State-of-Play: ESG in Private Equity in Belgium

Introduction

Since the presentation of the European Green Deal[1] on 11 December 2019, the European Commission has been putting sustainable finance mechanisms in place to support the transition towards a climate neutral and circular European economy by 2050. Both public and private financing streams are necessary as it is estimated that €175 - €290 billion in additional annual investment is required to meet the EU's 2030 and 2050 sustainability targets.[2]

The EU is implementing the EU Action Plan on Sustainable Finance[3] to steer public and private financing streams towards investments that contribute to these sustainability targets. This includes the adoption of mandatory reporting regulations such as the SFDR, CSRD, and EU Taxonomy.

While the mandatory regulatory body is still in development, Belgian private equity firms are choosing to already integrate Environmental, Social, and Governance (ESG) commitments into their strategy. Some are even going beyond compliance and adopting voluntary ESG reporting frameworks such as the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD), Global Reporting Initiative (GRI), the United Nations' six Principles for Responsible Investment (UN PRI), and Invest Europe's ESG Reporting Guidelines. This adoption of ESG reporting frameworks is stimulated and supported by the Green Deal Industrial Plan, which seeks to accelerate access to financing for the net zero transition in Europe.

KPMG research has identified differences in the level of ESG integration of Belgian private equity firms and we offer insights into how these gaps can be bridged effectively and efficiently.

This KPMG report outlines:

- The current and upcoming regulatory ESG requirements that Belgian private equity must comply with.
- How private equity institutions can turn compliance into long-term value creation.
- To what extent Belgian private equity firms are integrating ESG into their strategies.

1 *European Green Deal (European Commission).*
2 *Financing sustainable growth factsheet (European Commission, 2019).*
3 *Communication from the Commission – Action Plan: Financing Sustainable Growth (European Commission, 2018).*

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Current & Upcoming Regulatory Requirements for Private Equity

The European Green Deal and the newly released Green Deal Industrial Plan are catalyzing rapid regulatory developments in sustainable finance and ESG reporting. Below is an overview of mandatory ESG reporting frameworks, including when and how they apply.

Reporting Framework	Sustainable Finance Disclosure Regulation (SFDR)	EU Taxonomy	Corporate Sustainability Reporting Directive (CSRD)	Corporate Sustainability Due Diligence Directive[4] (CSDDD) (draft proposal)
Purpose	To improve transparency in the market for sustainable investment products, to prevent greenwashing and to increase transparency around sustainability claims made by financial market participants.	A common classification system for what qualifies as an environmentally sustainable investment to direct investments towards EU's sustainability targets and combat greenwashing.	An adaptation to the NFRD to include a larger scope of companies and strengthen its sustainability reporting requirements.	A due diligence framework for identifying and mitigating supply chain risks, complementing the SFDR, EU Taxonomy, and CSRD.
Enforcement Date	10 March 2021	1 January 2021	1 January 2024	Adopted by EU Commission on 23 February 2022. Enforcement date TBD.

Organizations in Scope	• Financial market participants offering investment products in the EU
	• Financial advisors who guide EU consumers
		Companies in scope of SFDR and CSRD	• All large companies meeting 2/3 criteria below:
			  • Companies with 250+ employees
			  • Companies with total balance sheet €20 million+
			  • Companies with turnover €40 million+
			• All small & medium listed companies as per 2026
				• All companies in high impact sectors covered by existing OECD sector guidance
				• Non-EU companies with EU-generated turnover of min. €150 million (group 1) or min. €40 million (group 2)[5]
				• European companies with worldwide turnover of min. €150 million AND 500+ employees (group 1) or 250+ employees (group 2)

4 The Corporate Sustainability Due Diligence Directive (CSDDD) aims to foster sustainable and responsible corporate behavior and to anchor human rights and environmental considerations in companies' operations and corporate governance. The regulation is still a draft proposal adopted by the European Commission only and the scope regarding the financial sector is still to be determined. The expectation is that private equity firms will require due diligence reporting from their portfolio companies to comply with the CSDDD but the final implications are still to be seen.

