CapitalDynamics
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ESG and Performance

A quantitative study on the relationship between ESG and financial outperformance in private markets

Volume 2

Executive summary

ESG-focused funds continue to be in the spotlight by both proponents and opponents of ESG investment practices. Proponents tend to argue that ESG consideration enhances financial performance through better risk management and value creation opportunities, while opponents argue that implementing ESG improvements sacrifice investment returns. At Capital Dynamics, we implement Responsible Investment with the goal to enhance long-term risk-adjusted returns for our clients. In our own study of the link between ESG and returns, we find five key takeaways:

1. Overall, funds considering RI factors outperformed other funds and demonstrated better risk profiles

2. Funds with Responsible Investment experience increasingly have an edge

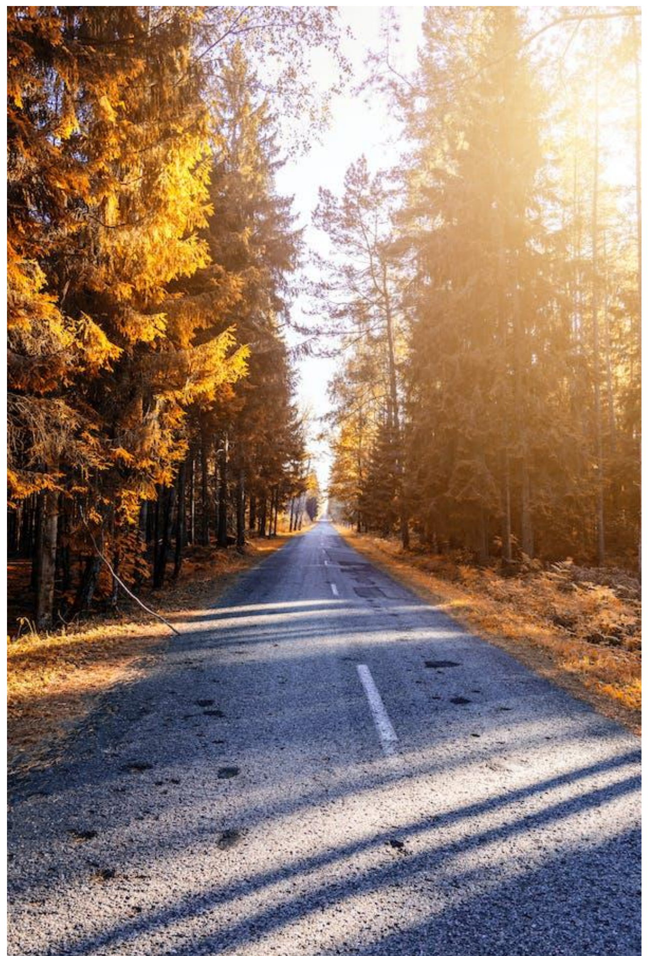
3. Funds with RI consideration generally provided higher downside protection

4. Funds with RI consideration demonstrated more attractive risk profiles (less variation in returns)

5. RI consideration contributed positively to returns of Principles for Responsible Investment ("PRI") members

We acknowledge that these findings do not conclusively demonstrate a causal relationship between ESG and performance. It is possible, for example, that managers which take ESG more seriously also have more structured approaches to underwriting more traditional investment risk and return metrics and considerations.

While continued research and understanding is required, this analysis contributes to the growing body of data and observational studies reinforcing the link between good ESG practices and better investment outcomes.



Introduction

In recent years, environmental, social, and governance ("ESG") factors have gained significant attention among investors and the ESG acronym has been subject to scrutiny, particularly in the U.S.

At Capital Dynamics, we tend to use the term 'Responsible Investment' ("RI") instead of ESG, as we believe this expression captures the quintessence of our duty towards our Limited Partners ("LPs"). Investing responsibly is at the core of our clients' needs and comprises:

1. Generating attractive risk-adjusted returns
2. Incorporating ESG criteria in the investment process

Nonetheless, some argue the consideration of ESG hurts performance, whereas proponents of ESG argue Responsible Investing ("RI"), done appropriately, has the potential to reduce downside risk and enhance long-term risk-adjusted returns. While literature remains inconclusive on the attributable effects of ESG criteria on returns, there is a growing body of evidence suggesting a positive relationship between ESG integration and investment returns in the private equity space.

