JENNIFER SIGNORI
Senior Vice President, ESG and Impact Investing

ESG in Private Markets: Investing for the Long Term

A glimpse into the future of ESG investing in the private markets.

From a state of broad awareness but uneven adoption only a few years ago, private market asset managers have generally come to accept environmental, social and governance (ESG) integration as a standard part of doing business. Driven by growing evidence of the efficacy of ESG analysis and interest among institutional investors, based on our experience, most general partners have an ESG policy in place that lays out their intention to apply ESG principles to investment decisions and in interactions with portfolio companies. Now, a key question is, what comes next?

Especially in the wake of COVID-19, there is heightened focus on ESG matters such as how companies treat their employees, manage their supply chains, plan for business continuity, secure their data and manage their governance. We believe that how companies behave and respond during this crisis could have long-term implications for employee and customer relationships, and will be a key differentiator in the months and even years to come. For private market firms, we believe that building on current policies with true commitment and follow-through will be crucial to heightening ESG results and capturing return potential associated with sustainability.

Implementation of ESG Integration

As a starting point, we believe that ESG factors should be considered, not as an add-on or screening mechanism for private portfolios, but as a core element of the due diligence process and in engagements with portfolio companies to add value. Just having a policy is therefore not enough—real commitment must also be present, and manifested through concrete steps: generating true buy-in from senior leadership; implementing practical, regular training; and embedding best practices into a playbook that all can come to understand and deploy, so that ESG practices are simply a part of day-to-day investment activities.

Moreover, ESG cannot be limited to discrete functions; it should flow beyond due diligence to investment, ownership and portfolio management so that ideas can be translated into action. For example, within our Private Markets group, a dedicated Operational Due Diligence (ODD) team conducts due diligence alongside the investment team, with its analysis including ESG factors constituting a key part of risk assessment and management. Also crucial is transparency and communication: ESG reporting is most relevant when it involves data that is actually utilized to manage portfolio companies and create value. Much is still to be done in this area, so that outcomes can be measured on an objective basis.

Connecting ESG With Value Creation

Beyond the structure of an ESG program, it must also focus on the right elements. As a general proposition, we believe that assessing ESG factors that are likely to be financially material is a good starting point, with the recognition that a broader focus on sustainability can have positive cascading effects on companies' reputations and long-term performance. Along those lines, we see two crucial areas where ESG factors may affect private company valuations:

- The first category is in *day-to-day operations,* in which incremental improvements can, in the aggregate, have implications for EBITDA over time. A commonly cited example is taking a proactive approach to environmental issues, which may help lower operating costs while staying on the right side of regulations and public opinion; separately, conscientious policies with respect to employees can lead to greater employee retention and competitive advantages over time.
- The second category is *tail risks* that are also highly relevant to financial results. ESG considerations such as climate and diversity are slow-moving yet pervasive, and many investors have historically dismissed these risks as not applicable to the investment holding period. However, as recent "once-in-a-lifetime" current events have demonstrated, these systemic ESG issues have the potential to completely upend businesses and societies, with likely implications for private market portfolios. For instance, seeking to understand and manage the effect of climate risk on portfolio companies may mitigate risks associated with extreme weather, while inclusive hiring and talent development can enhance companies' brand value, even during challenging periods, which in turn may translate into enhanced valuation multiples.

Industry studies have increasingly documented the connection between ESG and financial performance. In June of 2020, Bank of America Merrill Lynch reported analysis capturing this relationship between ESG and company valuation multiples and cost of capital. They found that "just like consumers have credit scores, companies pay different rates depending on their risk profiles. For U.S. companies, the cost of debt for 'good' versus 'bad' companies based on MSCI ESG scores can be nearly 200 basis points. Similarly, valuation multiples (forward price-to-earnings ratio) for 'good' companies rose from historically as low as a 20% discount to a 20% premium—effectively lowering the cost of capital."[1]

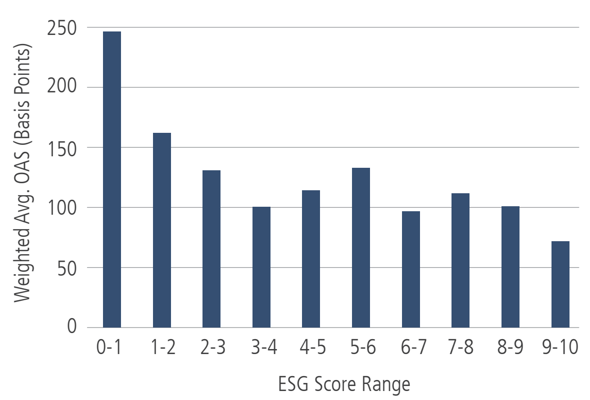
MULTIPLE RE-RATING LOWERS THE COST OF CAPITAL FOR COMPANIES WITH HIGH ESG SCORES

Relative Forward P/E of S&P 500 Companies in Top vs. Bottom Quintile by MSCI ESG Score (1/2007-8/2019)

Source: MSCI ESG Research LLC. BofA Global Research U.S. Equity & Quant Strategy, January 2007 – August 2019.

