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Unlocking the Green Premium in Private Equity

How Private Equity firms can create value by integrating ESG

pwc

Table of contents

Introduction

What is the purpose and relevance of this report?

In recent years, we have observed a growing challenge faced by clients in the private equity (PE) space when it comes to finding the right balance between ESG integration and value creation. We have witnessed an increasing interest among our PE clients concerning the novel sustainability regulations, with particular emphasis on the EU Taxonomy: They are eager to understand not just how to remain compliant, but how these regulations can serve as catalysts for value creation. Leveraging Strategy&'s strategic foresight and PwC's technical and subject-matter expertise, we have launched a two-part series aimed at addressing these critical concerns.

The first piece, titled "Unlocking the Green Premium in Private Equity," harnesses Strategy&'s strategic capabilities to demonstrate how ESG risks and opportunities can be successfully translated into tangible value. In this context, we also explore the role played by the sustainability regulation landscape, with a particular focus on the EU Taxonomy. Complementing our initial article, in the second piece named "Navigating the EU Taxonomy Usability Challenges" we leverage PwC's extensive technical knowledge in sustainable regulations to highlight the key challenges faced by organisations when assessing their eligibility and alignment with the Taxonomy. By understanding and effectively addressing these hurdles, PEs can leverage the EU Taxonomy to solidify their position as sustainable leaders and generate a green premium.

Why should Private Equity firms integrate ESG considerations into their investment cycle?

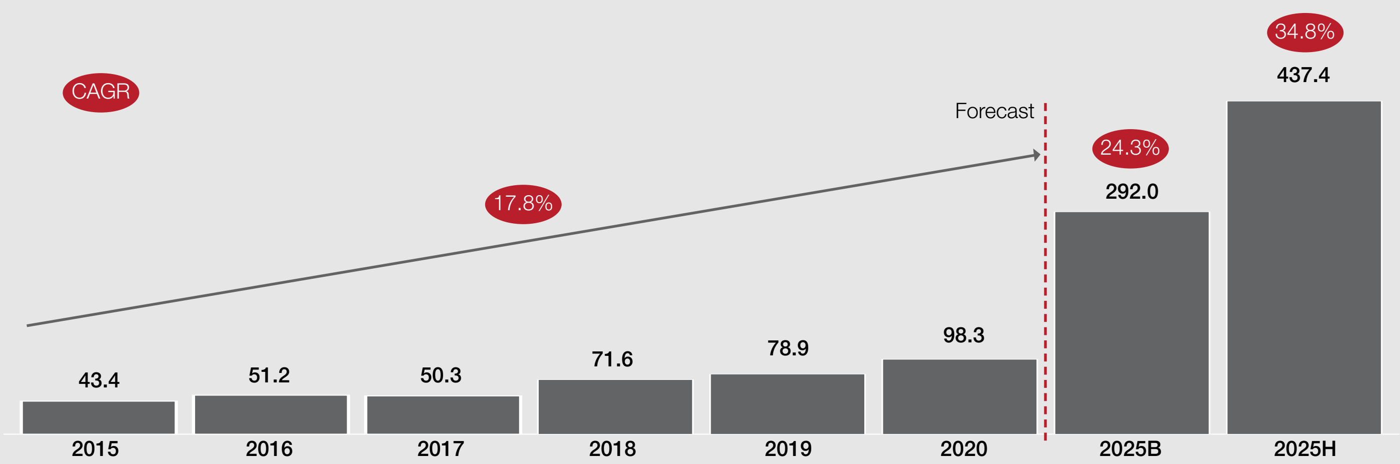
Private Equity's role in accelerating ESG transformations

Private Equity firms' (PEs) unique position in the financial ecosystem makes them vital players in the transition towards a sustainable economy. PEs' active, long-term engagement with portfolio companies, as well as their high levels of available capital, give them significant leverage to drive comprehensive ESG transformations across the economy.

The *2023 GPs' Global ESG Strategies* and the *2022 PwC EU Private Markets Report*, which contained data on 200 surveyed and interviewed General Partners (GPs) and Limited Partners (LPs) based in Europe, estimated European PE ESG AuM[1] at EUR 98.3bn in 2020 and projected this figure to reach EUR 292bn by 2025. This would represent an increase in PE SG AuM as a percentage of total from 10.7% to 20.7%.