In the U.S., the recent scrutiny on ESG investing centers on whether pension funds should be permitted to take ESG into consideration in making investment decisions. On one side, some propose that a pension fund should be singularly focused on generating a rate of return to match pensioner liabilities. On the other side, some propose that pension funds should be able to consider environmental and social objectives alongside return targets. Each side of this conversation brings important perspectives but it is our belief that the debate should be reframed.

The question is not whether a pension fund should sacrifice some level of return for impact targets but rather how RI, when properly implemented, may be accretive to long-term performance goals.

In this white paper, we use the terms ESG and RI interchangeably and explore the potential reasons why RI may lead to higher alpha in the private markets. We then present data from renowned literature and our own research, which suggest that robust RI consideration can lead to outperformance in long-term investment strategies.

The relationship between ESG and financial outperformance

A growing body of literature suggests that the integration of ESG factors in the investment process can enhance financial performance, mainly through downside risk protection and enhanced exit multiples of sustainable companies. The following drivers are commonly cited as factors that could explain the positive relationship:

1. ESG Integration and Enhanced Risk Management

One of the ways in which RI factors contribute to improved risk-adjusted returns in private equity is through enhanced risk management. By considering ESG risks and opportunities during due diligence and ongoing monitoring, private equity funds can identify potential value drivers and avoid potential risks. For example, evaluating a target company's environmental practices can help mitigate the risks associated with future regulations, reputational damage, or potential liabilities. Moreover, the potential issue of stranded assets on the balance sheet could be one of the most financially material risks if ESG criteria are not taken into account. Internationally well-esteemed frameworks, such as the Taskforce on Climate-Related Financial Disclosures (“TCFD”) require firms and asset managers to identify and manage climate-related risks, such as the risk of high-emitting assets becoming stranded.

2. Value Creation through Operational Improvements

Private equity funds that integrate RI factors in the investment process often uncover opportunities to drive value creation through operational improvements. By implementing improvement plans focused on sustainability, such as improving energy efficiency, reducing waste and optimizing supply chains, portfolio companies can realize cost savings and operational efficiencies. These improvements not only enhance financial performance but also contribute to long-term sustainability and resilience, and can help enhancing brand loyalty of portfolio companies.

3. Alignment with Stakeholder Expectations

The steep rise in Responsible Investment in private markets aligns with the growing expectations of various stakeholders, including Limited Partners (LPs), investors, regulators, employees and the broader society. LPs increasingly consider ESG factors as part of their investment decision-making process, preferring funds that demonstrate a commitment to Responsible Investment. By incorporating and promoting RI factors, private equity funds can attract and retain capital from investors who value responsible investment practices and help LPs to meet their own sustainability commitments, such as net zero pledges, in turn.

4. Access to New Opportunities and Markets

Considering RI criteria can also provide private equity funds with access to new opportunities and markets. As sustainable business practices gain momentum, companies that demonstrate strong ESG performance are better positioned to capitalize on changing consumer preferences and evolving market trends. Investing in sectors such as renewable energy, clean technology, and social impact enterprises can offer attractive growth opportunities and diversification benefits.

5. Enhanced Exit Opportunities and Valuations

Private equity funds that integrate Responsible Investment may benefit from enhanced exit opportunities and valuations.
As the awareness and demand for responsible investment rises, companies with strong ESG performance are often perceived as more attractive to potential buyers or public market investors. This can lead to higher valuations and increased exit multiples.

