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Private equity and sustainability: from measurement to improvement

Our second annual ESG Data Convergence Initiative report

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EXECUTIVE SUMMARY

- The ESG Data Convergence Initiative (EDCI) is a global initiative to advance environmental, social and governance (ESG) reporting in private equity and drive progress on ESG and financial value.
- In our second annual report, we note year-on-year response-rate improvements in the number of GPs, the number of funds, and most importantly a circa 90% increase in the number of portfolio companies.

  > But there is still further to go: circa 45% of Pictet Alternative Advisors' (PAA) private equity net asset value is captured by the data, and response rates furthermore vary by metric (only 55% of underlying companies disclosed their Scope 1 emissions, for example).
- The data highlight that the median private equity PAA portfolio company is less carbon intensive than the median public company, with 5.5 tCO2e[1] per $1 million of revenue versus 10.6 for the public benchmark.

  > There is nevertheless plenty of room for improvement: companies in the private and public firms benchmarks reduced their emissions intensity at a faster pace than PAA companies, and private companies overall seem to lag public counterparts in adopting renewable energy.
- The measurements captured in the EDCI data now allow us to focus our engagement efforts. Specifically, we see the importance of the 80/20 rule: for example, just 10 companies are responsible for circa 70% of reported Scope 1 emissions on which we have data.

  > As well as working to boost the participation rate over the next year, we will be able to use these data insights to target our work where it can have the greatest effect. Broader and deeper responses by the private equity industry will facilitate further concentration of efforts, in what we hope will be a virtuous cycle of improvement.

[1] Tonnes of carbon dioxide equivalent

EDCI at a glance

What	Why	How
The EDCI is a global initiative to advance ESG reporting in private equity and drive progress on ESG and financial value. It was launched in October 2021, and Pictet has been a Steering Committee member representing LPs since then	It was launched to address the low comparability and standardisation of ESG data across the private equity industry. The EDCI's ambition is to streamline the collection and reporting process for ESG key performance indicators, to increase transparency and facilitate the comparability of data between companies and sectors.	By collecting data through six categories of ESG metrics, mainly on GPs' portfolio companies': –Greenhouse gas (GHG) emissions –Renewable energy –Diversity of board members –Work-related accidents –Net new hires –Employee engagement Benchmarks are produced to allow investors to compare their portfolio companies' performance with peers.

Over 450 GPs and LPs have joined the project, representing over $38 trillion in AUM and 6,200 portfolio companies (2023 cycle)

INTRODUCTION

In our inaugural EDCI report last year, we highlighted a remark from Peter Drucker: "If you cannot measure it, you cannot improve it".

This year, we are pleased to report significant progress on the first of these two elements: thanks to an improved response rate from our underlying general partners (GPs), funds and portfolio companies, we have materially increased the breadth of our measurements.

While we are still determined to raise the participation rate further, this better availability of data gives us the opportunity to focus more on the 'improve it' phase.

"MEASURE IT"

Our second annual survey yielded a materially superior response rate. In the PAA private equity universe:

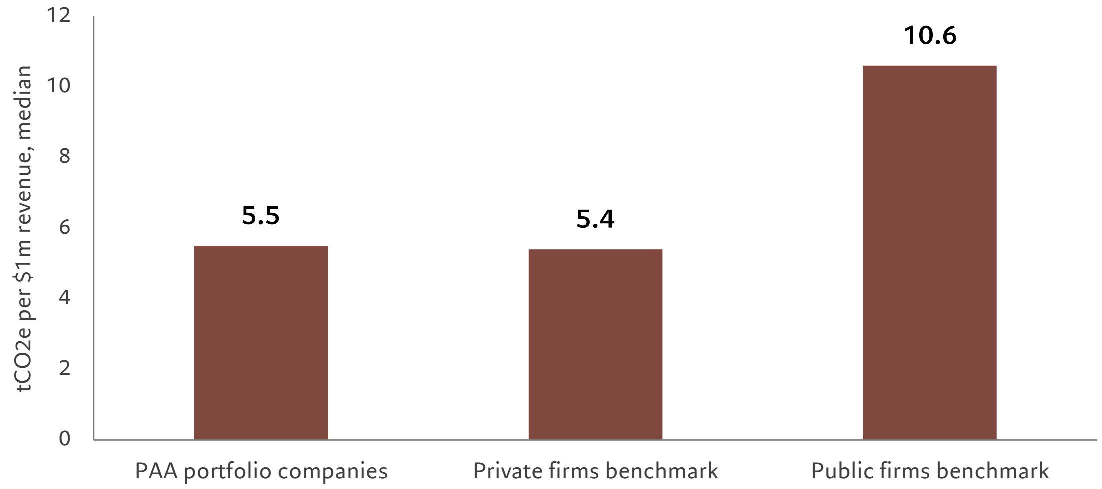
More than 550 companies reported – representing an increase of circa 90% compared with the previous year.