1 Private Equity ESG Assets under Management (PE ESG AuM) data from PwC EU Private Markets Report survey and Preqin database

European PE ESG AuM: Forecasts to 2025 (EUR bn)



Forces behind Private Equity's growing embrace of ESG

The PE industry's increased consideration of ESG factors is underpinned by four key drivers:

- **Shifting societal values:** Recent social and environmental events have led to a global shift towards sustainability, making climate risks a central issue on the agenda.
- **Changing investor behaviour:** More and more LPs are pursuing ambitious ESG strategies as they come to the realisation that financial returns and sustainability goals are not at odds but rather can reinforce each other.
- **Policy shifts and regulatory changes:** The EU is leading the way in promoting sustainability in the financial ecosystem, imposing stricter regulations and legislation towards ESG in private markets.
- **ESG's value creation and risk mitigation power:** PE players, while still lagging behind in terms of ESG integration compared to other Private Markets (PM) asset classes, are experiencing a significant shift towards ESG, as GPs recognize its material importance not just for regulation compliance purposes, but also for protecting existing value and uncovering new value creation opportunities.

Private Equity's ESG Integration across the Investment Cycle

These four drivers are pushing PEs to increasingly incorporate ESG considerations throughout the investment cycle, from origination to exit:

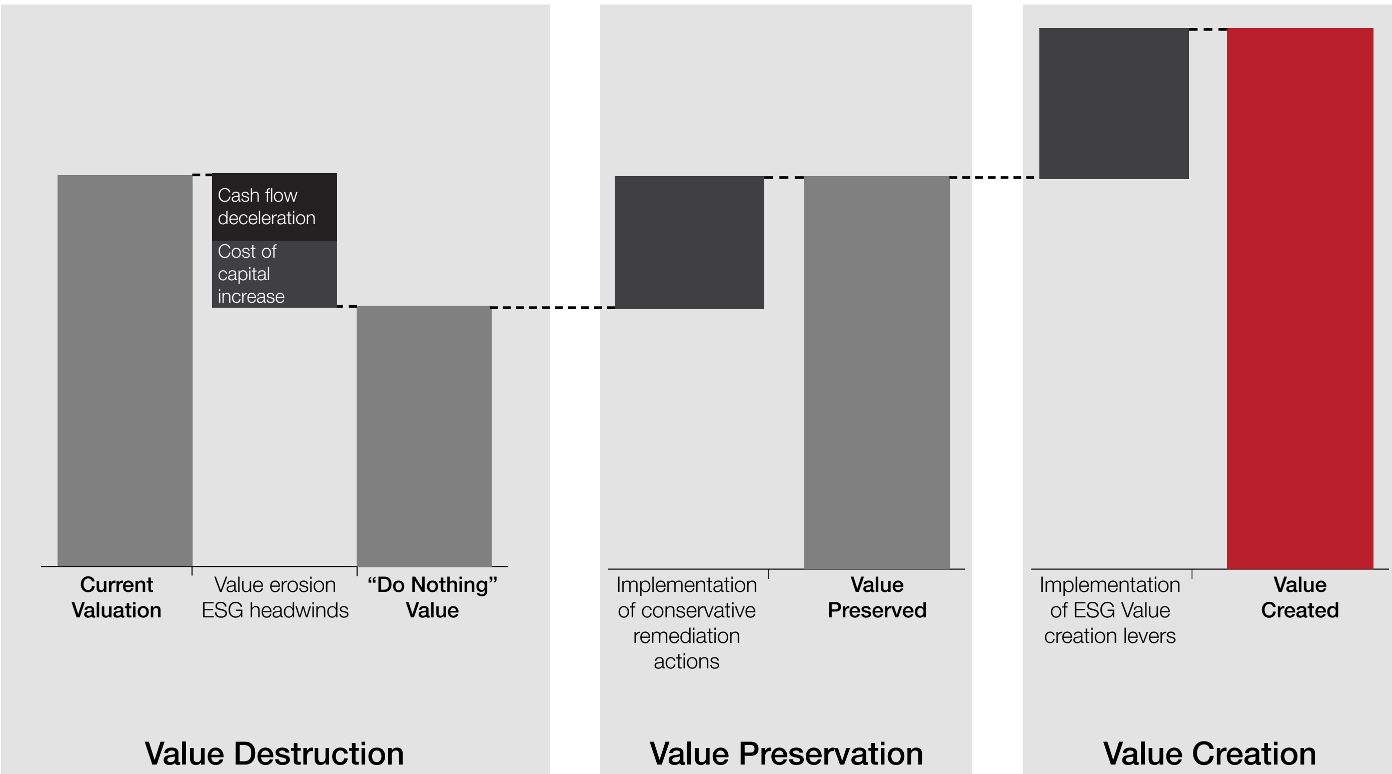
- **Market Screening:** Establishing screening procedures to identify ESG risks and opportunities within target companies and industries.
- **Due Diligence:** Incorporating ESG factors into due diligence to identify and mitigate potential ESG risks. It provides insights into potential value creation and helps in setting action plans to improve ESG performance.
- **Holding Period:** Identifying and implementing the right value levers to improve the ESG performance of a company and pave the way for ESG value creation upon exit.
- **Exit:** Providing accurate and quantifiable ESG-related KPI improvements during the holding period to facilitate a more objective assessment of ESG performance, increase its valuation, and attract potential buyers.

