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Delivering on the value creation potential of sustainability

Key priorities for Private Equity – *Nordic lens*

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INTRODUCTION

Value creation as the top driver for sustainability in Private Equity

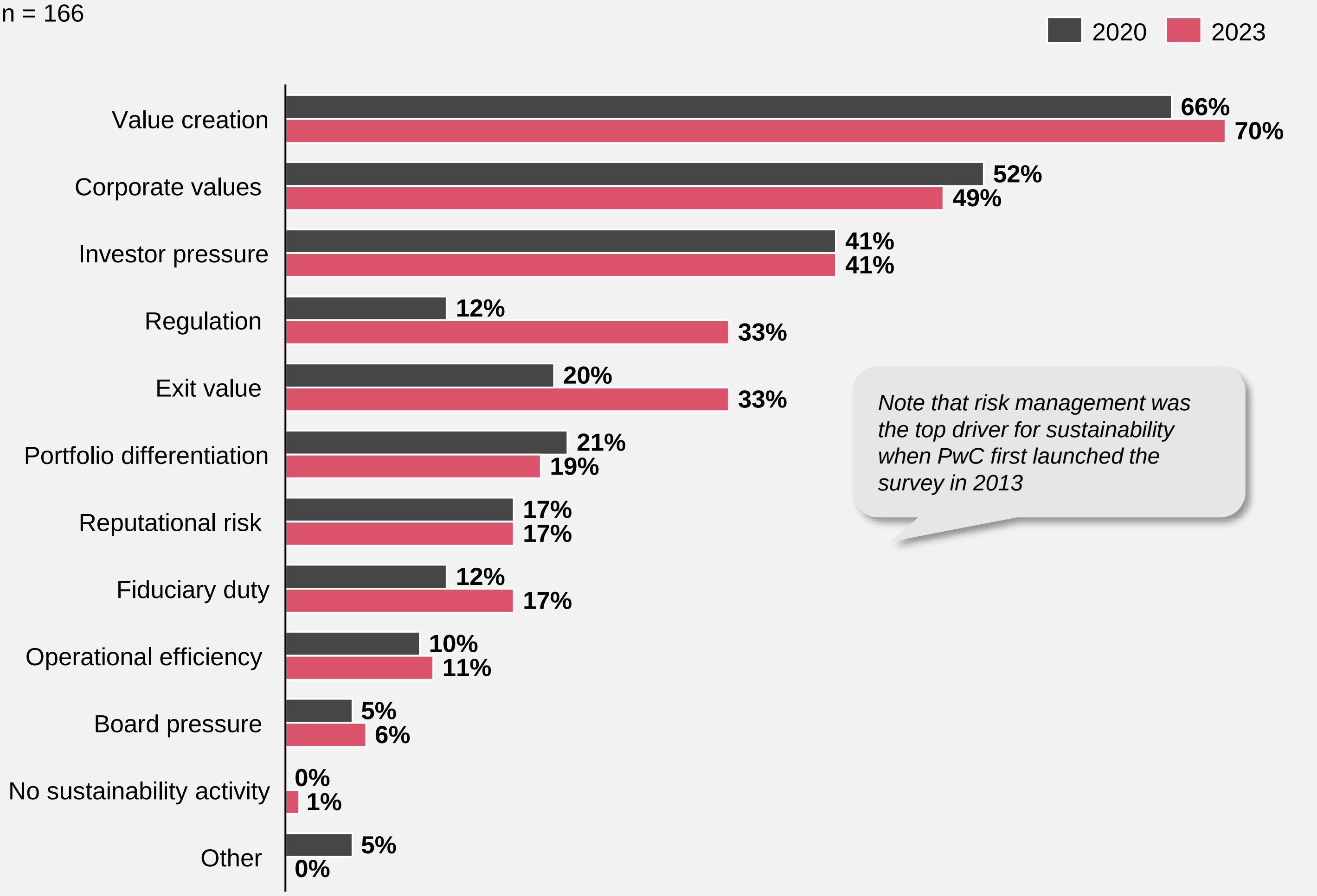
Sustainability has risen on the agenda of Private Equity firms, from compliance and risk management to the core of value creation. While investors have been working to integrate Environmental, Social and Governance (ESG) factors into investment processes for several years, value creation is now the top driver for sustainability in Private Equity. Our survey, covering more than 150 PE firms globally, reveals that 70% place value creation as a top driver for sustainability, marking a significant increase from previous surveys.