"A growing body of literature suggest that the integration of ESG factors in the investment process can enhance financial performance"

In February 2021 the NYU Stern Center for Sustainable Business published the results of a study that analyzed more than 1,000 research papers on the relationship between ESG investing and financial performance[1]. The NYU Stern report establishes six key findings from their analysis:

1. Improved financial performance due to ESG becomes more noticeable over longer time horizons
2. ESG integration as an investment strategy performs better than negative screening approaches
3. ESG investing provides downside protection, especially during a social or economic crisis
4. Sustainability initiatives at corporations appear to drive better financial performance due to mediating factors such as improved risk management and more innovation
5. Studies indicate that managing for a low carbon future improves financial performance
6. ESG disclosure on its own does not drive financial performance

More recently in February 2023, Noah Bani-Harouni et al. published the results of a joint research project, which suggests that ESG integration plays an important role in the end-to-end investment process of private equity funds, from initial screening of target companies to integrating RI objectives in the value creation plans to monitoring the RI improvements throughout the fund life[2]. The study reveals three key implications for RI-focused investors in the private markets:

1. Private Equity funds with better ESG profiles on average yield higher internal rates of return (IRR):

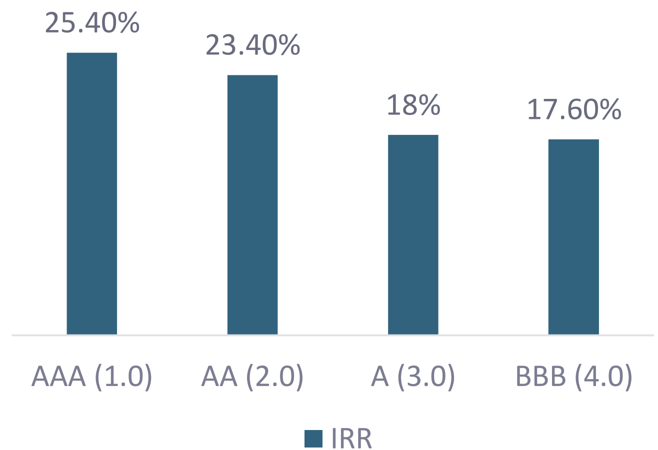


Figure 1: Average IRR for different levels of aggregated RepRisk Rating of fund portfolios

2. Investors that take the lead in ESG transformation achieve better ESG profiles than funds that delegate ESG improvements to portfolio company management

3. Private Equity funds that implement ESG improvement plans for portfolio companies and regularly monitor progress against the targets, achieve greater ESG transformation

Is there an ESG bubble?

Critics and opponents of ESG investing often cite that the implementation of ESG improvement measures sacrifices returns. For example, reducing a portfolio company's carbon footprint requires the measurement of greenhouse gas emissions, which in turn requires resources with technical expertise. Generally such measures represent costs in the short-term until the benefits of the improvement measures (such as enhanced energy efficiency) can be realized.

Undeniably, ESG-focused funds have enjoyed a steep increase in popularity over the recent years. Some argue, this is due to the enhanced return potentials of responsible investment, while at the same time regulation, policy action and changing inter-generational perspectives have influenced the rise in ESG funds. For example, the heightened climate awareness among the public and regulators have generated a push for ESG funds. As a result, private equity managers that could afford to hire and keep in-house technical expertise to keep up with LP demands and regulatory compliance quickly enjoyed a competitive advantage.

However, the difficulty in finding a definite answer on the potential link between ESG and financial performance comes from the need to dissect the data, for example to account for such demand shifts in favor of thematic trends, including ESG investing.

Perhaps more importantly though is to recognize that ESG standards are a moving target. What has once started as ethical investing by excluding "sin stocks", has rapidly evolved into much more sophisticated approaches to responsible investment. To this extent, old ESG investing practices from five years ago do not equate to the expectations of today's market. With this in mind, the answer on the link between ESG and performance keeps evolving, depending on the ESG investment style (for example negative exclusions, best-in-class screening and impact investing), the point in time and the corresponding sample size of the study.

Capital Dynamics' study on ESG and performance

Summary

In 2023, we conducted a quantitative study to test the hypothesis that Responsible Investment has the potential to enhance long-term risk-adjusted returns. We analyzed the fund performance of GPs who are UNPRI signatories versus the fund performance of managers who are not actively promoting RI. Our study found that funds considering Responsible Investment factors demonstrated more attractive risk and return profiles. The downside protection and variation of returns was consistently better after funds started considering RI. Also, return enhancement through RI implementation has manifested in more recent vintages. The results confirm our approach of incorporating Responsible Investment factors in our processes has the potential to generate enhanced downside risk protection and higher long-term risk-adjusted returns for our clients.