5 Group 1 companies: all EU limited liability companies of substantial size and economic power (with 500+ employees and EUR 150 million+ in net turnover worldwide). Group 2 companies: Other limited liability companies operating in defined high impact sectors, which do not meet both Group 1 thresholds, but have more than 250 employees and a net turnover of EUR 40 million worldwide and more.

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Reporting Framework	Sustainable Finance Disclosure Regulation (SFDR)	EU Taxonomy	Corporate Sustainability Reporting Directive (CSRD)	Corporate Sustainability Due Diligence Directive[6] (CSDDD) (draft proposal)
Reporting Requirements	**1. Entity-level disclosures** • Policies relating to the integration of sustainability risks in investment decisions • Due diligence policies regarding the Principal Adverse Impact (PAI) of investment decisions • How the remuneration policy is consistent with the integration of sustainability risk **2. Product-level disclosures** • Classify products as Article 6, 8, or 9 • Disclose ESG policy • Describe how sustainability risks are integrated in the investment decisions and impact on returns • Explain whether and how a product considers PAIs • Taxonomy disclosures	**For non-financial undertakings:** • EU Taxonomy eligibility and non-eligibility on proportion of Turnover, CapEx, and OpEx • EU Taxonomy alignment and non-alignment on proportion of Turnover, CapEx, and OpEx • Qualitative disclosures **For financial undertakings:** • Proportion of assets exposed to economic activities that qualify as eligible and non-eligible • Respective Green Asset Ratio (GAR)/ Green Investment Ratio (GIR)	**1. Topic-specific disclosures on Environmental, Social, and Governance matters** **2. Sector-specific disclosures** **3. Information on the:** • business model • KPIs, targets • Double materiality • Due diligence • Risk & opportunity management **4. Overall requirements include:** • Inclusion in the Annual Report • External (limited) assurance as of FY2024	• Integrate due diligence into policies • Identify actual or potential adverse human rights and environmental impacts • Prevent or mitigate potential impacts • Bring an end to, or minimize, actual impacts • Establish and maintain a complaints procedure • Monitor the effectiveness of the due diligence policy and measures • Publicly communicate on due diligence

Table 1: Mandatory Reporting Frameworks

6 *The Corporate Sustainability Due Diligence Directive (CSDDD) aims to foster sustainable and responsible corporate behavior and to anchor human rights and environmental considerations in companies' operations and corporate governance. The regulation is still a draft proposal adopted by the European Commission only and the scope regarding the financial sector is still to be determined. The expectation is that private equity firms will require due diligence reporting from their portfolio companies to comply with the CSDDD but the final implications are still to be seen.*

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Why is it important to integrate ESG?

While these ESG reporting frameworks will become a requirement for private equity firms as well as for their portfolio companies, they are also a strategic opportunity. Ensuring ESG compliance means value protection for private equity but ESG can also become a source of value creation when strategically implemented.

Benefits of integrating ESG into the investment lifecycle include:

Increased transparency of portfolio companies

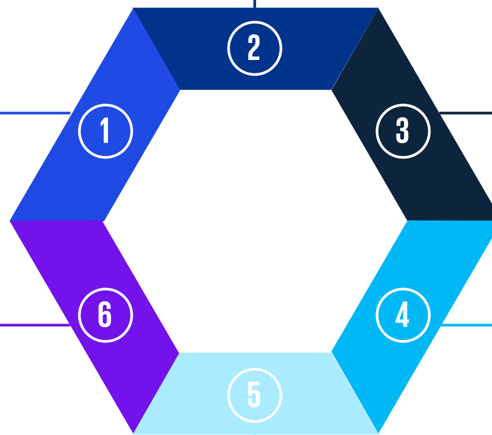
By requiring portfolio companies to report on ESG information, private equity firms gain more insight into a portfolio company's ESG risks and opportunities. This also reduces the risk of non-compliance in regulatory disclosure requirements and possible regulatory fines.

Reduced ESG risks

Mitigating ESG risks automatically reduces overall portfolio risk in terms of reputation, legal, compliance, and climate risk.

