Private Funds CFO

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How PE fund administrators can facilitate ESG

Limited partners are increasingly asking GPs for ESG information; fund administrators, in the absence of global reporting standards, are positioned as an enabler to help fund managers move the needle on sustainability, Robert Caporale of Gen II Fund Services writes.

When it comes to reporting, the private equity industry has been challenged at times by the lack of uniform guidance. This was true 20 years ago, when the valuation debate kicked off in earnest and eventually resulted in a new fair-value accounting standard, Topic 820 (FKA: FAS 157). The next front in the disclosure wars is coming into focus as LPs press fund managers to not only adopt environmental, social and governance policies, but also provide regular and comprehensive sustainability reporting to show traction against new non-financial goals.

To be sure, the pressure is coming from all sides. PwC conducted a survey in which more than half of LPs (56 percent) said they turned down fund investments on ESG grounds. Meanwhile, GPs today better appreciate the headline risk in a politically charged environment in which their peers are continually under fire for investments that might have overlooked certain social risks. ESG has moved from a check-the-box exercise to a far more strategic undertaking to show how GPs can create value and mitigate risk through sustainability practices.

But it's one thing for GPs to say they are committed to ESG principles; it's a whole other thing to measure how sustainability risks are integrated in their investment decisions as well as assessing and disclosing what could be the likely impact of such risks on the returns of a given fund (see Article 6 of Regulation (EU) 2019/2088 of 27 November 2019 on sustainability-related disclosures in the financial services sector).

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An added challenge – one that isn't insignificant – is that fund managers in PE still don't have a universal framework to follow to report on non-financial KPIs at either the fund- or portfolio-company levels. This can make the idea of ESG reporting seem overwhelming for back-offices already under-staffed and under-resourced.

An often-overlooked starting point to collecting ESG data can be found among third-party fund administrators – those who have the relationships, data, technology and experience to assist a GP in formulating and actioning their ESG strategy.

New demands; same challenges

The same factors that made fair-value reporting so challenging 20 years ago also stand in the way of ESG reporting. Recall that at one point, there were as many as seven different PE-trade groups and accounting organizations all proposing their own unique standards to assess fair-value. Today, there is no shortage of proposed frameworks through which to measure and report on ESG metrics and LPs aren't exactly forthcoming with explicit guidance.

While there has been limited collaboration among the framework organizations and even some consolidation among these groups (IIRC and SASB, for instance), settling on a specific reporting framework, to practitioners, is akin to pulling a name out of a hat. In fact, the Institutional Limited Partners Association threw its hat in the ring when it unveiled its own framework in the last week of July. Moreover, in the same way fair value is both an art and a science, determining materiality in ESG reporting – across a diversified portfolio of companies – often imposes an uncomfortable level of subjectivity on a profession oriented toward deep conviction.

Scale drives consensus

Even though it's the limited partners pushing for ESG reporting, ironically, it's the GPs themselves who are raising the reporting bar. In the process, they're creating higher expectations for transparency among even the less vocal LPs.

Preqin, for instance, documented clear correlations between the very largest fund managers in PE and the level of transparency provided. The difference in transparency scores between the very largest fund managers based on AUM and the very smallest was even more acute at the asset level (versus fund-level disclosures).

This shouldn't be a surprise, as the largest firms with a sophisticated IR team already in place have committed the time and resources to create a dedicated sustainability function. They're not merely trying to meet LP expectations; to leverage these investments, they're creating a differentiated capability, knowing full well that capital is gravitating to GPs offering the most transparency. The ILPA even noted that the organization used large- and mid-cap managers as a reference point in architecting their own alternative framework.

The largest mid-market firms, however, are not that far behind. Fund administrators serving all client sizes have a bird's eye view to help mid-sized and emerging managers provide the same level of transparency as the very largest PE fund managers

The journey begins with data

For fund managers beginning this journey, data collection often represents the biggest challenge. It's not just about what data firms should be collecting or the preferred framework to follow, but also how to go about collecting it.

The specific data requirements will differ across the various ESG frameworks and, at the asset level, by what's material for each portfolio company. But as the larger bellwether firms stand up and refine their ESG reporting capabilities, LPs are also coalescing around certain ESG metrics. Fund administrators, positioned at the nexus of GP/LP reporting processes, can help to systematize the new information demands through their ESG data collection tools.

GPs, in turn, gain a benchmarking tool that allows them to track non-financial performance over time and potentially against their peers, while progress can be measured even as new companies enter the portfolio and as mature assets exit.

Technology facilitates standardization

Technology will play a key role in democratizing ESG reporting. Currently, some of the largest firms have thrown money and resources at the problem and have developed sophisticated ESG reporting systems over a fairly short period of time. But the same way fund administrators have leveraged economies of scale to invest in and develop cutting edge fund-accounting technology, performance systems and analytics engines, the same efforts are now being dedicated to ESG solutions that will soon level the playing field.

Already, capabilities are in place among the first movers that can streamline or automate data collection, workflow management, aggregation and reporting. In the future, ESG metrics will be integrated with performance and attribution data. The upshot for managers – and a distinct advantage fund administrators have over traditional fintech vendors – is that GPs will be able to measure the extent to which ESG efforts augment value creation and support returns.

Equally important, though, is that software by its nature will help instill guardrails that engender consistency across funds and across firms – no easy task given the principles-based approach that guides ESG disclosures today.

Regulators: mounting up

ESG has been on the radar of fund managers for some time. However, regulatory attention is adding renewed urgency. The SEC, in April, initiated a "review of ESG investing," but in Europe, the Sustainable Finance Disclosure Regulation already went into effect in March. For managers domiciled in Luxembourg or other EU jurisdictions subjected to AIFMD, UCITS or MiFID regulations, this new regime effectively imposes transparency and disclosure requirements on both managers and funds; establishes a taxonomy through which to determine sustainability criteria; creates climate-related benchmarks; and mandates that sustainability factors are incorporated into core governance processes.

The ESG string, at this point, can't be pushed back. GPs, if they haven't already, should get their arms around how they can begin to tackle ESG demands, even without clear direction from their LPs or policymakers. In this vacuum, fund administrators will likely emerge as a facilitator of industry standards. Certain factors must be in place, but those fund administrators that have the requisite people, process and technology will be in a unique position to bring clarity to an area that has traditionally been open to so many different interpretations.

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