Study Methodology

We analyzed the relationship between private equity fund returns and Responsible Investment by making a hypothesis that managers reporting to the UNPRI (i.e., signatories to the UNPRI) have established RI processes that could impact their return profile. We mapped a list of UNPRI managers and their year of joining the initiative with buy-out funds and performance data available on Preqin. The performance of 1,556 buy-out funds of vintage years 2006 - 2020 were analyzed, providing us 15 years worth of data. Out of these funds, 679 were managed by signatories to the UNPRI, amounting to 44% of the sample size. For the purpose of our study, a fund was classified as considering RI factors, if the manager joined the UNPRI during the investment period of a fund (5 years). This resulted in 328 funds (21% of total sample) being classified as funds considering responsible investment factors.

Overview of PRI signatories

The Principles for Responsible Investment have grown increasingly in importance in signifying a serious approach to ESG underwriting among financial market participants across the globe. As of June 2023, the initiative consists of 5,371 signatories, out of which 4,094 (76%) are investment managers[3].

Signatories to the initiative commit to integrate responsible investment best practices in their investment process. In particular, signatories commit to the following six principles:

Principle 1: Incorporate ESG issues into investment analysis and decision-making processes

Principle 2: Be active owners and incorporate ESG issues into our ownership policies and practices

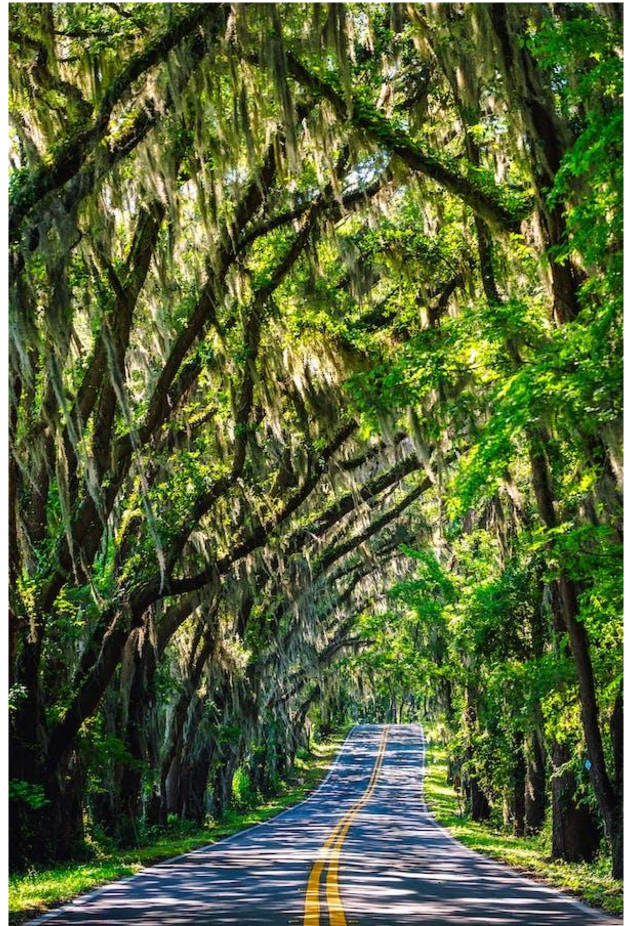
Principle 3: Seek appropriate disclosure on ESG issues by the entities in which we invest

Principle 4: Promote acceptance and implementation of the Principles within the investment industry