Nonetheless, the integration of these ESG considerations into the investment cycle comes with costs, especially in the short term. For example, the implementation of ESG value levers entails upgrading assets, infrastructure, policies, and processes, as well as providing training to employees, which require significant capital expenditures. Additionally, collecting and analysing ESG data to comply with the upcoming regulations can be time-consuming and requires specialised expertise, which may necessitate hiring outside consultants or dedicating additional internal resources to it. Some reporting frameworks or standards may even require external verification or assurance, further increasing costs in the short term.

What role does ESG play in value preservation and value creation?

The ESG Value Bridge: Integrating sustainability to enhance company value

The following ESG value bridge exemplifies the crucial role played by ESG in sustaining and enhancing a company's value. Neglecting ESG integration in a company's operations, on the other hand, could lead to value destruction. It's important to note that maximising financial returns and pursuing ESG goals are not mutually exclusive but rather complementary. As ESG regulations evolve, the implementation of sustainable practices becomes a core investment criterion, presenting value creation opportunities and mitigating risks.



Inaction on ESG can lead to value destruction due to, for example, progress on ESG by peers, changing customer needs, employee and investor expectations, or regulatory obstacles.

Implementing conservative remediation actions can lead to value preservation on the short term, but it will not be enough to preserve value on the long term.

The successful implementation of ESG value creation levers can unlock significant value creation.

Integration of ESG Factors into classic valuation approaches

An important part of understanding the impact of ESG on a company's value is how these value creation factors are integrated into the classic valuation approaches. PE firms typically use a combination of valuation methods to assess the value of their portfolio companies, such as discounted cash flow analysis or comparable company analysis. When integrating ESG factors into these valuation methods, PE firms will need to adjust their traditional valuation assumptions and models to account for ESG risks and opportunities.

Discounted Cash Flow Analysis

Discounted Cash Flow Analysis (DCF) is a widely used valuation method that involves estimating a company's future cash flows and then discounting them back to their present value using a discount rate. The integration of ESG risks and opportunities into a DCF can either be done by adjusting the projected cash flows or by adjusting the cost of capital.

Integration into the cash flow projections

By incorporating ESG risks and opportunities into cash flow projections, it is possible to integrate the impact of ESG factors on a company's revenue, expenses, and capital expenditures. For example, climate risks such as physical, weather-related disruptions may lead to higher operating costs, while opportunities such as investments in renewable energy may lead to cost savings and increased revenue in the future. A growing body of academic research has found a positive relationship between strong ESG integration and financial performance. NYU's research paper "ESG and Financial Performance[1]" analysed over 1,000 research papers and found a growing consensus that effective management of ESG issues by corporations typically leads to better operational metrics and stock price. Additionally, the study shows that decarbonisation strategies have a strong correlation with improved financial performance.

The table below highlights the value creation aspect of the previous ESG value bridge, presenting a non-exhaustive list of factors, categorised by stakeholder groups, that can impact a company's valuation by increasing cash flow through revenue growth or cost reduction.

