# ESG & Sustainability: Why Private Markets Should Prioritize Now

August 2024

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# Introduction

Sustainability considerations, captured by performance of relevant environmental, social, and governance (ESG) metrics, are quickly becoming a top priority for firms in the private markets.

The ESG landscape has evolved quickly in recent years, with regulatory developments providing greater focus on sustainability-related disclosures. Alongside this pressure, investors and other stakeholders have shown increased interest in transparency around corporate sustainability. Simply put, the need for ESG data has never been more pressing than it is today.

To be successful, general partners (GPs) will need to develop accurate, data-driven strategies and meet the rising demands for transparent reporting.

This eBook takes a close look at the importance of sustainability in the private markets and why firms should get started on developing an ESG strategy today. It highlights:

- The factors driving the growing demand for ESG data
- The benefits of incorporating these factors into investment decisions
- Considerations for getting started on the sustainability journey

# What's Driving ESG Adoption?

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## Regulatory Developments

Private market reporting on sustainability factors has been largely voluntary. However, in the past few years, there has been an uptick in the introduction of mandatory regulations aimed at increasing transparency in reporting on a global scale.

> Staying ahead of existing and emerging regulations will help prepare firms and portfolio companies to manage complexities and meet reporting timelines.

While some, such as the Corporate Sustainability Reporting Directive (CSRD), have global reach and widespread impact, many disclosure requirements are specific to entities operating in a given region. As a result, the scope of a firm's activities and areas of operation will determine the regulations to which it must comply. See Figure 01 below for notable European and US regulations.

The trend toward increased regulatory scrutiny is also evident in the Asia Pacific region, where jurisdictions are increasingly using the ISSB's IFRS S1 and S2 standards as a foundation for developing disclosure frameworks. IFRS S1 covers General Requirements for Disclosure of Sustainability-related Financial Information and IFRS S2 covers Climate-related Disclosures. Singapore, for instance, has announced the implementation of phased-in mandatory climate-related disclosures aligned with the standards. Others, such as Hong Kong and New Zealand, have unveiled plans to move forward with implementing mandatory disclosures.

As regulatory bodies refine requirements to standardize reporting, investors can expect to feel continued pressure to comply. Responding to new requirements will take time, so staying ahead of existing and emerging regulations will help prepare firms and portfolio companies to manage complexities and meet reporting timelines.

**FIGURE 01**

Notable ESG Regulations in Europe and US

| REGULATION | REQUIREMENTS | IMPACT AREA | TIMELINE |
|---|---|---|---|
| Sustainable Finance Disclosure Regulation (SFDR) | Level 1: mandatory entity-level disclosures on ESG-related activities, including the sectors they invest in and portfolio companies.<br><br>Level 2: more detailed entity and product-level disclosures, including pre-contractual and annual reporting disclosures based on proposed Regulatory Technical Standards. | Asset managers and other financial market participants in the EU. Any companies registered to market to EU investors | In effect |
| Corporate Sustainability Reporting Directive (CSRD) | Expands the scope of the Non-Financial Reporting Directive (NFRD) to include large private companies in the region and introduce more detailed sustainability reporting as well as an audit of reported information. | Large companies in the EU (more than 250 employees) | In effect; companies to report their 2024 data in 2025 |
| UK Sustainability Disclosure Requirement (SDR) | Enhances transparency and standardizes sustainability-related disclosures through sustainable investment labels, product- and entity-level disclosures, and an anti-greenwashing rule to support disclosure of impacts. | Anti-greenwashing rule applies to all FCA-authorized firms in the UK<br><br>Investment labels and other disclosures apply to UK asset managers and UK-domiciled funds | Anti-greenwashing rule, investment classification and labeling rules in effect<br><br>Rest will be phased in through 2026 |
| SEC Climate Disclosures | Public companies disclose climate-related risks material to the business, results of operation, or financial condition, including Scope 1 and 2 emissions, as well as Scope 3 emissions if material. | US; venture-capital companies or other funds where at least 50% of assets are comprised of venture capital investments | Approved in March 2024; currently in an administrative stay |
| CA SB253: California Climate Corporate Data Accountability Act | California companies are to disclose their externally assured scope emissions, starting in 2026 with Scope 1 and 2 and upstream and downstream supply chain Scope 3 emissions in 2027 thereafter. | US; Private and public companies that do business in California with revenues in excess of $1 billion | Will go into effect in 2026 for 2025 data |
| CA SB261: California Climate-Related Financial Risk Act | California companies are to disclose their climate-related financial risks and measures they have adopted to reduce and adapt to those risks, and to publish a public climate-related financial risk report. | US; Private and public companies that do business in California with revenue in excess of $500 million | Will go into effect in 2026 |
| CA 54: Fair Investment Practices by Advisors | Venture Capital Companies (VCCs) to report on the demographics of the founding teams of portfolio companies in which they invested during the prior year. | US; venture-capital companies or other funds where at least 50% of assets are comprised of venture capital investments | Will go into effect in 2026 |
| Corporate Sustainability Due Diligence Directive (CSDDD) | Minimum requirements across EU member states to develop and implement appropriate measures to conduct due diligence across global supply chains. | Large companies in the EU, US companies with European supply chains or with significant operations in EU | Will go into effect in 2025, EU member states will have 2-year period to adopt into law |
| SEC ESG Investment Disclosures | Requires specific disclosures for ESG-focused funds and advisers, including an overview of a fund's ESG strategy, how it incorporates ESG in investment decisions, and how it votes proxies or engages companies on ESG issues. | US; Certain registered investment advisers, investment companies, and business development companies | Proposed May 2022; not yet in effect |

