

novata

How to Build the Business Case for ESG Integration in Private Equity

A General Partner's Guide

October 2024

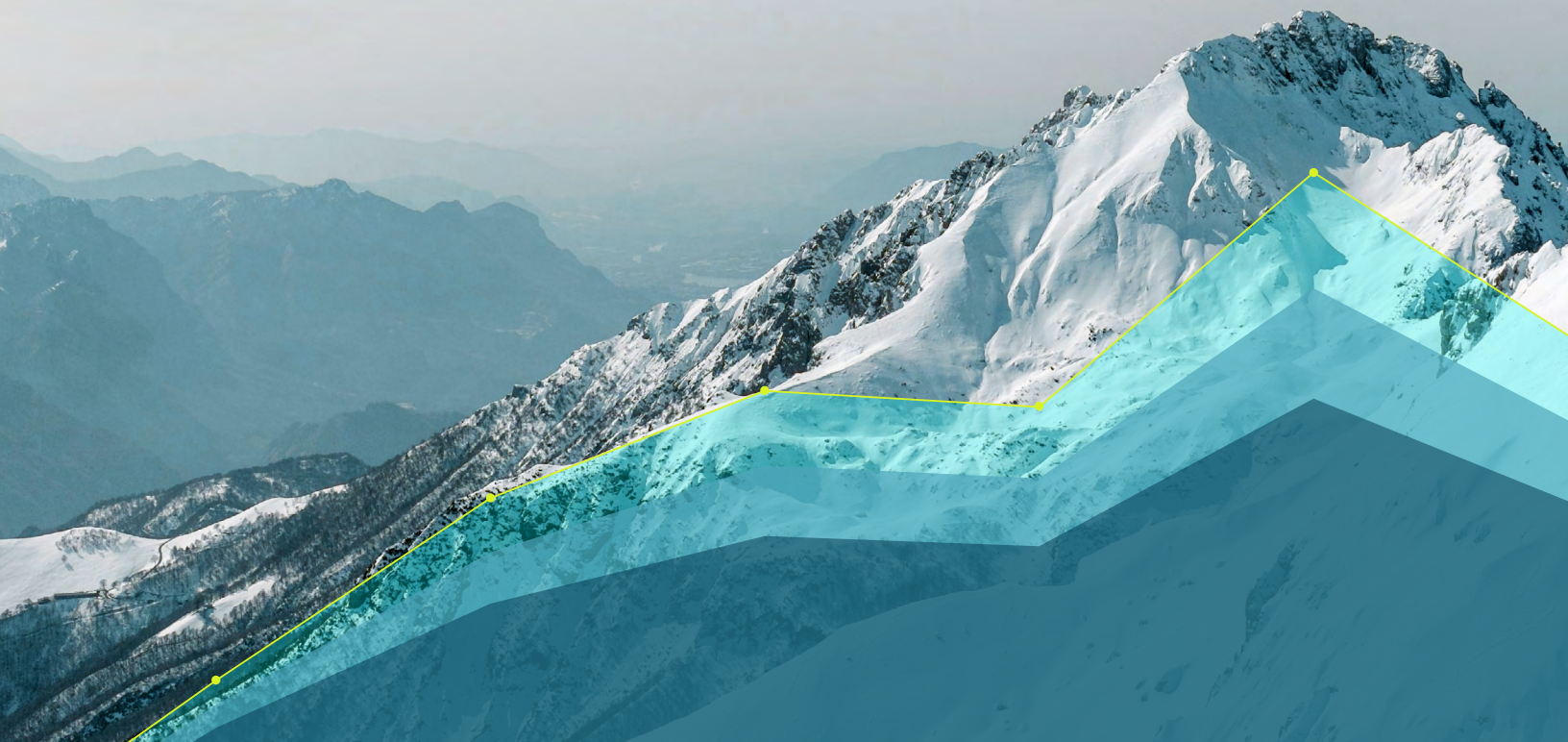


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Preparing Your Business Case

About Novata

Executive Summary

Driven by changing investor priorities, rising pressure from regulators, and public expectations for businesses, environmental, social, and governance (ESG) considerations continue to grow in importance in private markets. What was once viewed as a check-the-box exercise is increasingly being seen as additive to investment performance, [according to Bain](#), and 70% of limited partners (LPs) say their organization’s investment policies include an ESG approach.