1 *ESG and Financial Performance: Uncovering the Relationship by Aggregating Evidence from 1,000 Plus Studies Published between 2015 – 2020*, 2021, NYU Stern, Rockefeller Asset Management, by Tensie Whelan, Ulrich Atz, Tracy Van Holt and Casey Clark

Easy to measure → Hard to measure

Regulators	Customers	Investors	Suppliers and Vendors	Competitors	Employees
• More likely to get **permissions and licenses**; • Reduced probability of **fines and sanctions**; • Potential tax benefits and lower carbon taxes; • Eligible for **subsidies**.	• **Retain and attract new customer segments**; • **Offer new "green" products**; • Enter **new markets**; • More competitive **pricing** in the long run.	• Access to new **capital sources** and **more leverage**; • **More attractive to investors**; • Lower **cost of financing** (both debt and equity).	• Long-term **cost savings** from reduced carbon dependency (e.g., lower COGS, energy costs); • Lower **insurance costs**; • Reduced **CapEx** in the long-term by allocating capital to low-carbon alternatives.	• Increase of **market share** thanks to a better competitive **positioning**.	• Increase in **productivity** and therefore lower **cost of labor**; • Positive impact on **employee engagement**.

Additionally, a key factor affecting the value creation capability of any company is the perception of the brand by internal and external stakeholders. The way a company manages its ESG risks and opportunities can affect its reputation and brand value, which in turn can influence market sentiment and business outcomes. According to a recent article by PwC Strategy&, "*ESG Market & Stakeholder Sentiment*"[1], the increased importance of ESG reputation and brand is being shaped by a shift from a shareholder-centric economy to a wider stakeholder economy. As a result, companies must assess their ESG market and stakeholder perception compared to ESG materiality performance to identify where their brand is lagging or leading in the market and how to close the gap and capitalise on it. It is crucial for companies to clearly identify, measure, align and engage ESG brand and stakeholder perception and engagement to drive business performance.

Integration into the cost of capital

Adjusting the cost of capital to incorporate ESG risks and opportunities involves modifying the discount rate used to estimate the present value of future cash flows, taking into account the level of perceived risk. According to the previously mentioned NYU study, there is strong evidence demonstrating a correlation between lower sustainability-related risks and improved financial performance, which can provide protection against downturns during economic or social crises.

Taking a different perspective and looking at the evidence provided by ESG ratings and their relationship to the cost of capital, the research article "ESG and the Cost of Capital"[2] conducted by MSCI found that companies with high ESG scores experienced lower costs of capital compared to those with poor ESG scores over a four-year study period in both developed and emerging markets. The study also showed that this relationship was true for both the cost of equity and debt.

The following table provides an overview of the main climate risks that should be considered while calculating the cost of capital of a company.

1 *ESG Market & Stakeholder Sentiment, PwC Strategy&*
2 *ESG and the Cost of Capital*, 2020, Morgan Stanley Capital International (MSCI)

Climate Risks Examples		
Physical Risks	**Acute**	Acute risks such as hurricanes or wildfires can cause extensive damage to buildings and infrastructure, leading to significant financial losses.
	Chronic	Chronic risks have a slower onset but can have long-term impacts on a company's operations, such as rising temperatures and sea levels.
Transitional Risks	**Policy and Legal**	Policy and legal risks arise from non-compliance with climate-related regulations or carbon pricing regulations.
	Technology	Technology risks arise from the disruption caused by new technologies that support the transition to a low-carbon economy. For example, the shift towards electric vehicles.
	Market	Market risks arise from factors that can impact the supply and demand for a company's products and services, such as changing consumer preferences.
	Reputation	Reputation risks arise from negative publicity related to a company's environmental practices.