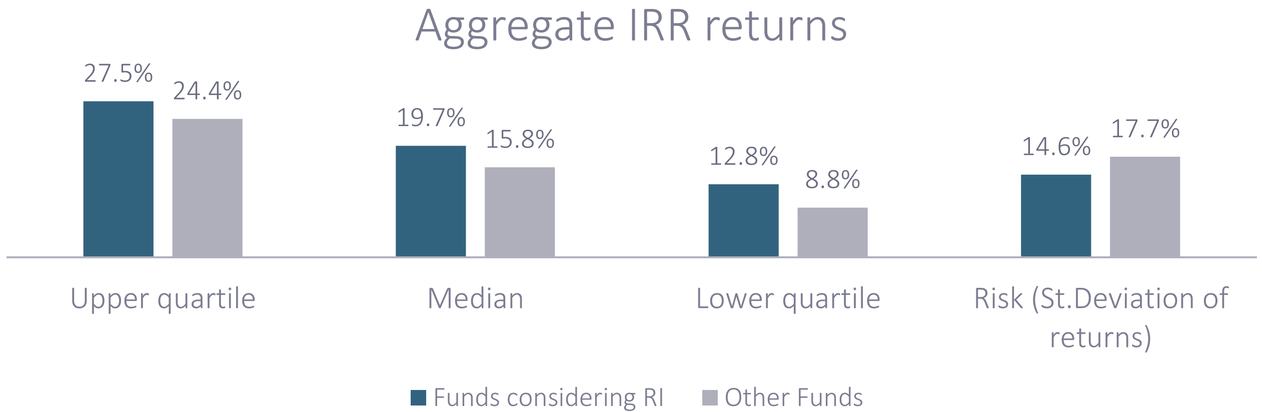
Principle 5: Work together to enhance our effectiveness in implementing the Principles

Principle 6: Report on our activities and progress towards implementing the Principles

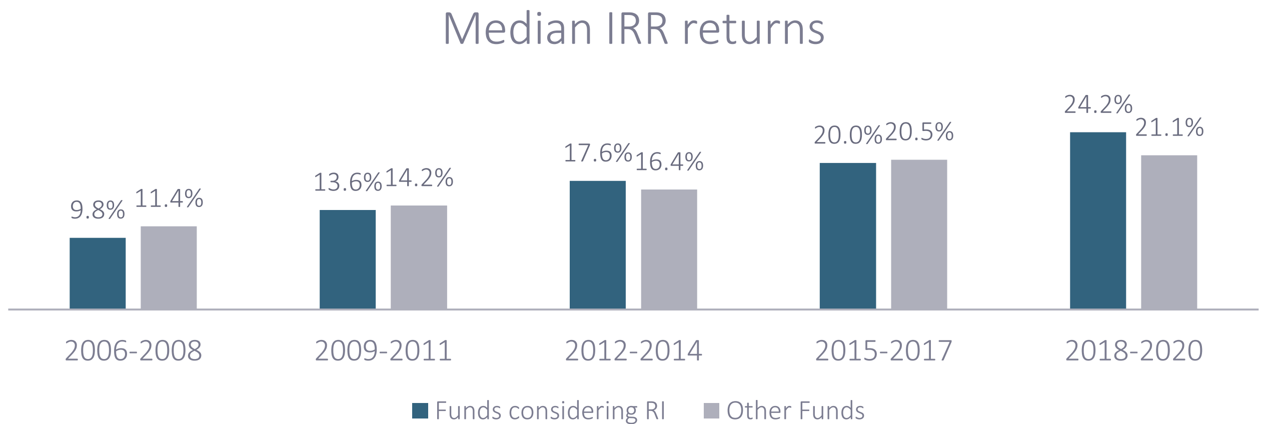
Given the deep integration of best practices in responsible investment among PRI signatories, our study uses the UNPRI membership as a proxy for private equity funds that consider ESG. Our study reveals five core insights in the relationship between ESG and investment returns:



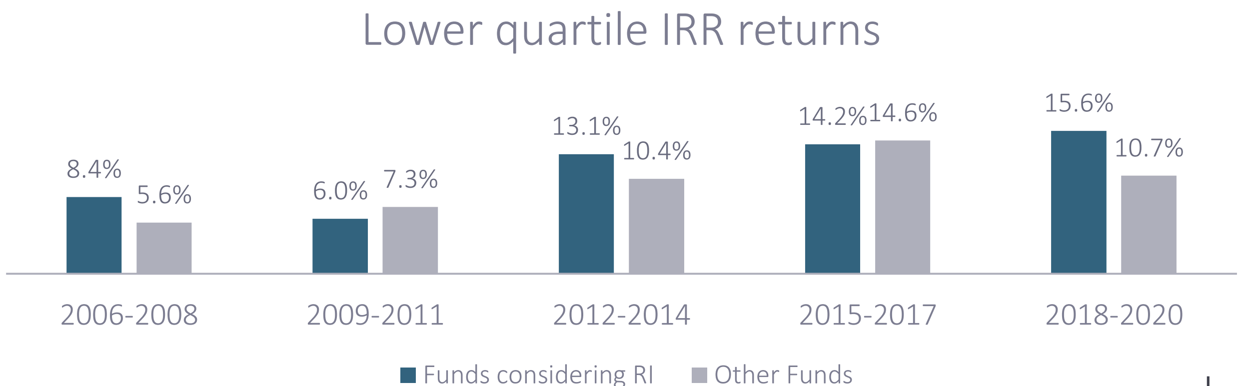
#1 Overall, funds considering RI factors outperformed other funds and demonstrated better risk profiles



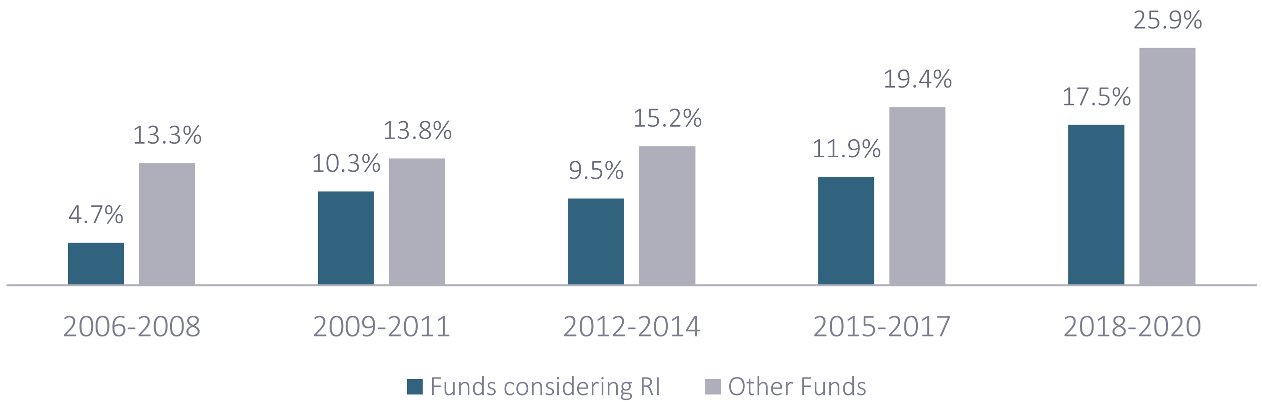
#2 Funds with Responsible Investment experience increasingly have an edge



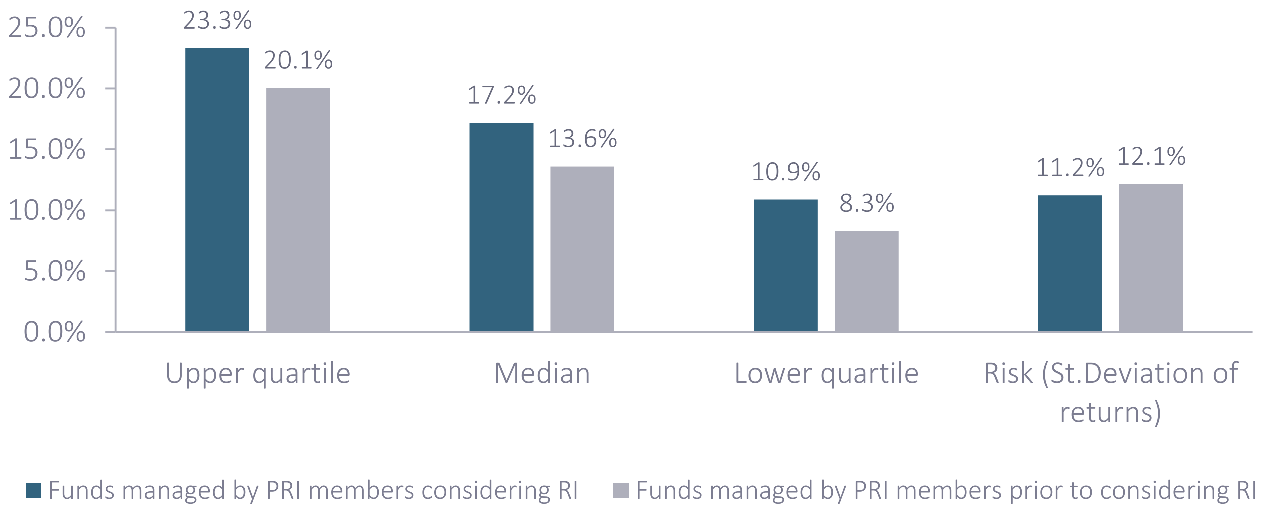
#3 Funds with RI consideration generally provided higher downside protection