The rising demand for ESG data makes it imperative for general partners (GPs) to incorporate ESG considerations across the investment lifecycle and demonstrate how they account for these sustainability metrics. However, implementing a firm-wide ESG strategy requires internal buy-in that begins with leadership. To make the case for ESG integration, individuals charged with leading the ESG work or function will need to communicate the benefits within the context of a firm’s needs.

This eBook dives into best practices for building a business case for ESG integration, including:



of limited partners (LPs) say their organization’s investment policies include an ESG approach.

Source: Bain

01 Demonstrate the financial value.

Effective ESG integration can help investors mitigate risks, cut costs, and ensure higher valuation of portfolio companies at exit. The ESG metrics GPs track on the Novata platform, such as energy and water usage, can help companies increase EBITDA by lowering costs. The business case should highlight the added financial value of considering ESG factors as well as the cost of the absence of an ESG focus on accessing capital and creating blind spots in managing investments.

02 Highlight regulatory risks to communicate urgency.

Changing regulations around ESG disclosures and rising pressure from LPs suggest that demand for ESG data will continue to intensify. It takes time to build an ESG strategy and ensure compliance, so the time to get started is now.

03 Address stakeholder concerns.

Internal stakeholders, including senior managers, investment teams, those tasked with investor relations, and portfolio company leaders, may have pushback against integrating an ESG approach. Understanding their concerns will prepare you to respond as you make the business case for an ESG focus.

04 Outline budget needs.

When presented with a new initiative, leaders want to understand the problem it is trying to solve, the benefit, and the cost. Identify the resources needed to effectively implement an ESG plan, including skills, expertise, and technology solutions, as well as associated costs upfront.

For ESG advocates who need to make the business case, this guide explores these four considerations and offers guiding questions to help frame the conversation for ESG integration.

01 Demonstrate the Financial Value

Incorporating ESG considerations into investment decisions creates opportunities to improve the financial value and performance of portfolio companies, which is a crucial lever to pull for stakeholders. According to [Capital Group's 2023 ESG Global Study](#), 57% of investors believe that incorporating ESG analysis in their processes can uncover attractive investment opportunities.

Considering ESG factors at each stage of the investment lifecycle can provide a holistic view of each portfolio company's risks and opportunities for growth.



PRE-INVESTMENT

Pre-investment, ESG data can provide insight into how companies account for existing and emerging risks material to the business, which produces a more comprehensive due diligence assessment. This could look like waste and water management for a manufacturing company or privacy and data security concerns for technology companies. How a company is preparing for the impact of climate change on business activities is also a necessary consideration as [collapsing ecosystems](#) create significant operational risks.

POST-INVESTMENT

Post-investment, ESG data can inform how GPs engage with portfolio companies to mitigate operational and reputational risks, drive bottom-line impact, and improve the valuation upon exit. This could look like recommending actions to [improve operational efficiency](#), lower energy use, or create inclusive workplace cultures that increase employee retention. [According to McKinsey](#), rising operating expenses can affect operating profits by as much as 60%, and ESG implementation can help mitigate these rising expenses. The specific initiatives and support that a firm may prioritize will vary based on the portfolio company's materiality and be tailored to their unique opportunities for value creation.


EXIT

ESG performance is also increasingly important in the exit process. In a [2021 EY study](#), 72% of PE executives said they expect an ESG premium in companies they are considering exiting. Fifty-seven percent also said that a social impact policy, including Diversity, Equity, and Inclusion (DEI) commitments, is a critical area of focus in exits. A company's ESG performance can impact its valuation, and GPs that have already engaged portfolio companies on ESG will be able to better answer long-term sustainability questions. For instance, [Carlyle](#) found that increasing the total revenue an oil and gas company gets from renewable energy from zero to 40% could double the typical energy company's EBITDA valuation multiple.