In this article we discuss key priorities for Private Equity funds in the Nordics in delivering on the value creation potential of sustainability. In particular, we explore **how sustainability can be defined**, **incorporated into investment processes**, and **measured with the latest regulations**.

Our insights are shaped by our project experience and dialogues with over 20 Nordic Private Equity firms throughout 2023, many of which are recognized as global sustainability leaders.

EXHIBIT 1
Top drivers for sustainability activity in private equity

Share of respondents ranking each driver among the top three for their firm/fund
n = 166



Source: PwC Global Private Equity Responsible Investment Survey 2023

Defining what is and what is not “sustainable” in an evolving regulatory environment

Despite the growing focus on sustainability in Private Equity, the definition of what is “sustainable” remains open to interpretation. While PE firms look to regulations such as the Sustainable Finance Disclosure Regulation (SFDR) and the EU Taxonomy to enhance transparency and avoid potential “greenwashing”, the regulatory environment is still evolving in scope and coverage. The SFDR and the EU Taxonomy provide PEs with an overarching framework to classify funds and investments as “sustainable”.

As of today, the EU Taxonomy takes an environmental perspective, whereas the SFDR introduces a broader approach allowing companies to define their own frameworks for evaluating and qualifying investments for their sustainability linked funds. In addition to defining criteria to ensure that an investment “does no significant harm” and follows good governance practices, we see leading PE firms describing relevant environmental or social objectives and defining thresholds for qualification. For instance, they consider the percentage of revenue aligned with the EU Taxonomy or contributing to the United Nations Sustainable Development Goals (SDGs), as well as outline how impact will be accelerated during the ownership period.

> *To match the available universe of targets, current scope of the regulation and our sustainable investments commitments, we have developed our own framework to complement the regulatory guidance and communicate with our stakeholders*
>
> \- **Nordic PE fund**

Incorporating sustainability into the investment cycle

Sustainability considerations are increasingly integrated into all stages of the investment cycle, from sourcing to active ownership and exit. We observe leading Nordic Private Equity firms aligning their investment strategy with sustainable objectives, as well as screening potential investments on pre-defined sustainability criteria. Moreover, the sustainability or ESG due diligence (ESG DD) is becoming a key component of the investment process.

Almost 60% of the surveyed PE firms reported that they performed ESG DDs on all targets evaluated over the past year. In fact, more than half of the surveyed PE firms chose not to pursue a deal and almost 40% reported having amended the share purchase agreement in the previous year because of sustainability factors. See our deep dive on the next page on the evolving scope of the ESG DD.

During the ownership period, the PE funds work actively to incorporate sustainability into the business strategies and daily operations of portfolio companies. The priorities will be driven by the outcomes of the materiality assessment, as well as the PE firm’s investment strategy. We often see the importance of understanding the impact of different products and services and optimize the supply chain for profitable growth in line with emission reduction commitments.

To prepare for a potential exit, leading Private Equity firms focus on positioning their investments as attractive to SFDR article 8 and 9 funds, as well as highlight further sustainability-related value creation opportunities for potential new owners.

Source: PwC Global Private Equity Responsible Investment Survey 2023

Getting the most out of the ESG Due Diligence

While ESG Due Diligences are increasingly becoming the norm, we observe large variations in the due diligence scope and focus, ranging from simple check lists to thorough assessments. Leading PE firms typically use the ESG DD to understand both current sustainable contribution and ability to fully leverage the sustainability potential of the target, tailoring the due diligence based on investment strategy and key characteristics of the target, such as industry, value chain positioning and risk profile.

Based on delivering 100+ ESG due diligence assignments over the past two years in the Nordics, PwC and Strategy&'s methodology includes an evaluation of the target's maturity on material topics, assessment of climate risk exposure, analysis of sustainability positioning relative to peers, and the development of a transformational roadmap. The roadmap typically includes identification of sustainability-related value creation levers, evaluation of impact on business case and investment needed to fully leverage the target's sustainability potential. In this way, the ESG DD is brought closer to typical Commercial and Operational due diligence topics. The DD can also be linked to the PE firm's overarching sustainability framework, assisting in evaluating sustainable contribution or tailoring the growth plan towards reaching defined sustainability thresholds.

