ESG as an asset: Private equity considerations from the SEC's climate proposal

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Investment in environmental, social and governance (ESG) factors is a top priority for private equity, and it has been for quite some time. Thanks to the increasing belief that strong ESG scores command a higher premium,[1] ESG has rapidly transformed from a nice-to-have differentiator into an integral component of each stage of the investment life cycle, from the growing mandate for investment in ESG to asset owners' calls for general partners (GPs) to apply an ESG lens to all potential investments. This change has also shifted the lens through which new investment strategies are underwritten. In fact, 72% of large private equity firms with annual revenues of $50 million to $1 billion have incorporated ESG strategies into their portfolio of asset classes.[2]

Investor demand has played a key role in this transformation, along with efforts from agencies such as the U.S. Securities and Exchange Commission (SEC) to enhance accountability and engender trust. In the first half of 2022, the SEC released its landmark proposal for climate risk disclosure: a proposal that, if enacted, would elevate the timeliness and rigor of ESG reporting to that of financial reporting. While written with U.S. public issuers at the forefront, the proposal has powerful implications for private equity firms, and it is time to prepare.

A birds'-eye view of the SEC proposal

Through the Enhancement and Standardization of Climate-Related Disclosures for Investors proposal,[3] the SEC is seeking greater specificity, comparability and reliability of public companies' climate-related data for the benefit of investors, with an upside for other stakeholders such as policymakers. At a high level, the proposed rule would require:

- Disclosure of the financial impact of climate-related events and activities on consolidated financial statements if the aggregate impacts are 1% or more of a line item in the financial statements, plus related costs or expenditures if the aggregate impact exceeds a 1% threshold.
- Disclosure in the Form 10-K of Scope 1 and Scope 2 greenhouse gas (GHG) emissions — subject to reasonable assurance down the road — as well as disclosure of Scope 3 emissions if they are material or included in emissions targets or goals.

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[1] KPMG U.S., *ESG Considerations for Private Equity,* 2022, https://www.kpmg.us/content/dam/global/pdfs/2022/private-equity-considerations-brochure.pdf.
[2] Humzah Yazdani, "The Bright Spots in a Complicated ESG Framework," *World Economic Forum*, July 25, 2022, https://www.weforum.org/agenda/2022/07/still-reason-for-optimism-about-esg-investing/.
[3] U.S. Securities and Exchange Commission, "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors," March 21, 2022, https://www.sec.gov/news/press-release/2022-46.

- Disclosure in the Form 10-K of governance and risk management factors; physical and transition risks; targets or goals of any transition plan; scenario analyses, if used; carbon offsets or renewable energy certificates, if used; and internal carbon pricing, if used.[4]

Note that additional proposals from the SEC, specifically the Enhanced Disclosure Rule and the Names Rule, zero in on public investment companies to provide enhanced clarity.[5]

Implications for private equity

On the surface, the SEC's climate proposal applies to U.S. public registrants, so it is understandable to overlook its potential implications for private equity firms, many of which operate within the private markets. However, we see applicability of the SEC's proposal through three angles:

1. Publicly traded private equity firms: Private equity firms that are listed on U.S. stock exchanges would need to adhere to all the reporting requirements, tracking, monitoring and reporting the climate-related risks, emissions and governance structures for themselves and their portfolio companies.
2. Portfolio company IPOs: Taking portfolio companies public is a common exit strategy. In pursuing this option, private companies that may not otherwise be subject to the proposed SEC regulations would need to include this information in the IPO registration statement.[6] Similarly, certain publicly traded companies may decide they are not up to the task of rigorous ESG reporting and therefore may consider take-private opportunities, thus entering the purview of private equity investment.
3. Intersection of public and private market demands: Even for private equity firms that operate entirely within the private markets, the SEC's proposal has the potential to raise expectations for high-quality, high-volume and highly comparable ESG data. This could pressure private equity funds to disclose more information to their limited partners (LPs), targets and the market more broadly.

