

AlixPartners point of view

# **THE ESG SHIFT: PRIVATE EQUITY'S PATH THROUGH EMERGING NON-FINANCIAL REALITIES**

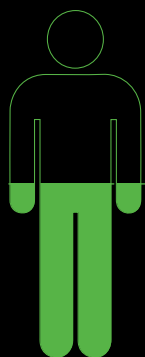


2023 is set to be a year of continued economic disruption for PE. IPEM's fifth annual Private Equity survey published this year, developed in collaboration with AlixPartners, acts as a litmus test for the industry, as 188 European GPs gave us their views on the road ahead.

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The economic threats of inflation, interest rates, and funding availability have superseded the threat of climate change and its consequences. However, the internal priority list for firms in 2023 is topped by ESG once again (72%). Fund Reporting/Transparency also features highly, with an increased focus to be placed on this area again this year. Climate action is cited as the most important ESG priority for 2023, while 69% of GPs agree that PE can provide serious answers to climate.

## THERE IS STILL MUCH WORK TO DO.



**JUST HALF OF OUR RESPONDENTS CURRENTLY MEASURE CARBON EMISSIONS,**



**AND AROUND 4 IN 10 HAVE DEFINED CARBON FOOTPRINT REDUCTION PLANS, SET CLEAR TARGETS, AND IMPLEMENTED CARBON OFFSET INITIATIVES.**

Viewed statically, the investment required here could be seen as simply a greater cost burden, or even an inflation driver, but it is vital that climate action and ESG is viewed as part of a more dynamic system, where the steps made to transform now will improve long-term trajectory; company image; the ability to access funding; hiring potential; talent retention; and, ultimately, exit values.

# HOW TO NAVIGATE AN INCREASINGLY COMPLEX REGULATORY FRAMEWORK?

Three pieces of EU regulations are set to change the tone in extra-financial reporting:

## 1 THE EU TAXONOMY    2 THE SUSTAINABLE FINANCE DISCLOSURE REGULATION (SFDR)    3 THE CORPORATE SUSTAINABILITY REPORTING DIRECTIVE (CSRD).

Their common purpose is to direct capital flows towards sustainable investments, by first providing transparency:

Since January 1st 2023, financial products are subject to SFDR assessment, defining three categories based on ESG level of consideration, with specific reporting obligations:

- “Article 6” label includes by default all financial products
- “Light Green” Article 8 are funds promoting ESG characteristics
- “Dark Green” Article 9 products have a structured and formalized ESG investment thesis

On top of SFDR, the Taxonomy sets a harmonized framework for economic activities to qualify as environmentally sustainable. Thus, a sustainable activity should 1) contribute substantially to an environmental objective (i.e climate change mitigation) while 2) proving that it Does No Significant Harm to any other (DNSH criteria).

Reporting obligations for “Article 8” and “Article 9” products include:

- Investment alignment to the Taxonomy
- The 14 Principal Adverse Impact indicators (PAI), evaluating the investment impact on total ESG scope, from GHG emissions to the gender pay gap, while also including exposure to controversial weapons

Portfolio companies will also be subject to reporting obligations through the Corporate Sustainability Reporting Directive (CSRD), replacing the NFRD (Non-Financial Reporting Directive). Main updates are the extension of the scope (turnover above €40m and 250 employees), the normalization of mandatory indicators and the introduction of third-party verification. The first reports are expected in 2025 based on 2024 activity.

This transparency effort will come at a cost: compiling these reports will require time and resources to collect and process large volumes of granular data. Beyond reporting, the ESG approach should effectively help manage an asset’s value creation trajectory by being:

- Specific to the company: related to the sector and economic ambitions
- Impactful: addressing key drivers
- Measured by relevant indicators

## WHAT IMPACT ON THE INVESTMENT CYCLE?

Before acquisition, the output of the Due Diligence process should include an “as-is” picture of the asset ESG performance, taking into account its impact, main challenges, and potential trajectory. For Article 9 funds, the ESG assessment will feed the sustainability investment thesis in compliance with SFDR. However, ESG performance is so tightly linked to operational and reputational risks and thus to exit value that all funds would benefit from the exercise. On top of that, including ESG within the value creation plan may become inevitable for all asset managers, given the regulatory context is rapidly evolving.

For the post-acquisition phase, the transition path is to be clearly outlined. It should rely on realistic goals and actionable plans and be aligned with the company’s sector-specific economic and environmental challenges, as well as its own business plan.

Ultimately, the trajectory should be characterized by a small set of relevant, measurable KPIs, ideally shared by all stakeholders and present in management packages, carried interests, and dashboards.

# HOW TO EFFECTIVELY SUPPORT PORTFOLIO COMPANIES?

We're pleased to see that many GPs are taking proactive steps to prioritize Environmental, Social, and Governance (ESG) concerns. By recruiting dedicated ESG managers and providing them with the necessary resources to define and implement action plans, these firms are demonstrating a strong commitment to responsible investing and sustainable growth. As such, serious issues such as diversity and inclusion, supplier policy, and travel policy are tackled head-on bringing value to the portfolio companies. When it comes to transitioning and decarbonizing, we strongly believe that the highest stakes are beyond the "low-hanging fruits", and require to tackle the core business assets such as research and development, end-to-end supply chain and more. For example, circularity cannot be achieved without addressing product design such as reparability and recyclability, implementing sustainable business models like renting, and optimizing end-to-end supply chain processes such as reverse logistics and second-hand markets.

Additionally, we believe that a parallel can be drawn between the ecological and digital transitions, and it's crucial for companies to learn from their experiences. In the early 2000s, several companies could be considered to have addressed their digital transformation efforts somewhat superficially, many of them quickly named a CDO without rethinking the entire business model and individual business units that could be transformed. The ecological transition will be even more disruptive and potentially shorter, which means that it is even more important to avoid these traps by considering each industry's unique challenges. The critical areas that need to be addressed won't be the same for everyone, which is why the heart of any business must be considered to achieve real impact.

## IN SHORT, THE WHOLE BUSINESS MODEL IS TO BE QUESTIONED AND RECONSIDERED.

Four recommendations to set up a realistic and feasible transition path:



**1** Avoid being too generic to side-step potential greenwashing accusations (increasingly framed by regulations) and superficial solutions



**2** Avoid "one-size-fits-all" solutions, given the complexity and variety of the challenges to be addressed by individual companies and industries



**3** Adopt the right balance between an overly granular approach and an 80/20 actionable one. The latter will be vital in helping identify and tackle the relevant and impactful ESG items for the business



**4** Address and question the whole business model to embed sustainability at every level of the value chain and throughout the entire product or service life cycle to achieve results through truly impactful changes

This process requires deep strategic and operational expertise and business knowledge, embedding and transforming a sharp sense of priority into a long-term actionable approach. **This is what AlixPartners can bring to the table.**

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## ABOUT US

For more than 40 years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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