EXHIBIT 2

ESG Due Diligence scope – Can be conducted as a stand-alone exercise, or integrated with commercial due diligence

3-step approach combining materiality and maturity assessment, competitive positioning, and roadmap

	1 Materiality and maturity analysis	2 ESG competitive positioning	3 Transformation roadmap
Key activities	1. Identification of sector-relevant ESG topics 2. Climate risk assessment (physical and transitionary); product carbon footprint 3. Assess maturity of ESG management	1. Peer comparison and voice of customer 2. Best in class positioning 3. Positioning to address market trends and external drivers	1. Investor sustainability commitment alignment 2. Sustainability-related value creation levers, options and quantification including Net Zero pathways 3. Roadmap/integration in FPP with resource planning
Output	Material topics analysed based on target's value chain position & internal operations set up, impact and financial perspective (double materiality) and the maturity of ESG management of the topics to establish the baseline incl. product level LCA carbon footprint	Direction from a competitive landscape and regulatory & stakeholder (including voice of customer) requirements perspective by assessing the gap between best in class peers and providing recommendations on closing those gaps	Assessment of key sustainability value creation levers, quantification of their impact on the underlying business case and investments needed to fully leverage the sustainability potential of target including incorporation to full potential plan (FPP)

Source: PwC Global Private Equity Responsible Investment Survey 2023

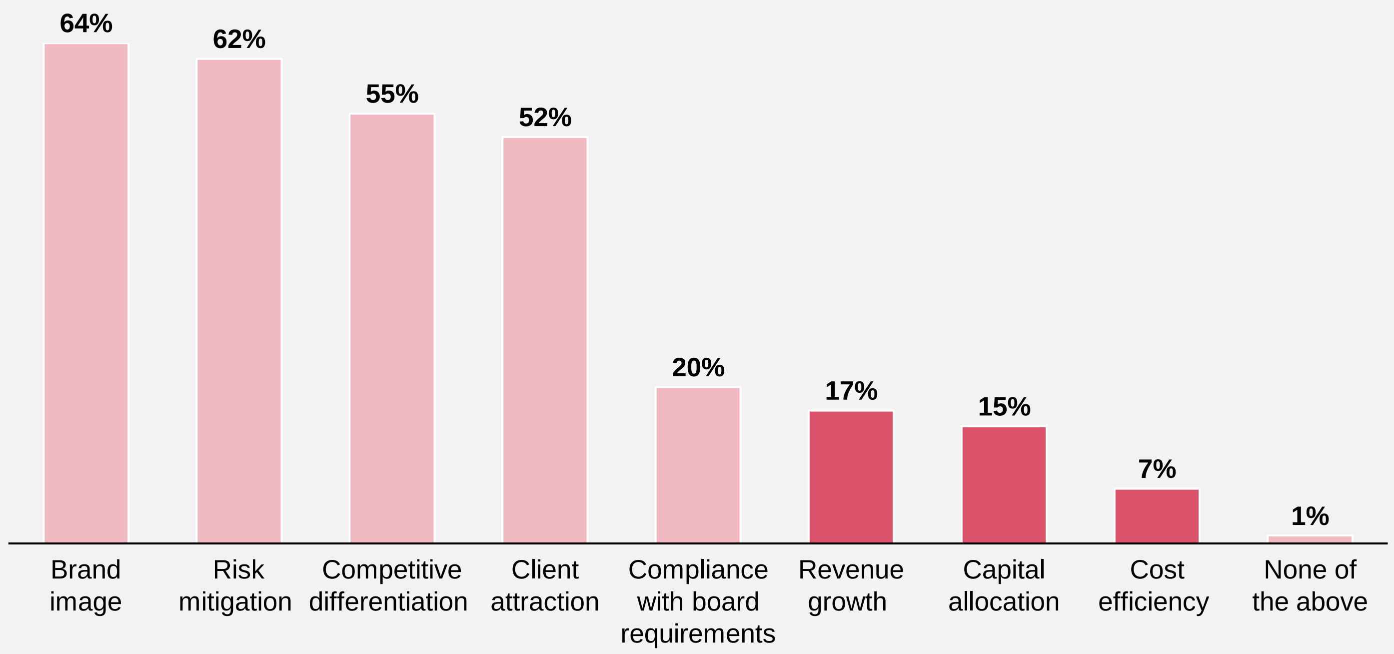
MEASURING IMPACT

Where is the value in sustainability and how can it be measured?