COMPANIES WITH HIGHER ESG SCORES TEND TO ENJOY LOWER COST OF CAPITAL

Weighted Average Option-Adjusted Spread (OAS) vs. MSCI ESG Scores of S&P 500 Companies, as of August 31, 2019



Source: MSCI ESG Research LLC. BofA Global Research U.S. Equity & Quant Strategy.

[1] Bank of America Merrill Lynch, ESG Is Transforming Asset Management, June 2, 2020.

More recently, during the market upheaval stemming from the coronavirus pandemic, a UBS study found that 60% of the largest sustainable and ESG-focused mutual funds and ETFs lost less market value than the S&P 500.[2]

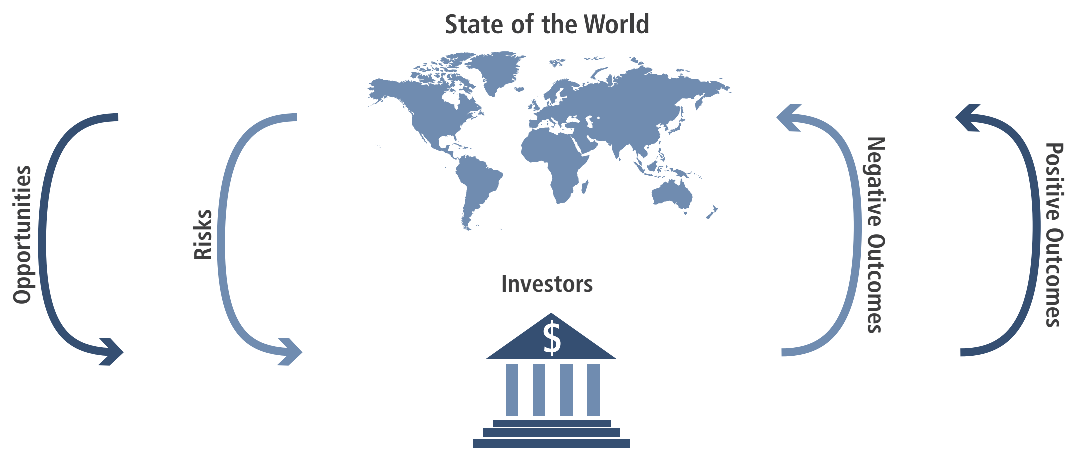
In the context of private markets, there isn't the same standardization of third-party ESG ratings and daily stock price movements to conduct the same scale of analysis. However, we believe that the logic should still apply to a company, whether it is listed in the public markets or not (and companies are increasingly choosing to remain private longer). Qualitatively, driving strategic and operational improvements is at the heart of private markets investing. A bias to quality and resilient companies is especially pronounced in an environment of economic uncertainty and potential volatility, and high-quality companies are commonly ones that perform well on relevant ESG matters. A recent McKinsey study, for example, found that 83% of C-suite leaders surveyed believed that ESG programs would contribute more to shareholder value over the next five years, and that they would be willing to pay about a 10% median premium to acquire a company with a positive ESG record over one with a negative record.[3]

Looking Forward, Broadening the Aperture

Global events in the context of rapid technological change and information flows are prompting calls to action. Businesses and investors are part of the broader system and play a key role. Companies may have myriad effects on employees, the community and the environment through their operations and products and services. Given the heightened public and investor focus on the social and environmental outcomes effected by companies (such as outlined by the United Nations Sustainable Development Goals), we could potentially enter a feedback loop to companies' valuations.[4]

'FEEDBACK LOOP' OF ESG AND OUTCOMES

Continuous Cycle of Investors' SDG Outcomes, the Resulting State of the World, and ESG Investment Risks and Opportunities



Source: United Nations Principles for Responsible Investment, "Investing with SDG Outcomes: A Five-Part Framework." Consultation Draft as of April 2020.

These impacts are becoming increasingly important to governing organizations and regulators on a global basis. For instance, the European Union's sustainable finance taxonomy, or "green taxonomy," and Japan's transition taxonomy seek to create more structure and guardrails while also facilitating investment toward activities that contribute to positive sustainability outcomes. Interestingly, the European Union's €750 billion COVID-19 recovery plan is expected to be linked to sustainable finance, which may influence the path of capital flows in the coming years.[5] Certainly, views differ across regions and stakeholders as to the path and degree of change, but such efforts are heightening expectations for businesses and investors.

[2] UBS, Sustainable ETFs: Resilience amidst market drawdowns, March 2020.
[3] "The ESG premium: New perspectives on value and performance," McKinsey & Company, February 2020.
[4] Source: United Nations Principles for Responsible Investment, "Investing with SDG Outcomes: A Five-Part Framework." Consultation Draft as of April 2020.
[5] Source: European Commission, "Europe's Moment: Repair and Prepare for the Next Generation," May 27, 2020.

It goes without saying that private markets investors generally have a long-term view, and many ESG issues typically play out over the span of years. A perennial challenge is the difficulty of isolating and quantifying improvements in company value from better stakeholder management, business continuity, or enhanced brand recognition tied to ESG initiatives. However, it is becoming increasingly clear that *without* ESG, it is more difficult to be a top-tier, high-quality company or asset manager. In our view, positive ESG performance is inextricably linked with high-quality companies and high-quality managers; thus, a general partner that is able to create the policies and processes, *and* ultimately follow through with implementation on ESG is likely to get many other things right as well.

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

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