#4 Funds with RI consideration demonstrated more attractive risk profiles (less variation in returns)



#5 RI consideration contributed positively to returns of PRI members



Concluding remarks

Our study suggests a positive relationship between responsible investment consideration and financial performance in the private markets. The results demonstrate that funds with stronger RI focus provide better downside risk protection and achieve higher IRR than funds that do not take ESG factors into account.

We acknowledge that study results on the relationship between RI and investment returns may differ depending on the study methodology. Additionally, we recognize that managers who have more rigorous approaches to RI may also have more rigorous approaches to other aspects of the investment decision-making process, which may skew the results.

We are hopeful that over time, data on ESG fund performance will continue to grow and improve in quality. For example, the regulatory push towards adopting sustainable practices in numerous jurisdictions, including the adoption of standardized, comparable ESG data, such as the European Sustainability Reporting Standards ("ESRS") and the International Sustainability Standards Boards ("ISSB"), will help investors in the long-term to identify and monitor evidence of financial materiality in a statistically meaningful way.

While ESG in private market investing has gained increasing prominence, there have also been challenges raised regarding the role of these factors in investment decision making. In the U.S., ESG has become more politicized in recent quarters with certain policymakers, pensions, and investors raising concerns as to the appropriateness of these considerations. The postulation is that the role of an asset manager should be restricted to delivering strong returns for their clients. Capital Dynamics' goal is to demonstrate that, in fact, the data suggests we must consider ESG for exactly this reason.

"Investing responsibly is at the core of our clients' needs and comprises generating attractive risk-adjusted returns and incorporating ESG criteria in the investment process"

Our study is part of a growing body of data underpinning the finding that disciplined ESG underwriting results in better risk-adjusted performance for investors.

In addition, investments with environmental or social objectives may represent a source of diversification as a part of a broader portfolio. Unlike conventional investing, environmental or socially oriented investment strategies may be driven more by secular tailwinds than short term market cycles. As an example, consider the U.S. Inflation Reduction Act, EU Green Deal, UK Net Zero Targets among a myriad of policies supporting global clean energy initiatives. This policy support inherently reduces the cyclicality of clean energy, battery storage and other investment opportunities linked to the energy transition. While more conventional investments typically experience under-investment and valuation weakness during periods of economic stress, this is less likely to be the case for asset classes supported by longer term policy considerations. As such, these strategies have the potential to exhibit less correlation with the rest of an investor's private market portfolio across a full market cycle. Taken collectively, there is good reason to believe that asset managers, Limited Partners, and non-traditional investors should all consider the environmental and social impacts of investments irrespective of politics or personal preferences.

About Capital Dynamics

Capital Dynamics is a recognized industry leader in responsible investment, receiving high marks from the UNPRI and GRESB for its Investment & Stewardship Policy, and investment strategies. The Firm combines robust returns with market-leading responsible investment practices, including designing, implementing and trademarking the Capital Dynamics R-Eye™ Rating System – a unique, best-in-class approach to diligence and rating of each investment based on UNPRI principles and UN Sustainable Development Goals.

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