*Updated: August 2024

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# LP Expectations

Across the private markets, limited partner (LP) pressure has been a significant driving factor in the adoption of sustainability considerations. The appetite for ESG data is clear. In a 2024 survey of over 250 LPs, 49% of respondents said the integration of ESG factors through the deal cycle impacts manager selection, and an engaged approach makes managers more appealing.

> GPs who can link their ESG initiatives directly to value creation strategies...are the ones who stand out.

Matt Schey, Managing Director for External Affairs and Sustainable Investing at ILPA, speaking on a Spring 2024 Novata webinar

While LP priorities may differ across firms, external factors such as regulations have been shown to influence their focus. According to Private Equity Wire's 2024 LP survey, regulation and risk management are among the top factors influencing LP sustainability strategies. Other influencing factors include financial returns, internal stakeholder pressure, and wider considerations around climate change.

The focus on climate is also mirrored in GP efforts, demonstrating key areas of concern for investors. An LGT Capital Partners survey of 381 PE managers globally saw an uptick in the number of managers monitoring greenhouse gas emissions, a jump to 48% from 28% in 2021. A positive trendline was also observed with DEI efforts, with 69% now having a DEI policy in place and 56% considering DEI in their investment decisions.

With LP expectations for GPs to provide sustainability data on an upward trajectory, the ability to clearly articulate a sustainability strategy and link ESG initiatives to value creation will be a differentiator when it comes to accessing capital.

# ESG In Private Markets: Novata's Take

Drawn from hundreds of conversations with GPs and LPs, here are some observations about ESG in the private markets.

**01** Sustainability isn't only about making the world a better place. It's about smart and risk-averse business practices that make businesses more valuable. Impact investing is about making the world a better place, potentially at the cost of some financial return. Impact and ESG are two different disciplines.

**02** Most GPs raising institutional money find they need to have or commit to having a coherent sustainability strategy. "Coherent" doesn't mean you need to have every last detail sorted out, and there are basic steps that all firms can take to demonstrate progress on their ESG strategy.

**03** Most GPs are already considering ESG factors in some capacity—they just need help tracking, packaging, and communicating it. Many GPs also already have several examples of "Sustainability Champions" in their portfolios but are not able to capture this narrative.

**04** Many North American-based LPs want to see how value creation initiatives are driving higher EBITDA or lower discount rates while also having a positive environmental or social benefit.

**05** The sustainability space has long been an alphabet soup of different standards and metrics. While this is still the case, we are moving closer to convergence, thanks to the work of organizations like the ESG Data Convergence Initiative (EDCI) and the International Sustainability Standards Board (ISSB).

Expectations for GPs to prioritize ESG considerations will continue as the connection between these factors and financial returns becomes clearer. Getting started with data collection now puts GPs in a good position to respond to increasing pressures and take advantage of the benefits that drive better business outcomes.

Scott Kennedy
Co-Founder
Novata

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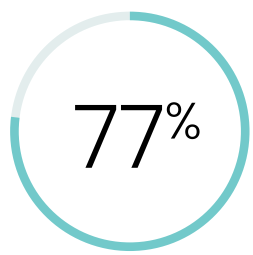
# Stakeholder Pressure

Among the stakeholders focused on the sustainable impact of a business are its customers and workforce. Demand for sustainability reporting has historically been higher in public markets than private markets. As a result, private companies that are part of the value chain of public entities will feel a ripple effect from the impact of disclosure expectations. For instance, the growing regulatory interest in Scope 3 emissions data will mean an increased demand for emissions reporting from private companies.

Beyond supply chain concerns, applying an ESG lens to business decisions has been shown to help improve customer satisfaction and employee engagement. Results from a global SEC Newgate study found that 77% of consumers agreed it was important for companies to take action on ESG principles, with 68% stating that companies should communicate the results of their efforts more clearly for consumers and investors.

Similarly, sustainability is an important consideration for today’s employees, and a strong ESG focus will be an increasingly significant factor in attracting and retaining Millennial and Gen Z talent, who will make up most of the future global workforce.

In a recent Deloitte study, more than half of Millennial and Gen Z employees will research a brand’s environmental impact and policies before accepting a job. One in six respondents also disclosed they have already changed jobs or sectors due to climate concerns, and around 25% plan to do so in the future.




77% of consumers agreed it was important for companies to take action on ESG principles

Source: Global SEC Newgate study

The report further highlights that these generations expect their employers to provide training and support for developing skills necessary for transitioning to a low-carbon economy. With the global demand for green skills on the rise and considering the critical role skilled talent will play in companies achieving sustainability goals, upskilling employees in this area can help employers stand out in a competitive job market.

