Private equity: The rise of ESG considerations

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Essential ESG considerations for private equity firms

While ethical investment and the consideration of environmental, social and governance (ESG) factors hardly represent new concepts in private equity investment, the weight that such ESG considerations are given in the investment decisions and portfolio management strategies of private equity firms has undoubtedly increased.

This mainstreaming of ESG has been strengthened by the on-going COVID-19 pandemic, regulatory changes and amid growing evidence that ESG balanced portfolio demonstrate resiliency, improve returns and generally limit risk. As a result, private equity firms are increasingly eager to promote their view of ESG criteria as not only an essential component of investment due diligence, but as an opportunity for value creation as well.

ESG & investment decision-making

Through a private equity investment lens, ESG is the consideration of environmental, social and governance factors, alongside financial factors, in the investment decision-making due diligence process, and typically includes a number of considerations. A few of these key considerations include:

- ***Environmental:*** What kind of impact does a company, often the target, have on the environment? Does the company's operations create environmental regulatory risks? What efforts, if any, has it taken to limit its carbon footprint or reduce emissions? How does it, if at all, responsibly source materials?
- ***Social:*** How does the company improve its social impact, both within the business and in the broader community? What are its policies and procedures around diversity and inclusion, workplace treatment and corruption? Do those policies align with current market practices and applicable laws?
- ***Governance:*** What corporate governance issues exist for the company? How does the company's board and management drive policies and practices around competitive behaviour, procurement and fair trade? What are its policies and procedures with respect to transparency and independence, responsible hiring, and conflicts of interest and do those policies and practices align with governance best practices and applicable laws?

While considering these ESG factors in the investment-making decision process, the financial materiality of one factor relative to another will vary by industry and company. Environmental considerations may skew more heavily in the investment decision-making process for a business that operates a mine than it would for investment in a national clothing retailer, which may place more emphasis on human rights risks associated with its international supply chain

Key ESG considerations for private equity decision making

- ***ESG due diligence*** : In the context of due diligence, the same lens that private equity firms apply to financial, tax and commercial considerations is now being attached to ESG criteria when considering whether to invest in a company. Likewise, many institutional investors are including ESG-related requests as part of their due diligence of fund sponsors. Essential ESG due diligence from a legal perspective often includes a review of a target's compliance with business ethics, bribery and corruption laws, compliance with human rights legislation and international treaties, compliance in respect of occupational health and safety, supply chain and waste management laws, and inspection of environmental practices for alignment with environmental licenses, permits and legislation.

  Moreover, multiple third-party scorecards and indices, which often measure, monitor and quantify companies based on their annual reports, corporate sustainability measures and board structure, among other things, are being leveraged by private equity to discern a company's ESG rating as part of the overall due diligence process. Notably, a low ESG rating may not necessarily be a roadblock to a potential acquisition, but an area for improvement, risk mitigation and in some cases, an opportunity for value creation. Investors may look to capitalize on a company's underdeveloped ESG standing rather than view it as a reason not to make an acquisition.

- ***Regulatory shifts*** : Apart from growing consumer and investor consciousness over ESG issues, the steadfast rise of ESG can partially be attributed to ongoing regulatory developments globally, including within Canada. Such regulatory developments have already begun to take shape in Europe with the introduction of the European Union's Sustainable Finance Disclosure Regulation (SFDR) in March 2021. The European Union's SFDR imposes sustainability disclosure obligations on financial market participants and financial advisors with respect to financial products. In a similar vein, international standards around ESG are also developing, including the United Nations "Principles for Responsible Investment" (PRI), to which over 180 investment manager and asset owner are signatories in Canada alone.

  On the domestic front, while Canada has yet to introduce its own pure ESG regulation, amendments to the *Canada Business Corporations Act* (CBCA) in 2019 instituted new diversity disclosure rules for certain corporations and codified the common law principle that a corporation's board of directors may consider the impact of corporate decisions on broader stakeholder groups, including the environment. Recently, Bill S-216, *An Act to enact the Modern Slavery Act and to amend the Customs Tariff*, was introduced to the Senate of Canada for its first reading. It passed second reading and was referred to Committee on March 30, 2021. If passed, Bill S-216 will enact Canada's first modern slavery disclosure legislation, which would impose supply-chain reporting requirements with respect to forced or child labor on certain companies listed on Canadian stock exchanges.

As additional regulations tied to ESG are introduced in the future, there will be a corresponding impact on the investment decisions and portfolio management strategies of private equity firms. Put simply, it will be increasingly important for private equity firms to continually monitor compliance with ESG aspects of various regulatory regimes as they relate to their portfolio companies and account for compliance with those regulatory regimes within their investment decision-making processes.

While some observers may be inclined to dismiss ESG considerations as simply the latest hot market trend in business and private equity in particular, that view fails to account for a noticeable shift in societal climate partially brought on by the COVID-19 pandemic, and more importantly the fact that a thoughtful consideration and management of ESG factors by private equity has considerable potential to assist in achieving two key goals of any business: driving value and limiting risk.

A consideration of ESG factors by private equity is a critical component in limiting operational, reputational and legal risk in the investment decision-making process and in strategic management of portfolio companies. There is plenty of market data to suggest that businesses that incorporate ESG considerations within their governance and operational frameworks often demonstrate a degree of increased resilience and in some cases superior value return.

By

Jennifer Archer, Sunny Garcha

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BLG Offices

Calgary

Centennial Place, East Tower
520 3rd Avenue S.W.
Calgary, AB, Canada
T2P 0R3

T 403.232.9500
F 403.266.1395

Ottawa

World Exchange Plaza
100 Queen Street
Ottawa, ON, Canada
K1P 1J9

T 613.237.5160
F 613.230.8842

Vancouver

1200 Waterfront Centre
200 Burrard Street
Vancouver, BC, Canada
V7X 1T2

T 604.687.5744
F 604.687.1415

Montréal

1000 De La Gauchetière Street West
Suite 900
Montréal, QC, Canada
H3B 5H4

T 514.954.2555
F 514.879.9015

Toronto

Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada
M5H 4E3

T 416.367.6000
F 416.367.6749