ESG considerations lead to better risk management and **value creation.**

Fundamentally, ESG considerations lead to better risk management and value creation by helping investors account for material risks—such as climate change or regulatory compliance—and identify opportunities to increase the profitability of portfolio companies. Many of the risk mitigation practices embedded in ESG considerations are fundamental to the investment process, so showcasing the connection to the firm’s existing practices and post-transaction support will build a strong case for buy-in across the firm.

A graphic featuring the number '57%' in a large, dark blue font. The number is enclosed within a thin, dark blue circular line that is open at the top and bottom. The background of the graphic is a soft, glowing light blue and white, suggesting a sun or moon behind clouds. The entire graphic is set against a background of rolling hills under a golden-yellow sky.

57%

of investors believe that incorporating ESG analysis to their processes can uncover attractive investment opportunities.

Source: Capital Group



02 Highlight Regulatory Risks

In recent years, there has been a global rise in the introduction of sustainability regulations aimed at increasing transparency and accountability in corporate ESG reporting. In response, many general partners (GPs) are exploring how to navigate a complicated landscape, understand the requirements relevant to them and their portfolios, and comply with global and regional regulations.

ESG regulations differ by region, so firms that operate globally may be in-scope for multiple regulations simultaneously. When building the business case, highlighting the impact of existing and emerging mandates on your operations—and those of your portfolio companies—will help communicate the importance of ESG integration. Non-compliance with regulations is a significant

risk as many jurisdictions are instituting penalties for firms and companies that do not meet reporting requirements. The table below provides an overview of notable ESG disclosure regulations in the US and Europe, as of August 2024.

In the Asia Pacific region, [jurisdictions are increasingly using](#) the ISSB's IFRS S1 and S2 standards as a foundation for developing disclosure frameworks. As an example, Singapore has announced the implementation of phased-in mandatory climate-related disclosures aligned with the standards. Similarly, Australia, which [recently passed a bill](#) to introduce mandatory climate reporting in 2025, is also expecting the release of climate disclosure standards aligned with IFRS S1 and S2.