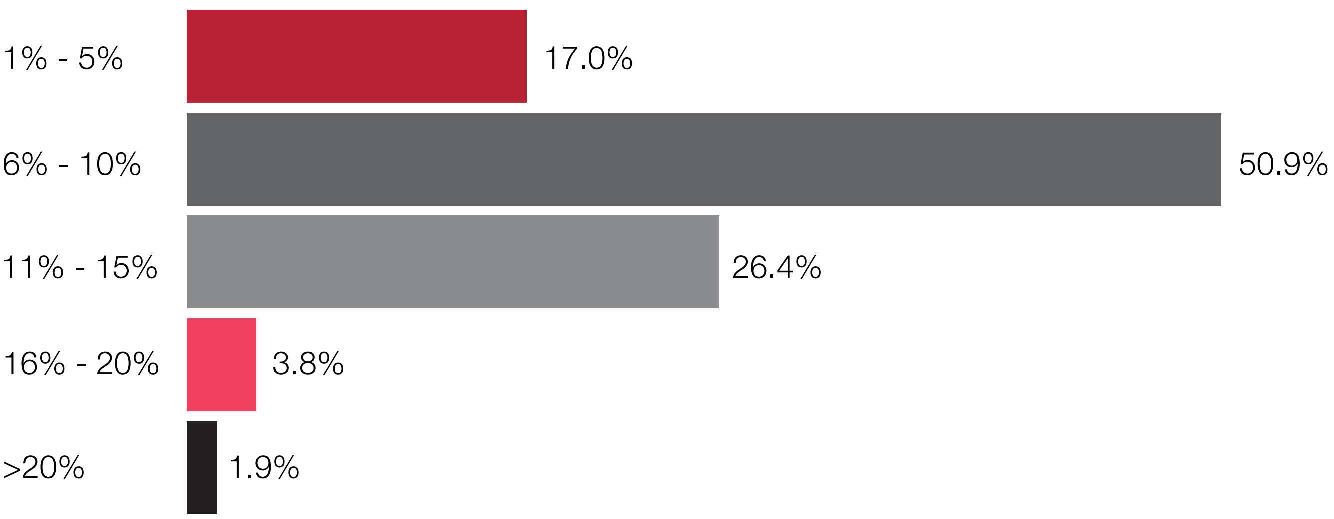
To conclude with the DCF approach, it is important to highlight that, when integrating ESG risks and opportunities into the DCF, it is crucial to avoid double counting by integrating them into both cash flow projections and the cost of capital. It is recommended to include the financial impacts of these risks and opportunities directly in cash flow projections instead of the cost of capital since it is more direct and observable.

Comparable Company Analysis

In this method, the impact of ESG factors on a company is factored into, for example, its P/E or EV/EBITDA multiples. When selecting comparable companies, various factors such as location, industry and growth need to be taken into account. Additionally, when evaluating ESG impacts, it is also interesting to consider physical and transitional risks metrics, such as annual GHG emissions (e.g., Scope 1,2,3 GHG / EBITDA).

In line with this, the *2022 PwC EU Private Markets Report* showed that most of the PE GPs experienced higher exit multiples thanks to the incorporation of ESG into their investment cycle, showing a positive correlation between integrating ESG-related opportunities and higher multiples.

By approximately how much did incorporating ESG into the investment cycle yield high exit multiples? (PE GPs)



What are the implications of sustainability regulations for Private Equity firms?

Pressure from LPs and Regulators for ESG integration

LPs often play a crucial role in driving GPs to consider new topics when making investment decisions. An example is the integration of sustainability, where LPs may demand that GPs align with their sustainability agenda, either because they have established their own net-zero targets or due to regulatory mandates to address ESG concerns in their investments.

Due to the Sustainable Finance Disclosure Regulation (SFDR), LPs are increasingly urging GPs to implement more rigorous ESG frameworks and offer enhanced transparency and disclosure regarding their sustainability practices. In this way, the PwC "*2023 GPs' Global ESG Strategies*" clearly demonstrates a significant misalignment between the reporting requirements of LPs and the current ESG reporting practices of GPs, whose ESG reporting level is inadequate in meeting the expectations set by LPs.

Implications of SFDR and EU Taxonomy regulation for Private Equity firms

The EU Taxonomy Regulation and the SFDR are central to the legislative effort to promote sustainability and transparency. PEs and their portfolio companies are affected by both regulations, therefore, it's important to grasp their interrelations:

- **Article 6** or "grey funds" covers funds that do not integrate any kind of sustainability into the investment process. While this article requires asset managers to disclose the integration of sustainability risks in their funds, it does not require Taxonomy alignment.

- **Article 8** or "light green funds" applies to financial products that promote environmental or social characteristics. According to the SFDR, the activities of Article 8 funds-portfolio companies do not have to be Taxonomy aligned. However, unlike Article 6 funds, the disclosure of the integration of sustainability risks is not enough, and a proportion of the investments included could be considered "environmentally sustainable" in the meaning of Article 9. However, the Commission clarified that Article 8 funds can include investments that are environmentally sustainable under Article 9, and not necessarily be Taxonomy aligned.

