How ESG is changing the relationship between GPs and LPs

James Gow, our Chief Client Officer, recently led a virtual roundtable with several Chief Financial Officers and Chief Operating Officers within the private fund industry to discuss how environmental, social and governance (ESG) and sustainability factors were shaping interactions between Limited Partners (LPs) and General Partners (GPs). Here, James shares some of the key takeaways.

ESG is now firmly part of the LP due diligence process

All of the participants in our working group confirmed that ESG has become an integral part of the investment decision-making process for LPs. A few years ago, GPs would expect to receive "do you have an ESG policy?" as part of an LP's due diligence, whereas today they routinely receive an average of 50 questions focusing on various ESG-related themes. The challenge for GPs when answering these questions is that many LPs are still trying to work out what they are looking for, and why it's important to them. In the meantime, without a more clearly defined approach for LPs to follow, box-ticking exercises are still prevalent.

LPs are looking for more clarification of ESG standards from GPs

The group told us that the private fund industry is crying out for a clear set of standards, and so too are investors. In a perfect world, firms would be able to clearly demonstrate their ESG practices and commitment with a universally recognised rating. However, given that ESG is still such a broad, subjective term, this level of standardisation is still considered some way off.

While it was noted that several regulatory bodies are developing their own specific ESG questionnaires for LPs to use, there was a clear sense more needed to be done to promote standardised ESG approaches, and to join up some of these separate efforts.

SFDR has not been plain sailing

Another key point emerging from the discussion was how GPs had been instructed to interpret the Sustainable Financial Disclosure Regulations (SFDR). Understandably, GPs had received advice in the interpretation of taxonomy and fund reporting requirements in the run-up to the implementation date of 10 March 2021. One of the biggest issues was the ESG information that GPs should be making available on their websites.

The group told us they found the SFDR rules counterintuitive at time. For example, while smaller funds can effectively opt out of disclosures, publishing ESG policies on a corporate website, can trigger taxonomy disclosures under SFDR. Some participants told us external advisers had even recommended removing ESG policies and reporting material from their website, to avoid triggering taxonomy requirements.

Meaningful benchmarks are needed

Another 'pain point' highlighted was the challenge of ESG reporting requirements. A noticeable theme across different sectors suggested many firms are increasingly proficient at carrying out ESG-related activities. Still, without meaningful benchmarks to measure against, they often struggle with articulating what they do and why.

At the Aztec Group, our conversations with LP clients have highlighted their need to receive data from GPs in a consistent format. But these efforts can be hampered by different reporting structures as well as different taxonomies that firms are reporting under. Moreover, getting meaningful, easily comparable data from portfolio companies – on areas such as greenhouse gas emissions, to name one example – can present a big challenge for GPs. Therefore, obtaining and presenting standardised data in a format that makes it easy for the LP to fully analyse and make use of it, to establish where improvements are being made, is an area where more progress needs to be made.

Our panel also discussed the problem of data overload, which can be frustrating on all sides. LPs don't want to receive raw portfolio company data they will struggle to analyse and interpret; they prefer information in a more digestible format. Case studies that show ESG challenges, initiatives and results over time can be a more effective way of presenting information to LPs – helping to paint a clearer picture that allows for more meaningful portfolio company comparisons.

Building a firm-wide ESG culture

All of the participants talked about the importance of building and maintaining an ESG culture. GPs looking to show LPs they are serious about ESG, must be authentic in what they do and some are using story telling as well as data capture to achieve this.

One panellist suggested that one of the most effective ways to drive change is through hiring resources explicitly dedicated to ESG, thereby ensuring the subject is considered a full-time responsibility in its own right. Another noted that for senior management, the challenge is to keep moving things forward, focusing on areas that make a difference, avoiding distractions, and resisting the trap of attempting to “boil the ocean”. Of course, change does not happen overnight, and senior management needs to demonstrate a strong commitment to embedding and instilling ESG values from the top-down.

Summary

Our working group discussion demonstrated that while some GPs & LPs are still in the early stages of getting to grips with ESG, the direction of travel has already been determined. But there really is no ‘one-size-fits-all’ approach that will work. Measurements need to be meaningful, relevant and proportionate, not just applied for the sake of getting a box ticked. Therefore, the drive to more standardised taxonomy of ESG is perhaps one of the biggest challenges GPs face today.

The good news is that all our contributors recognise the private funds industry has travelled an enormous distance in just a few years. Hopefully, the industry is moving towards a greater understanding of GP reporting requirements, and an improved interpretation of ESG regulatory disclosure rules. Above all, everyone agreed that a consolidated view of ESG standards across all working groups would be invaluable, and that the more constructive dialogue occurs between GPs and LPs on what standards are achievable, the better. We all want the initiative to go beyond regulatory requirements, and become more effective at defining, measuring, evaluating and communicating ESG impacts, to the benefit of all participants.