However, we also note that while the number of participating entities increased, response rates *per question* were highly variable. For example, only 55% of companies that disclosed to the EDCI did so for their Scope 1 emissions.

With that caveat, we can begin to monitor developments in areas where we received a sufficiently high number of responses.

A first theme to highlight is that the median PAA and private portfolio company is less carbon intensive than the median public company. Figure 1 shows that the carbon intensity of the median private company is in fact almost half that of the median public equity.[2]

Figure 1. Scope 1 and 2 GHG emissions intensity is on average lower in this private equity sample than in stock markets



Source: EDCI templates submitted by PAA GPs, BCG EDCI benchmark, data to 31 December 2022. This chart adds the medians of Scope 1 and Scope 2 intensity figures; while we acknowledge this is not mathematically conventional, in our view it allows us to generate directional insights into the portfolio.

[2] Please refer to the appendix on page 7 for an explanation of the methodology behind these categories.

While the Scope 1 and 2 emissions for PAA portfolio companies are similar to those of the private firms benchmark – and significantly below the public firms benchmark – they differ in their year-on-year rate of change.

The steadiness in emissions intensity for PAA portfolio companies between the two years reflects the results for the full dataset (in which companies vary between one year and the next), but we can detect some improvement when we narrow the focus to the subset of companies that submitted data for both years.

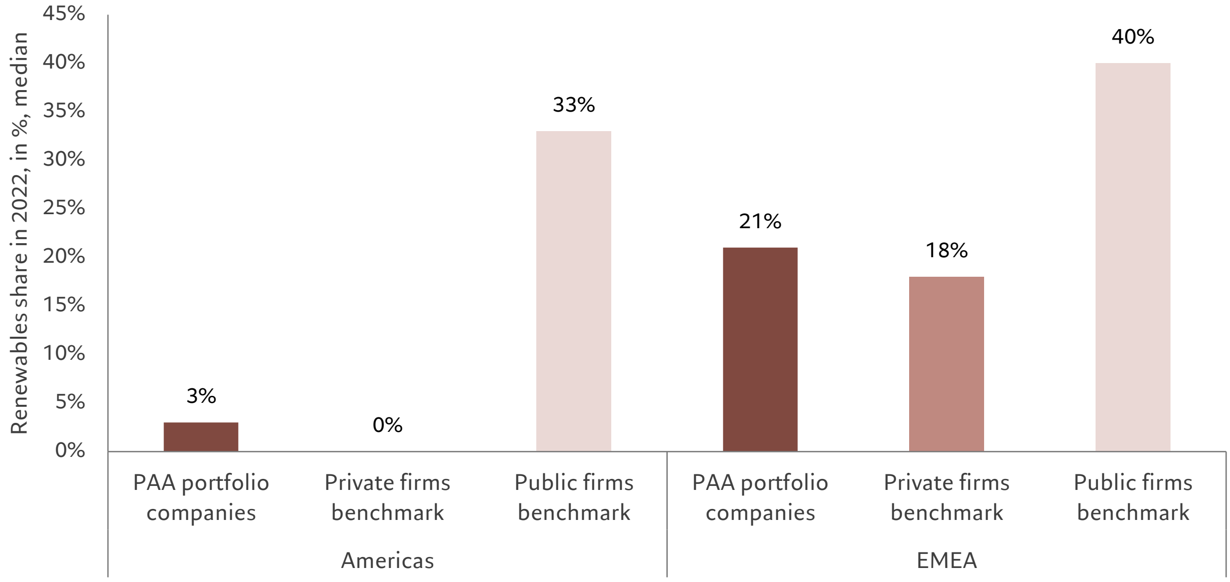
In a like-for-like comparison of 93 companies, median GHG emissions intensity declined by 18%.

Set against this improvement in emissions intensity, we must recognise that emissions still rose in *absolute* terms in this cohort of 93 companies.

This emphasises the importance of considering the data holistically: we must also monitor absolute emissions and work where possible to minimise them.

One intriguing facet of the data here is that renewables adoption in private companies lags that in public companies (Figure 2).

Figure 2. Renewables adoption is higher for public companies



Source: EDCI templates submitted by PAA GPs, BCG EDCI benchmark, data to 31 December 2022

The much greater share of their energy mix coming from renewables in public companies could be a function of their size and maturity; 52% of listed companies have published a climate target, according to MSCI.[3] It is pleasing that PAA portfolio companies are slightly further ahead on this journey than the median private company reporting to EDCI, but the delta to public equities makes clear the potential for

[3] Source: MSCI, The MSCI Net-Zero Tracker, April 2024

the private universe to reduce its carbon footprint – especially in the US. An interesting observation from Boston Consulting Group in this regard is that, across the full EDCI dataset, private companies held for two or more years triple their use of renewable energy, from an average of 6% to an 18% contribution of renewables to their energy mix.[4]

The S sense

The EDCI tracks social datapoints as well as environmental ones. This year, we note that more than 50% of PAA portfolio companies maintained or increased the share of women on their board, better than the private firms benchmark.