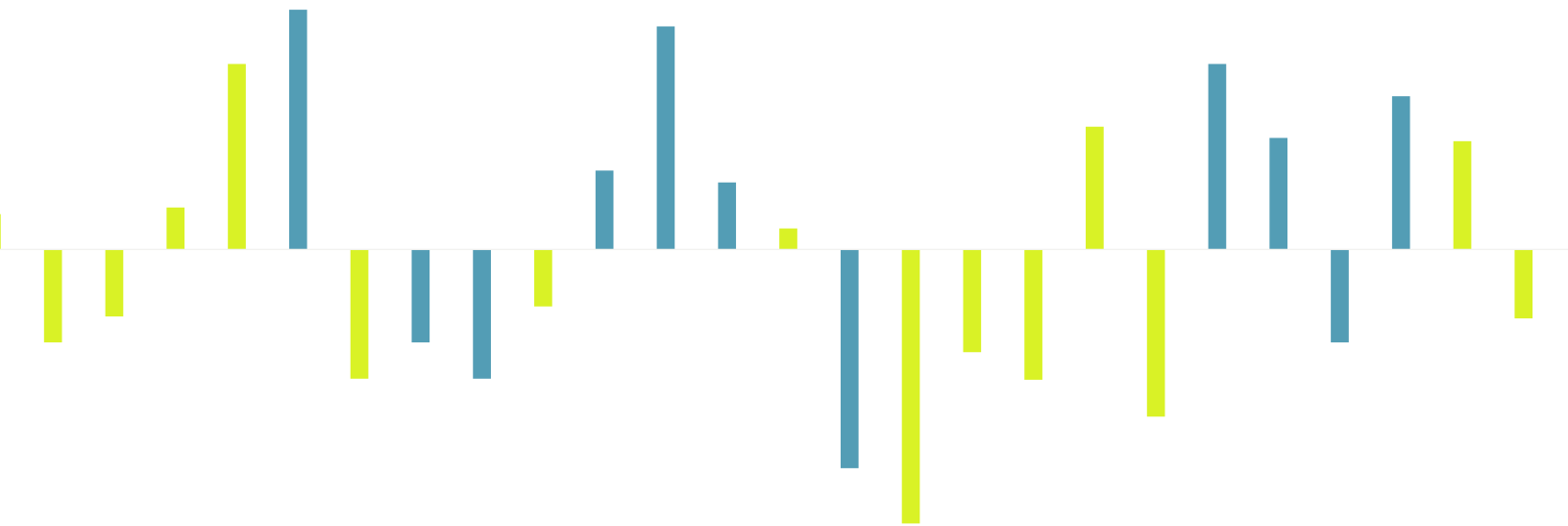
ESG Regulations in Private Markets

The ESG regulatory landscape is evolving quickly as the need for transparency around sustainability risks grows. Below are notable disclosure regulations in Europe and the US with an impact on the private markets.

REGULATION	REQUIREMENTS	IMPACT AREA	TIMELINE
Sustainable Finance Disclosure Regulation (SFDR)	<p>Level 1: mandatory entity-level disclosures on ESG-related activities, including the sectors they invest in and portfolio companies.</p> <p>Level 2: more detailed entity and product-level disclosures, including pre-contractual and annual reporting disclosures based on proposed Regulatory Technical Standards.</p>	<p>Asset managers and other financial market participants in the EU.</p> <p>Any companies registered to market to EU investors</p>	In effect
Corporate Sustainability Reporting Directive (CSRD)	<p>Expands the scope of the Non-Financial Reporting Directive (NFRD) to include large private companies in the region and introduce more detailed sustainability reporting as well as an audit of reported information.</p>	<p>Large companies in the EU (more than 250 employees)</p>	In effect; companies to report their 2024 data in 2025.
Streamlined Energy and Carbon Reporting (SECR)	<p>Provides transparency and encourages improvements in energy efficiency and carbon emissions by promoting reduction among businesses. SECR requires large UK companies to disclose their energy use, greenhouse gas (GHG) emissions, and energy efficiency measures in their annual reports.</p>	<p>Large companies and Limited Liability Partnerships (LLPs) that meet two or more of the following criteria:</p> <ul style="list-style-type: none"> • Turnover of £36 million or more • Balance sheet total of £18 million or more • 250 employees or more 	In effect, companies
UK Sustainability Disclosure Requirement (SDR)	<p>Enhances transparency and standardizes sustainability-related disclosures through sustainable investment labels, product- and entity-level disclosures, and an anti-greenwashing rule to support disclosure of impacts.</p>	<p>Anti-greenwashing rule applies to all FCA-authorized firms in the UK</p> <p>Investment labels and other disclosures apply to UK asset managers and UK-domiciled funds</p>	Anti-greenwashing rule, investment classification and labeling rules in effect Rest will be phased in through 2026
SEC Climate Disclosures	<p>Public companies disclose climate-related risks material to the business, results of operation, or financial condition, including Scope 1 and 2 emissions, as well as Scope 3 emissions if material.</p>	<p>US; Private companies that supply to public companies; Publicly traded companies</p>	Approved in March 2024; currently in an administrative stay
CA SB253: California Climate Corporate Data Accountability Act	<p>California companies are to disclose their externally assured scope emissions, starting in 2026 with Scope 1 and 2 and upstream and downstream supply chain Scope 3 emissions in 2027 thereafter.</p>	<p>US; Private and public companies that do business in California with revenues in excess of \$1 billion</p>	Will go into effect 2026 for 2025 data