When exploring the value of sustainability, the primary benefits often lie beyond currently readily measurable financial outcomes. Our survey respondents were more likely to mention qualitative gains such as "competitive differentiation" and "brand enhancement" as their top sustainability advantages. These, in turn, tend to correlate with improved financial performance. However, determining the precise financial value derived from sustainability endeavors can be a challenge for Private Equity firms. Surprisingly, less than 20% of respondents point to revenue growth, capital allocation or cost efficiency as their top three sustainability benefits. While PE firms acknowledge the potential positive financial impact of sustainability-related improvements, a scarcity of data often hinders their ability so-far to attribute value creation directly to sustainability efforts.

EXHIBIT 3
Top sustainability benefits for PE firms

Share of respondents ranking each sustainability benefit among the top three for their firm/fund
n = 166



Although quantifying the value of sustainability measures appears challenging, many Private Equity firms have actively engaged in efforts to measure and report the positive impacts of their investments. As an example, Summa Equity applies Impact-Weighted Accounts (IWAs) to calculate the monetized impact its portfolio companies have on employees, environment, and end consumers. We also increasingly see companies reporting on avoided emissions, also referred to as "Scope 4" emissions, which can be explained as reductions occurring outside of a product's life cycle or value chain, but as a result of the use of the product. As the scope of the Corporate Sustainability Reporting Directive (CSRD) expands to cover more companies, it will promote more consistent sustainability reporting and provide companies with tools to better understand and measure their impact.

Source: PwC Global Private Equity Responsible Investment Survey 2023

MEASURING IMPACT: CSRD

Leveraging CSRD beyond compliance to drive sustainable and profitable growth

The Corporate Sustainability Reporting Directive (CSRD) is a legislative framework by the European Union (EU) aimed at harmonizing sustainability reporting and disclosure requirements for corporations. While CSRD implementation is often seen as a regulatory burden, leading Private Equity firms use the CSRD process to analyze the status-quo of sustainability in each portfolio company and its respective industry to identify business-relevant sustainability related opportunities and risks. These will in turn be integrated into corporate strategies and value creation plans.

EXHIBIT 4
The CSRD – from compliance & reporting to direct impact on corporate strategy and business model

CSRD elements…

New material ESG topics
Through double materiality assessment

Value chain perspective
Contribution to sustainability impact of customers (e.g. Scope 3 GHG emissions)

Detailed disclosures
Market wide benchmarks to increase comparability and new decision criteria

Disclosure of EU Taxonomy alignment
Share CapEx, OpEx, and turnover from sustainable activities

…have effect on…

Sustainability strategy
Prioritization areas, resource, initiatives/measures

Customer expectations
Regarding sustainability performance

Investor expectations
Regarding sustainability performance and ESG risk management

… impacting:

Corporate strategy and business model

Is your strategic plan a fitting response to increased sustainability demands?

Non-exhaustive

A key component of CSRD is the climate transition plan, requiring companies to understand and disclose their greenhouse gas emission baseline, as well as a pathway to achieve climate targets aligned with 1.5ºC scenario, the warming trajectory agreed under the Paris Agreement. Companies therefore need to identify emission reduction levers to meet climate commitments while securing profitability and growth.

As more companies fall under the CSRD reporting remit, this will drive also sustainability data harmonization and availability to help assess sustainability context more efficiently.

Delivering on the value creation potential of sustainability

In short, focusing on sustainability is not just about being responsible – It can create value, reduce risks, and open new opportunities for Private Equity firms. As sustainability continues to gain importance in the investment landscape, we see three key priorities for 2024 to turn words into actions:

1. **Develop frameworks to establish and communicate the fund's definition of sustainability, and how to measure and boost the sustainable contribution of current and potential investments during ownership.** This will help funds navigate in an evolving regulatory landscape, enable more transparent communication with investors, as well as provide investment professionals with a clear path to enhancing sustainable contribution and value.

2. **Continue to incorporate sustainability across the investment cycle, focusing in particular on getting the most out of the ESG Due Diligence.** Broadening the ESG DD scope and aligning it with key commercial and financial topics, has the potential to uncover and test key sustainability-related value creation hypotheses, and incorporate these in the Full Potential Plans early on.

3. **Use the current regulatory push to get a better understanding of impact, as well as to align sustainability commitments with ensuring profitable growth and clear exit value at the end of the investment period.** In particular, the CSRD requirement to disclose greenhouse gas emission baseline and net zero pathway, should be leveraged to incorporate climate targets in corporate strategies, prioritizing cost-effective emission reduction levers.

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