Preparing for the ESG future

Since demand for ESG data is not going away any time soon, regardless of what is required by the final climate disclosure rule, it is in the best interest of GPs to take a few "no regrets" steps. The specifics of those steps will depend on a number of factors — including industry, maturity of ESG reporting, ownership and degree of influence and proximity to public markets — but there are several considerations that all private equity firms should keep in mind:

- Understand how ESG factors are assessed at all stages of the investment life cycle: As new regulation comes into view, it will be important for private equity firms to stay abreast of ESG risks, opportunities and data at all stages of investment, from pre-deal evaluation to holding to exit. According to KPMG UK research findings, private equity funds are increasingly addressing ESG factors earlier in the investment life cycle, with 34% of GPs evaluating ESG at the start of deal evaluation, 37% during the due diligence process, 7% at the start of investment and 9% during normal business operations.[7] Although these commitments are made to investors, the rigor to ensure consistent execution is often not in place.
- Prepare for high-quality, high-volume ESG data: Recognizing the intensity of data collection that both stakeholders and the proposed SEC regulations require, private equity firms are bolstering their technology platforms to improve their ability to capture, manage, analyze and report on ESG data at

[4] KPMG U.S., *SEC Proposes Climate Reporting and Assurance Rules*, March 2022, https://frv.kpmg.us/reference-library/2022/sec-proposes-climate-reporting-requirements.html.
[5] KPMG U.S., *SEC Investment Management Proposals Focus on ESG*, May 2022, https://frv.kpmg.us/reference-library/2022/sec-investment-management-proposals-focus-on-esg.html.
[6] U.S. Securities and Exchange Commission, "SEC Proposes Rules."
[7] KPMG U.S., *ESG Considerations for Private Equity*, 4.

scale. In working with private equity clients, KPMG has seen a desire by firms to develop and implement third-party software solutions including customized applications specific to clients' ESG data needs.

- Understand current commitments, methodologies and processes for measurement: Fund managers should review their disclosures relative to existing measurement, monitoring and reporting processes to evaluate shortcomings and understand the rigor and disclosure that would be needed to adhere to proposed rules.
- Develop an industry-based approach: For private equity firms that invest across several industry verticals, there is no one-size-fits-all approach to ESG engagement and reporting.[8] As firms begin to take a close look at the ESG risks, opportunities and data within their portfolios, it will be important to develop a bespoke approach for each industry and dedicate the necessary staff and resources to meet the monitoring, management and reporting demanded by stakeholders.
- Consider supply chain implications: Public companies seeking to meet climate goals, such as achieving net-zero emissions, are increasingly pushing their suppliers to provide more emissions data and reduce their carbon footprints, or else risk losing their business.[9] Private equity firms — and their portfolio companies — that operate within a public company's value chain should prepare for this new dynamic and the potential risks it presents to their revenue streams.
- Fully assess the GHG emissions inventory: It is important for private equity firms to have a complete understanding of their current GHG emissions inventory in order to evaluate potential risks and opportunities for the business and understand the implications of emissions reduction commitments for their business.
- Engage a cross-functional steering committee: Private equity firms should consider developing a cross-functional committee to review climate-related risks, opportunities and regulations to determine which factors are most relevant for the business. Following this analysis, they can assemble a cross-functional task force to implement reporting revisions.

Conclusion

On the surface, ESG reporting may look like an exercise in compliance and risk identification, but in today's environment, it is also an opportunity for value creation. This is an area where GPs and LPs are closely aligned.[10] In the private equity sector, ESG value creation can manifest at all stages of the investment life cycle, from identifying investments in decarbonization solutions to commanding a higher premium for enhanced employee satisfaction upon exit. Reliable data to prove this value creation will engender further trust among LPs and talent. While the SEC's proposal is heavily focused on the environmental component of ESG, the social and governance components cannot be overlooked. The private equity industry is making a concerted effort to reduce gender and racial inequality across its investments, and regulation surrounding diversity, equity and inclusion (DEI) reporting may be just around the corner. The market is craving greater specificity and transparency in private equity holdings, and as the regulatory environment continues to take shape, ESG reporting is poised to play a leading role.

[8] KPMG U.S., *Private Equity's ESG Sea Change,* May 2022, https://www.kpmg.us/industries/private-equity/esg-sea-change.html.
[9] Kristin Broughton and Mark Maurer, "Companies Push Suppliers to Disclose More Climate Data," *The Wall Street Journal,* November 17, 2021, https://www.wsj.com/articles/companies-push-suppliers-to-disclose-more-climate-data-11637145001.
[10] KPMG U.S., *An Opportunity for ESG Collaboration,* November 2021, https://advisory.kpmg.us/articles/2021/opportunity-for-esg-collaboration.html.

Authors

Tania Carnegie
Advisory Principal, Global Private Equity and Asset Management ESG Leader
KPMG U.S.
917-941-2338
taniacarnegie@kpmg.com

Elizabeth Ming
Audit Partner, Asset Management and ESG
KPMG U.S.
214-679-8368
eming@kpmg.com

Jeffrey Rojek
Client Global Lead Partner – Private Equity
KPMG U.S.
862-206-9473
jrojek@kpmg.com