ESG Regulations in Private Markets Continued

REGULATION	REQUIREMENTS	IMPACT AREA	TIMELINE
CA SB261: California Climate-Related Financial Risk Act	California companies are to disclose their climate-related financial risks and measures they have adopted to reduce and adapt to those risks, and to publish a public climaterelated financial risk report.	US; Private and public companies that do business in California with revenue in excess of \$500 million	Will go into effect in 2026
CA 54: Fair Investment Practices by Advisors	Venture Capital Companies (VCCs) to report on the demographics of the founding teams of portfolio companies in which they invested during the prior year.	US; venture-capital companies or other funds where at least 50% of assets are comprised of venture capital investments	Will go into effect in 2026
Corporate Sustainability Due Diligence Directive (CSDDD)	Minimum requirements across EU member states to develop and implement appropriate measures to conduct due diligence across global supply chains.	Large companies in the EU, US companies with European supply chains or with significant operations in EU	Will go into effect in 2025, EU member states will have 2-year period to adopt into law
Washington Senate Bill 6092 Concerning Disclosure of Greenhouse Gas (GHG) Emissions	SB 6092 requires companies with over \$1 billion in annual revenue and doing business in Washington (reporting entities) to report their direct and indirect greenhouse gas (GHG) emissions (Scope 1-3) annually.	Companies in the US that do business in Washington state with total annual revenues in excess of \$1 billion	Introduced in 2024; not yet in effect
New York SB S5437	Requires reporting and verification of Scope 1, 2 and 3 greenhouse gas emissions by a business with total annual revenues in excess of \$1 billion that does business in New York.	Companies in the US that do business in New York state with total annual revenues in excess of \$1 billion	Introduced in 2024; not yet in effect
Illinois HB4268 The Climate Corporate Accountability Act	Proposed Illinois bill will require US entities doing business in Illinois with total annual revenues over \$1 billion to annually disclose and verify their Scope 1, 2, and 3 GHG emissions.	Companies in the US that do business in Illinois with total annual revenues in excess of \$1 billion	Introduced in 2024; not yet in effect
SEC ESG Investment Disclosures	Requires specific disclosures for ESG-focused funds and advisers, including an overview of a fund's ESG strategy, how it incorporates ESG in investment decisions, and how it votes proxies or engages companies on ESG issues.	US; Certain registered investment advisers, investment companies, and business development companies	Proposed May 2022; not yet in effect



03 Communicate Investor Priorities

LP demand for transparency around ESG data has been a key driver of ESG integration among firms, making their changing priorities an important consideration for internal stakeholders. For instance, nearly half of limited partners in a [2023 SS&C Intralinks survey](#) noted that integrating ESG factors through the deal cycle affects manager selection and an engaged approach makes managers more appealing.

Concerns around ESG performance also affect M&A activity. A [KPMG survey](#) of 200 M&A practitioners found that 59% of corporate investors have had deals canceled due to ESG due diligence findings. 63% also noted their willingness to pay a premium for companies that align with their ESG priorities.

LPs have different interests and priorities around ESG, making it important to account for each request when communicating [investor expectations](#) around reporting and initiatives in the business case. Firms should be prepared to clearly communicate how sustainability considerations factor into operations and investment strategy and demonstrate how initiatives create value for the portfolio. Having a comprehensive and easily accessible ESG policy will help establish the firm’s reputation as a responsible investor and signal its priorities to both sustainability-minded investors and acquisition targets.

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Source: Bain

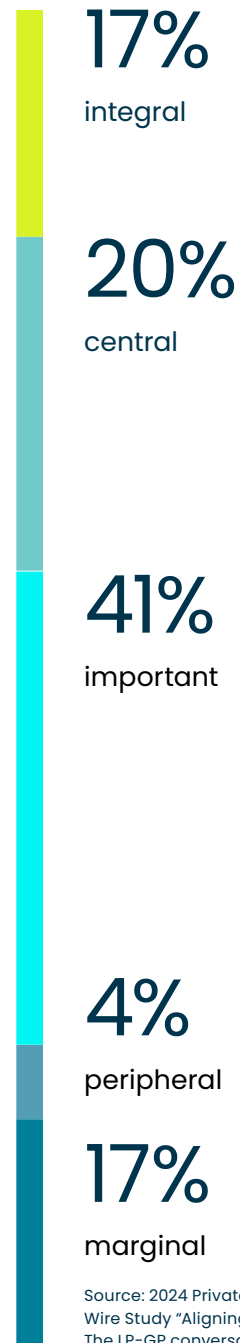
04 Outline Resourcing and Budget Needs

When laying out the case for ESG integration, identifying potential challenges and solutions, the resources to address them, and budgetary needs will help ensure teams have the necessary tools to roll out a plan across the firm.