Nonetheless, the median female board representation on PAA portfolio companies is by and large in line with the benchmark and remains more than 10 percentage points below the public benchmark, so there is room for improvement.

"IMPROVE IT"

The measurements captured in the EDCI data now allow us to focus our engagement efforts.

Specifically, in the graphic below we can see the importance of the 80/20 rule – this handful of companies is where improvements will have the greatest influence on portfolios.

Scope 1 GHG emissions	**10 companies** are responsible for **c.70%** of *reported* PAA portfolio GHG Scope 1 emissions
Scope 2 GHG emissions	**10 companies** are responsible for **c.60%** of *reported* PAA portfolio GHG Scope 2 emissions

Source: EDCI templates submitted by PAA GPs, BCG EDCI benchmark, data to 31 December 2022

Furthermore, the data help us understand not just *where* to engage as LPs, but *how* to engage too. For example, although the carbon intensity of the median private company is around half that of the median public equity (Figure 1), we know public companies have been improving on this measure at a faster pace than their private counterparts. Notwithstanding public companies' higher starting baseline, we in private equity can learn from what they are achieving; for example, accelerating the adoption of renewable energy could be one of several options (Figure 2). Indeed, this will be one area of focus in the next reporting cycle.

[4] Source: BCG, Sustainability in Private Equity 2023, October 2023

We can also use the granularity of the data to concentrate our efforts on sectors where our portfolio companies diverge from the benchmark. For instance, we can see in which sectors PAA portfolio companies have lower median GHG emissions than the equivalent sectors in the private firms benchmark, and where they on average exceed the benchmark's emissions.

CONCLUSION

As much as it is an update on last year's numbers, this report is also an invitation to more GPs and LPs to join the initiative. In 2022, the EDCI in total collected more than 62,000 data points from around 4,300 private-equity-backed companies, almost double the previous response rate – and better measurements should mean more targeted improvements.

For one concrete example of this targeting, in the next reporting cycle we will focus on private companies that have a decarbonisation plan in place. We would expect them to reduce their emissions at a faster pace than others lacking such plans, and hope to see this in the data.

Private equity assets under management are expected to reach \$8.5 trillion by 2028, from around \$5 trillion today.[5] In the US alone, the private equity industry directly generated \$1.7 trillion of gross domestic product in 2022 (approximately 6.5% of the country's economy) and directly employed 12 million workers earning \$1 trillion in wages and benefits.[6]

In this huge, growing and critically important industry, better measuring sustainability data – and using the data as a value-creation driver – can positively contribute both to returns and to our economy, society, and planet.

We look forward to continuing to work with the EDCI and a wider group of LPs and GPs to drive this progress.

[5] Source: Preqin, 'Global Report 2024: Private Equity', December 2023
[6] Source: American Investment Council, 'Economic contribution of the US private equity sector in 2022', April 2023

What's next?

From the 2023 cycle on, the EDCI will add one new category and three new KPIs.

GHG emissions
• Scope 1
• Scope 2
• Scope 3 (optional)

Renewable energy
• % renewable energy usage

Diversity
• % women on board
• % women in C -suite
• % underrepresented groups on board (optional)
• % LGBTQ on board (optional)

Work-related accidents
• Injuries
• Fatalities
• Days lost due to injury

Net zero
• Strategy (optional)
• Target (optional)
• Ambition (optional)

New

Net new hires
• Net new hires (organic and total)
• Turnover

Employee engagement
• Employee survey (yes/no)
• Employee survey response (optional)

Source: BCG EDCI benchmark

APPENDIX

Definitions of datasets

- PAA portfolio companies: set of companies for which GPs have submitted EDCI data for funds in which PAA is invested
- Private firms benchmark: set of companies that submitted data to EDCI, forming a benchmark created by BCG and available to EDCI members
- Public firm benchmark: set of companies in listed markets based on Refinitiv data and prepared by BCG (criteria being publicly listed, status in database as 'active', and only primary securities in selected exchange markets: HK, SSE, NASDAQ, NYSE, LON, Euronext Paris, Amsterdam, Brussels, Deutsche Boerse, Boerse Berlin, Duesseldorf, Muenchen, SIX Swiss Exchange)

Notes on methodologies

Metrics

For several of the KPIs used in the analysis, medians are used to reduce the impact of outliers as well as potential data quality issues.

Comparability

Year-on-year comparisons are difficult for some KPIs (e.g. GHG emissions) as they are mainly influenced by the sector exposure of the dataset. For the purposes of this exercise, we have done some like-for-like comparisons where feasible (e.g. where we have the same companies in the dataset for both years).

Comparison between datasets (e.g. PAA vs. private firms benchmarks) is valuable. Having said this, some differences might be explained by the differences in the sector mix of both datasets (e.g. for GHG emissions).

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