Meeting market demand for ESG funds

Consumers are increasingly sustainability-conscious while investors are increasingly interested in socially responsible investing (SRI). By launching ESG funds, private equity is tapping into this stream of financing.



Talent attraction and retention

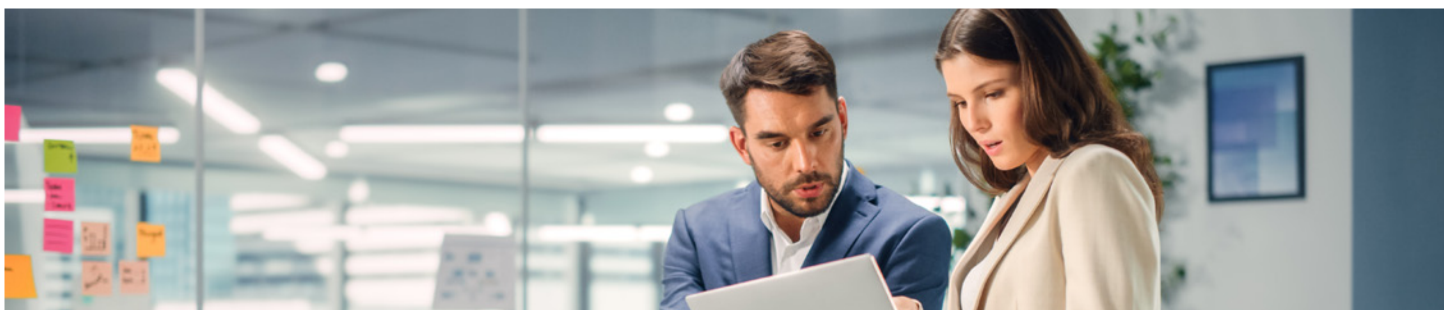
Talent is increasingly conscious of the ESG performance of their employers and companies considered sustainable are not only better placed to attract talent but also retain talent .

Improving ratings and corresponding financial benefits

By improving the ESG rating of portfolios, private equity firms can not only lower the cost of capital but also expect higher values. With higher valuation from ESG metrics, private equity firms can capture a premium at the exit phase.

Investment in a growing segment with high returns

ESG funds are establishing high returns and positive impacts which raises the portfolio value in the long term.



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Correlation between ESG risk ratings and economic moat ratings

Combined research by Sustainalytics and Morningstar found a correlation between the Sustainalytics' ESG risk rating[7] and Morningstar's economic moat rating[8] of companies (see figure 1).

- The research concludes that over a three-year period (July 2017 – June 2020), negligible/low ESG risk and wide moat companies have returned 55% to shareholders and consistently generate yearly higher returns, while no moat and high/severe ESG risk companies have led to losses for investors of 20%.
- Regarding the ESG momentum[9], the research shows that wide moat companies with positive ESG momentum have higher returns per year than companies with a wide moat and a negative ESG momentum.

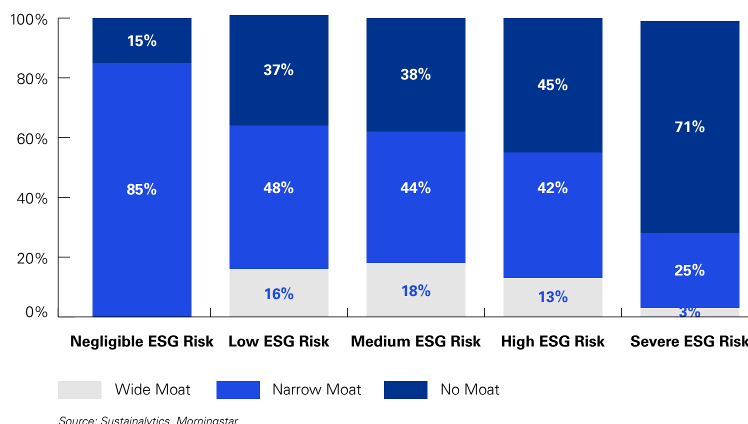

Figure 1: Distribution of economic moat ratings by ESG risk category.