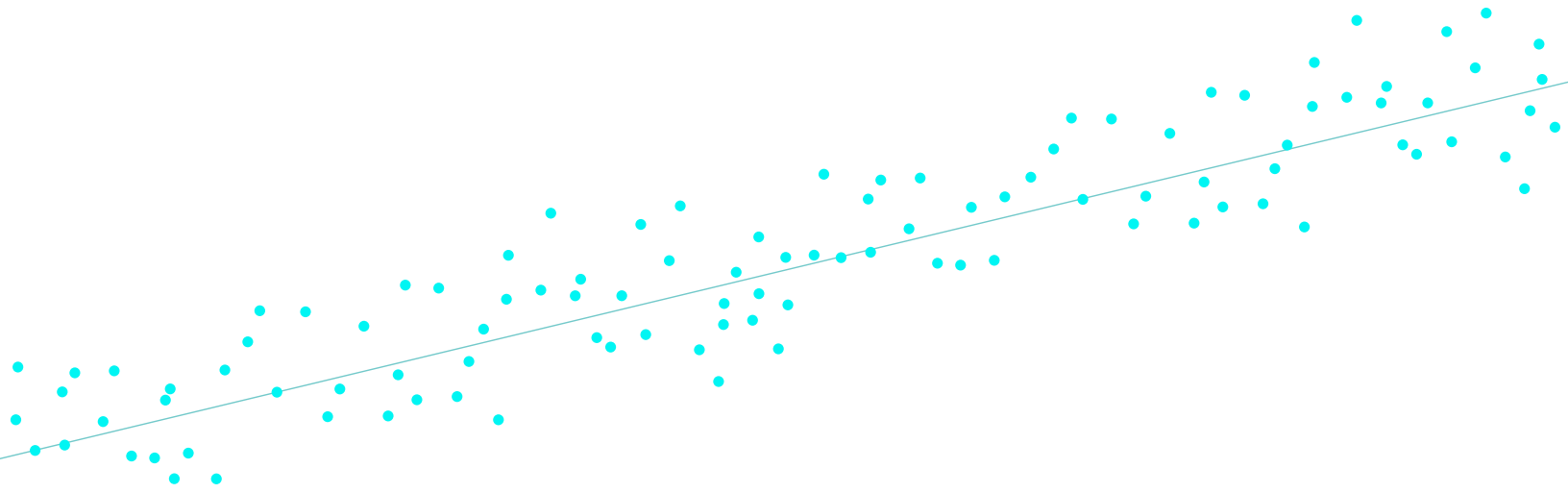
The evolving nature of the ESG landscape is requiring [firms to lean on expertise](#) to track performance and navigate regulatory requirements. As the focus on sustainability grows, private market participants [anticipate a rise in demand](#) for talent in specialized areas, such as climate and carbon accounting, as well as further integration of ESG-related skills and capabilities as core competencies across private equity firms. Given this, firms have an opportunity to gain a competitive advantage by providing education and training opportunities to upskill investment teams and portfolio company management teams to track performance and deliver on [sustainability value creation](#). This also demonstrates to LPs, current and prospective talent, and other stakeholders that the firm is committed to performing well on ESG concerns.

In addition to expertise, whether in-house or external, technology solutions are playing an important role in helping to optimize processes in a scalable way. A [2024 Private Equity Wire survey](#) found that data opacity and scarcity is a top pain point for LPs when it comes to ESG data from GPs. Additionally, a majority of LPs (78%) rated a GP's use of technology for ESG data collection and management as important, central, or integral.

Respondents were asked "How important is a GP's use of technology for ESG data collection and management?"



Source: 2024 Private Equity Wire Study "Aligning on values: The LP-GP conversation on ESG"



Firms that already collect ESG data without a dedicated tool usually have at least one person responsible for collecting the data on spreadsheets and engaging with portfolio companies. However, as LP and regulatory requests get more sophisticated and complex, investing in a scalable solution can help simplify processes and free up internal expertise to focus on creating value and delivering impact.