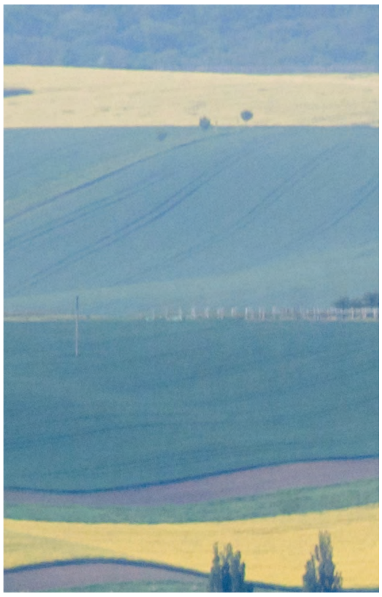
- **Article 9**, also known as "dark green funds," applies to products that target sustainable investments. The implications for PEs are that they must ensure the assessment of the Taxonomy alignment of their portfolio companies, either themselves or through an external party. This can be simple if portfolio companies already report on their Taxonomy alignment, but it can be challenging for mid-sized and small portfolio companies that don't have any Taxonomy reporting obligations.

PEs reporting under SFDR will have a limited window to ready themselves for obligatory disclosures. Accomplishing this task will prove to be a significant hurdle, as it will require the updating of investment processes and policies, as well as the collection of the necessary sustainability-related data from their portfolio companies. Given the time constraints, external support may be required by PEs, particularly if they seek to report their Taxonomy alignment or eligibility and aspire to be classified as Article 9 funds. According to PwC's *2023 GPs' Global ESG Strategies report*, more than forty percent of LPs and GPs interviewed highlighted the challenge posed by the short timelines for regulatory compliance and its associated burdens.

Moreover, businesses that fall outside the scope of the regulation have the option to voluntarily disclose their alignment with the EU Taxonomy. This is particularly interesting for PEs, as they can collaborate with their portfolio companies and encourage them to report their Taxonomy alignment, positioning them as socially and sustainability-conscious companies, and ultimately, generate a "green premium" upon exit.

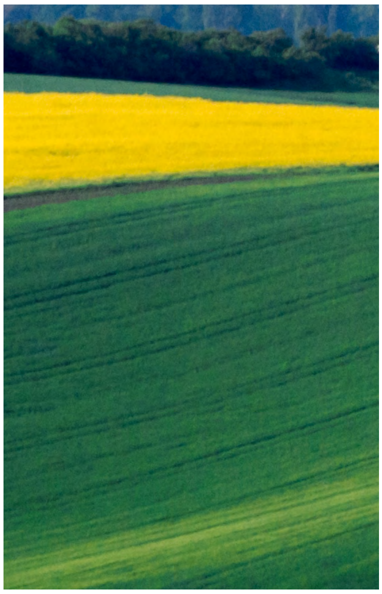
Conclusion

PEs play a pivotal role in advancing towards a green economy due to their capacity to channel significant capital towards sustainable initiatives…



We estimate that PE ESG AuM in Europe will reach EUR 292bn in 2025, tripling their value from EUR 98.3bn in 2020. PEs are increasingly integrating ESG considerations into their investment cycle, driven by the constantly evolving societal values, changing investor behaviour, new policies related to sustainability, and the potential of ESG to create value and mitigate risks.

...this places them in the spotlight of regulators, who are pushing investors and consequently PEs to enhance their level of ESG reporting…



LPs are increasingly demanding GPs to align with their sustainability agenda, either because they have established their own net-zero targets or due to regulatory mandates, particularly the SFDR and EU Taxonomy regulation. This has significant implications for PEs and their portfolio companies, including the need to assess the Taxonomy alignment of their activities, update their investment processes and policies, and collect sustainability-related data. While compliance with these regulations can be challenging and costly, it presents an opportunity for PEs to attract investors and to position themselves as socially and sustainability-conscious funds.

…which added to the positive correlation between ESG integration and increased financial performance…

ESG risks and opportunities can be integrated into the common valuation approaches, resulting in a potential increase in cash flow generation and lowering the cost of capital. This premise is also validated by several academic researches that show a positive relationship between strong ESG integration and financial performance, as well as positive correlation between ESG ratings and lower cost of capital.

…can ultimately lead to a “green premium” and boost valuation upon exit

The unique capacity of PEs to mobilise capital, coupled with the investor’s demand for sustainability reporting in alignment with the regulatory landscape, and the evident correlation between ESG and financial performance, culminate in the emergence of a “green premium”, which will boost the valuation of portfolio companies upon exit.

Contacts

Andrew McDowell
Partner
Strategy& Luxembourg
+352 621 33 2034
andrew.mcdowell@pwc.lu

Benedikt Jonas
Director
Strategy& Luxembourg
+352 621 33 6102
benedikt.jonas@pwc.lu

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