7 *ESG Risk Ratings measure the degree to which a company's economic value is at risk driven by ESG factors.*
8 *Economic Moat Rating represents a company's durable competitive advantage taking into account cost advantage, efficient scale, intangible assets, network effects and switching costs*
9 *Sustainalytics define ESG momentum as follows:*
- Positive: A decrease in ESG risk score of 3.0 points or more;
- Negative: A increase in ESG risk score of 3.0 points or more.

How ESG rankings can translate into corporate financial performance

MSCI analyzed the relationship between ESG rankings and corporate financial performance through three 'economic transmission channels', which can be summarized as cash-flow, idiosyncratic risk, and valuation.

Their analysis finds that companies with high MSCI ESG ratings experience the financial benefits listed below, resulting in higher valuations:

Higher average profitability.

Lower financial drawdown frequencies.

Lower costs of capital.

Source: MSCI. (2021) Deconstructing ESG Ratings Performance: Risk and Return for E, S, and G by Time Horizon, Sector, and Weighting in The Journal of Portfolio Management, 47(3).

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Assessment of ESG Integration in Belgian Private Equities

KPMG analyzed the presence of ESG criteria in the investment strategies and communications of 30 Belgian private equity firms – the sample is composed of companies with various levels of employee size and assets under management (AUM). The analysis was conducted through desk research **based on publicly available information** disclosed by the companies on their websites and other forms of documentation.

The strategy analysis covers the entire investment lifecycle from strategy to exit (see figure 2). For each of the six stages, ESG integration is measured by the presence of specific ESG criteria (see table 2) and expressed as a percentage. The percentage of each stage is then consolidated into a final total percentage score. It was also verified whether the private equity firm is a signatory of the UN PRI to determine its commitment to integrating ESG into the investment process.

01. ESG strategy

A clear ESG policy and framework for the house and funds / portfolio companies. Focused on the integration of ESG into investment processes and ownership practices, but important for the house to walk-the-talk too, demonstrating commitment from the top.

02. Fund raising strategy

Focused fund-level ESG strategy aligning to the house and LP requirements, as well as best practice (reporting) frameworks.