An intuitive technology solution can help streamline the implementation process and save time by making it easy to collect data from portfolio companies and report on performance. An ESG data management platform also provides insights to help firms benchmark performance across the portfolio and identify ways to improve company performance and value.

An ESG Data Solution for Private Markets

Investing in a technology platform can help firms simplify reporting processes, regardless of where they are in their ESG journey. For investors, Novata is a trusted sustainability management partner, providing an ESG data management platform and advisory practice to empower private markets to confidently align business decisions to sustainability goals. Novata provides:

- A clear starting point for GPs to confidently choose what to measure and track
- A painless data collection process with in-platform guidance and support for portfolio companies
- Insightful reporting and analytics to track and manage ESG data across the portfolio
- Expertise to help navigate due diligence, strategy development, carbon reporting, and regulations

[Learn more about how Novata supports investors.](#)

Preparing Your Business Case

In today's landscape, an ESG focus can be a competitive advantage for both the firm and the financial value of portfolio companies. Getting started with ESG is now imperative for investors seeking to increase their returns. The ESG landscape continues to change rapidly, and the pressure is rising from LPs, regulators, and other stakeholders.

Successfully making the case for ESG integration involves identifying and addressing the concerns

of key stakeholders, illustrating the value to the firm, conveying the urgency of mitigating regulatory risks, and demonstrating the financial benefits to the firm and portfolio companies. The checklist below provides questions to answer as a starting point for framing the conversation around ESG integration within the context of the firm's priorities. With this buy-in, ESG professionals can create a robust strategy that outlines key focus areas, a portfolio company engagement plan, and reporting strategy.

A GP's Checklist for Building the Business Case for ESG

While building the business case for ESG integration, answering the questions below can help ensure you have the information you need to craft a compelling case.

01 Demonstrate Financial Value

- ✓ How can we incorporate ESG considerations into our due diligence process?

- ✓ What industry-specific challenges are our portfolio companies facing?

- ✓ What risks are we overlooking that may impact performance?

- ✓ What material ESG risks impact the potential financial performance and valuation of companies in our portfolio?

- ✓ What ESG initiatives can we implement in the short term to increase company valuation and drive higher profitability in the future?

- ✓ What existing investment initiatives generate positive environmental or social externalities that we can highlight to our LPs and other stakeholders?

02 Highlight Regulatory Risks

- ✓ How do global regulatory changes impact our firm?

- ✓ What regulatory requirements are relevant to our LPs?

- ✓ What data can we collect today to prepare to comply with regulations?

- ✓ Do our portfolio companies face any regulatory changes that impact disclosures?

A GP's Checklist for Building
the Business Case for ESG
Continued

03 Communicate
Investor
Priorities

- ✓ How many ESG questionnaires are we receiving from investors?
- ✓ What are the main topics our investors care about?
- ✓ What internal ESG policies do we currently have in place and how do they help mitigate risks?
- ✓ What DEI initiatives do we have in place across our firm?
- ✓ What ESG and DEI policies do we require our portfolio companies to put in place?
- ✓ What DEI commitments have we made to our investors?

04 Outline
Resourcing
Needs

- ✓ Is there an executive sponsor for ESG and DEI initiatives within our firm?
- ✓ What is the internal budget for ESG compliance and initiatives?
- ✓ What training do we need to provide for investment teams, investor relations, compliance, leadership, and employees more generally?
- ✓ How are we currently tracking ESG data? Who is tasked with collecting this data from portfolio companies?



[Novata](#) is an ESG data management platform and advisory practice that empowers businesses to achieve their sustainability goals. We make it easy for private markets to navigate the evolving ESG landscape; collect, analyze, and report on the metrics that matter; and connect their sustainability strategy to meaningful outcomes—because it’s good for business and it’s good for the planet.

Our industry-leading technology offers flexible tools to meet increasing market and regulatory demands, while our advisory services provide expert support for strategy, performance management, carbon accounting, reporting, risk resilience, and regulatory readiness.

Backed by the Ford Foundation, Hamilton Lane, Microsoft, Motive Partners, Omidyar Network, and S&P Global, Novata is majority controlled by mission-driven organizations and its employees, and is a B-Corp-certified public benefit corporation.

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