# Sustainability as a Competitive Advantage

ESG considerations have quickly moved from a box-ticking exercise for investors to a crucial part of investment decisions, due in part to increased alignment on the value this data can provide. Specifically, accounting for ESG factors in the investment lifecycle can help firms better assess long-term risks and identify value creation opportunities across the portfolio.

From a risk management perspective, accurate, high-quality ESG data can provide insight into how portfolio companies account for risks material to their business, including environmental and social risks that can lead to rising costs across the supply chain (consider, for instance, the impact of biodiversity loss and the growing demand for carbon emissions data). The risk of greenwashing, wherein companies misrepresent their action or performance on sustainability, is also mitigated with transparency into this data.

ESG data can provide a holistic view of portfolio company performance across key metrics that are relevant to a firm. This data can be used to identify opportunities to drive top-line growth, reduce costs, and enhance the overall value of a company. In PwC's Global Private Equity Responsible Investment Survey, more than half (49%) of respondents credit ESG as a primary driver of value creation. The benefits include brand and reputational enhancement (64%), risk mitigation (62%), competitive differentiation (55%), and client retention and attraction (52%). Figure 02 below provides an overview of the value of considering ESG factors across the investment lifecycle.

**FIGURE 02**
ESG Data Incorporation in the Investment Lifecycle

| PRE-INVESTMENT | POST-INVESTMENT | EXIT |
| --- | --- | --- |
| Get a comprehensive due diligence assessment with insights into how companies account for existing and emerging material risks. E.g., waste and water management concerns for a manufacturing company or privacy and data security for technology companies. | Inform engagement with portfolio companies to mitigate operational and reputational risks, drive impact, and improve valuation upon exit. E.g., recommending actions to improve operational efficiency, lower energy use, or create inclusive workplace cultures. | Improve valuation at exit as private equity executives increasingly expect an ESG premium in companies they are considering exiting. A company's ESG performance can impact its valuation, and GPs that have already engaged portfolio companies on ESG will be able to answer long-term sustainability questions. |

Additionally, [Deloitte's 2024 ESG in M&A Trends] survey found that the growing availability of comparable ESG data is helping investors assess valuations and manage portfolios, as well as increasing confidence in transactions. While there is still some way to go for complete industry adoption of ESG factors, there is clear indication of its rising importance to investment practices.

Fundamentally, ESG considerations can lead to better risk management and value creation by helping investors account for material risks and identify opportunities to increase the profitability of portfolio companies.

49%

49% of respondents credit ESG as a primary driver of value creation

Source: PwC's Global Private Equity Responsible Investment Survey

## ESG-DRIVEN VALUE IN KEY AREAS

Source: PwC's Global Private Equity Responsible Investment Survey

64%

brand & reputational enhancement

62%

risk mitigation

55%

competitive differentiation

52%

client retention and attraction

# Getting Started with ESG Data Integration

As the demand for ESG data intensifies, there is a clear need for private equity firms to develop a robust and documented strategy to incorporate sustainability considerations. It can take months to outline a strategy, identify key metrics, collect and analyze data, and chart a course forward for the firm and portfolio companies. To be ready to respond to the growing pressure and report in the near future, it is critical to start today.

For firms new to the process, considering the questions below is a good start toward laying the foundation for a strong policy and strategy.

**01** What impact does our business have on the planet and local communities?

**02** What social or environmental topics do we want to positively impact?

**03** Based on existing frameworks such as the ESG Data Convergence Initiative or the UN Sustainable Development Goals, what metrics are most material to our business?

**04** Where is our business based, and what regulations may affect our operations?

**05** Which industries are most common in our portfolio, and how do they impact the planet and local communities?

**06** How might our portfolio companies already be incorporating ESG considerations into business operations?

**07** What resources do we have at our firm to successfully implement an ESG strategy?

## Simplify Your Journey with Novata

ESG data is a critical component of a successful sustainability strategy. Outlining what metrics are material, establishing data collection processes, and understanding the data can be challenging. Technology solutions can help teams needing extra support to get their ESG initiatives off the ground.

Novata helps investors and companies navigate the complex ESG landscape more easily by providing a unique blend of a technology platform and expert Advisory services designed to help users build their sustainability strategy effectively and efficiently. We offer a simplified process of selecting relevant metrics, clear and simple guidance for painless data collection, a cutting-edge secure contributory database to store data, and unique tools for analysis and seamless reporting to key stakeholders, including limited partners and regulators. Learn more about Novata.

Novata is an ESG data management platform and advisory practice that empowers businesses to achieve their sustainability goals. We make it easy for private markets to navigate the evolving ESG landscape; collect, analyze, and report on the metrics that matter; and connect their sustainability strategy to meaningful outcomes—because it's good for business and it's good for the planet.

Our industry-leading technology offers flexible tools to meet increasing market and regulatory demands, while our advisory services provide tailored support with data strategy, regulatory readiness, and carbon solutions.

Backed by the Ford Foundation, Hamilton Lane, Microsoft, Motive Partners, Omidyar Network, and S&P Global, Novata is majority controlled by mission-driven organizations and its employees, and is a B-Corp-certified public benefit corporation.