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ESG in European Private Equity: The Effects of COVID-19

Increasing interest in ESG issues presents an opportunity for sponsors to re-evaluate their existing ESG strategies.

The COVID-19 pandemic continues to present unprecedented challenges for private equity firms and their portfolio companies. A significant number of companies have been forced to undertake emergency liquidity measures, make difficult decisions to ensure the health and safety of their workforce, and pivot their business models, all whilst trying to maintain business continuity.

As the immediate triage period begins to wane, many sponsors are starting to consider how best to improve portfolio performance and take advantage of the record US$1.46 trillion in dry powder held by the sector.[1] The increasing government, investor, and limited partner interest in environmental, social, and governance (ESG) issues, particularly in light of the ongoing pandemic, presents a unique opportunity for proactive sponsors to re-evaluate their existing ESG strategies and reap the benefits of a "green recovery".

This *Client Alert* identifies some of the key potential effects of COVID-19 on ESG for private equity firms and their portfolio companies and addresses practical ways that sponsors can manage increasing ESG risks whilst leveraging the opportunities now and in the years to come.

The Shift From *E* to *S* and *G*

The scale and severity of COVID-19 has put ESG at the top of the agenda for many private equity firms and their portfolio companies. Concerns for employee health and safety throughout the various stages of the crisis have brought social issues to the forefront, as have questions around the resilience of established supply chains and the increasing pressure in some instances to re-shore. Governance issues have also arisen concerning the changing lens of director duties as companies enter financial distress.

The spotlight on *S* and *G* issues has diverted attention away from the environmental issues that have typically been at the front and centre of many sponsor-led ESG policies. The recent reduction in greenhouse gas emissions resulting from temporary shutdowns in travel and business operations, combined with the postponement of key climate summits, such as the United Nation's COP26, has also led to a perceived slowdown in momentum of environmentally-focused campaigns.

Continuing Environmental Initiatives

Still governments are continuing to work on long-term initiatives, such as the European Green Deal, which aims to make Europe carbon neutral by 2050 (see EU Commission Formally Announces European

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Green Deal). And leading academic and industry groups such as the World Economic Forum are urging for greater global collaboration to ensure green initiatives are a core part of economic recovery plans. The European Union's Next Generation EU economic recovery plan, for example, plants to set aside a significant part of the EU's €750 billion recovery package to fund green initiatives and energy transition projects.

Governments and regulators are also using the ongoing pandemic to push the sustainability agenda by linking *E* outcomes to COVID-19 emergency grants and loans. For example, the Canadian government's COVID-19 response has included issuing emergency loans tied to annual environmental performance reporting requirements consistent with the Task Force on Climate-related Financial Disclosures, an international benchmark established in 2015. Meanwhile, the French government recently announced that its EU's €7 billion bailout of Air France will be tied to a number of environmental targets.

Although private equity firms and their portfolio companies have not been major recipients of many publicly financed COVID-19 grants and loans, the ESG-related targets within these programs are a further indication of the increasing ESG focus of government agendas. The EU Technical Expert Group on Sustainable Finance has echoed this sentiment by encouraging both the public and private sector to focus on sustainability to guide plans for economic recovery from COVID-19, as has the European Banking Federation Board, which recently noted that recovery measures by EU institutions should align with sustainability objectives to accelerate the ongoing transition.

ESG: Luxury or Priority?

Aside from the growth in public policy initiatives, renewed interest in sustainability mandates by investors may soon bring ESG to the forefront for most private equity firms. Almost 2,400 investors and fund managers are signatories to the United Nations-supported Principles for Responsible Investment,[2] and influential institutions, including some of the world's largest investment firms, are increasingly considering sustainability as a core part of their future investment strategies. The Institutional Limited Partners Association's launch of Principles 3.0, which includes new guidance on ESG reporting and disclosure, is another recent example of the increasing significance that ESG will play in future funding decisions. Many sponsors have also embedded ESG principles into their internal policies, and may need to ensure that such factors are considered as part of their overall investment analysis and reporting requirements.

Leveraging the Opportunities

Although it is unclear when business-as-usual will resume, private equity firms are well placed to benefit from the increased focus on ESG by governments and investors. Forward-thinking sponsors can take the following practical steps to ensure they are well positioned in the post-COVID-19 world:

- ***Ensure existing portfolio companies are on top of ESG factors.*** Sponsors should consider undertaking an ESG "health check" on their portfolio companies, including analysis of the portfolio companies' peer benchmarking, consultation with employees, customers and other stakeholders, and communication strategies. Regulatory and market expectations may have changed since acquisitions were made, particularly with developments in technology or industry best practices. Sponsors should work with management teams to ensure they are on top of any new ESG issues that have arisen in response to COVID-19 (*e.g.*, updating health and safety protocols; assessing the resilience of existing supply chains). Analysis should be undertaken at regular intervals for high-ESG-risk business models, particularly those involving carbon-intensive assets at risk of becoming "stranded" due to changing regulations and demand.

- ***Re-evaluate existing ESG diligence strategies for new target companies.*** ESG factors should be considered an important part of due diligence, rather than a “nice to have”. Sponsors should critically analyse a target company’s approach to the ESG issues impacting its business model, as well as the ESG practices of its key contractual counterparties (*i.e.*, customers and suppliers) to ensure its efforts align with best practices in its sector. In addition, if a target company has accepted any public or bank-funded emergency grants or loans due to COVID-19, any ESG-specific targets or mandates, as well as any restrictions imposed by such grants or loans, should be clearly understood. Sponsors should also ensure that management teams are taking into account the transition to a digitised, low-carbon economy as well as any industry-specific trends (*e.g.*, electric vehicles and build-out of related infrastructure such as charging points) to ensure that their existing business remains resilient to future changes in government regulation.

- ***Take advantage of ESG-focused trends.*** The widespread disruption caused by COVID-19 has accelerated the growth of ESG-friendly businesses and innovations, such as those in digital health and workplace technology. These businesses, which were not typically prevalent pre-COVID-19, could now become increasingly relevant as governments begin to implement green recovery measures and consumers adjust to “new normal” conditions. Proactive sponsors should ensure that they stay on top of the ESG trends arising out COVID-19 to identify potential new M&A opportunities early as well as leverage such innovations to enhance the ESG credentials of existing businesses.

- ***Prepare for new regulatory developments***. Sponsors and/or portfolio companies that operate as Alternative Investment Fund Managers or provide MiFID portfolio management or advisory services will soon need to comply with new ESG-related obligations. The Taxonomy Regulation, due to come into effect at the end of this year, aims to provide a common framework to identify environmentally sustainable activity and, together with the Disclosure Regulation, obliges firms to embed performance against sustainability targets within remuneration policies and disclose on a website a firm’s sustainability due diligence process. If sponsors or portfolio companies have MiFID portfolio managers or investment advisers in their group, new rules (expected to come into force during Q1 2021) will also apply to the conduct of these services, as well as to their organisational systems and processes.

Conclusion

ESG has seen remarkable growth in interest and committed capital since it entered the public vernacular over a decade ago. Although COVID-19 has brought business-critical issues to the front of mind for many sponsors, proactive private equity firms should be looking to ESG to help accelerate sustainable growth and market-resilient businesses in the future for the benefit of their investors and the wider community.

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Endnotes

[1] As at June 2019. Source: Prequin (2020).

[2] As at November 2019. Source: Principles for Responsible Investment (2020).