVTAR **Top 10 Best Companies** for Women in India award 2017, 2016

EY Building a better working world

19 years
We have received the Global Most Admired Knowledge Enterprise (MAKE) Award since 1998.

Present across **15 locations in India**

World's #1 professional services employer Universum ranking **2017**

14 years on Diversity Inc's "Top 50 Companies for Diversity" list

EY is recognized as a global leading brand in Environment, Health and Safety services by Verdantix EHS Consulting Brands 2018 survey

Select Credentials - Financial Institutions

- Green Financing Strategy
- GHG emissions framework development
- ESG asessment of a fund
- ESG Due Diligences across sectors
- Climate Risk assessment of portfolio
- Sustainable Finance Disclosure Assurance
- Climate Change Due Diligence for investments in India
- ESG due diligence of potential investee (pre-investment)
- ESMS corporate roll-out program

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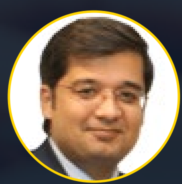

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