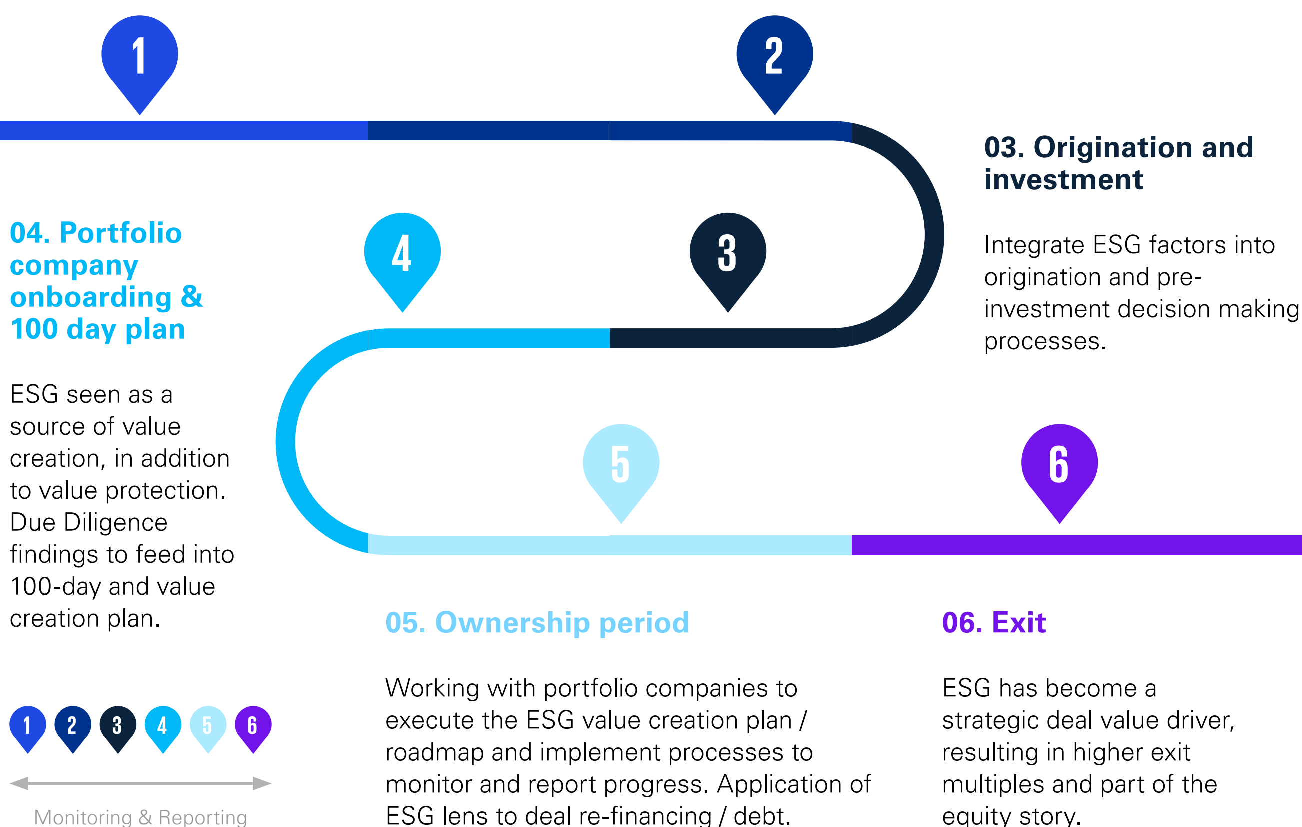

Figure 2: KPMG's Six Phases of Private Equity's ESG Investment Lifecycle

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Table 2 shows which ESG criteria was included for every phase of the investment lifecycle.

Phase & Criteria	Criteria Description
Phase 1: ESG strategy	
ESG policy	Does the entity have an ESG policy? Is it available on the website?
ESG materiality	Has the entity performed a materiality assessment?
ESG strategy & roadmap	Does the entity have an ESG strategy and roadmap?
ESG governance framework	Is there an ESG governance framework in place? Is it publicly disclosed?
Phase 2: Fundraising strategy	
Article 8/9 fund launch	Does the entity sell Article 8 or 9 products?
Regulatory compliance	Does the entity disclose non-financial information required by ESG regulations (ex. SFDR)?
SLL/Green bond strategy & disclosures	Is there a Sustainability-linked/Green/Social bond framework available?
Phase 3: Origination and investment	
ESG screening	Does the entity perform an ESG screening for its investments?
ESG due diligence	Does the entity perform ESG due diligence for its investments?
Impact fund specific due diligence	Does the entity perform a specific due diligence for impact funds?
ESG training & support for deal teams	Does the entity provide ESG training and/or support for its deal teams?
Phase 4: Portfolio company onboarding	
Carbon footprint of portfolio companies	Does the entity monitor the carbon footprint of its portfolio companies?
Phase 5: Ownership period	
Decarbonization pathways	Does the entity disclose that it requires a decarbonization pathway in its portfolio companies?
Climate risk assessment	Does the entity disclose that it requires a climate risk assessment of their portfolio companies?
ESG data monitoring	Does the entity disclose that it monitors ESG data of its portfolio companies?
ESG reporting & disclosures	Does the entity disclose that it requires ESG reporting and disclosures of its portfolio companies?
Phase 6: Exit	
IPO readiness	Does the entity disclose the inclusion of ESG ratings in the IPO readiness of its portfolio companies?
ESG prospectus	Does the entity include ESG matters in the 'offering memorandum'?
Sustainability communications	Does the entity engage in sustainability communications e.g., ESG reporting, sustainability-related webpages, ESG newsletter etc.?
ESG ratings & rankings strategy	Does the entity disclose having objectives in ESG ratings and rankings?
Vendor due diligence	Does the entity disclose that it performs vendor due diligence?

Table 2: ESG criteria per investment lifecycle stage

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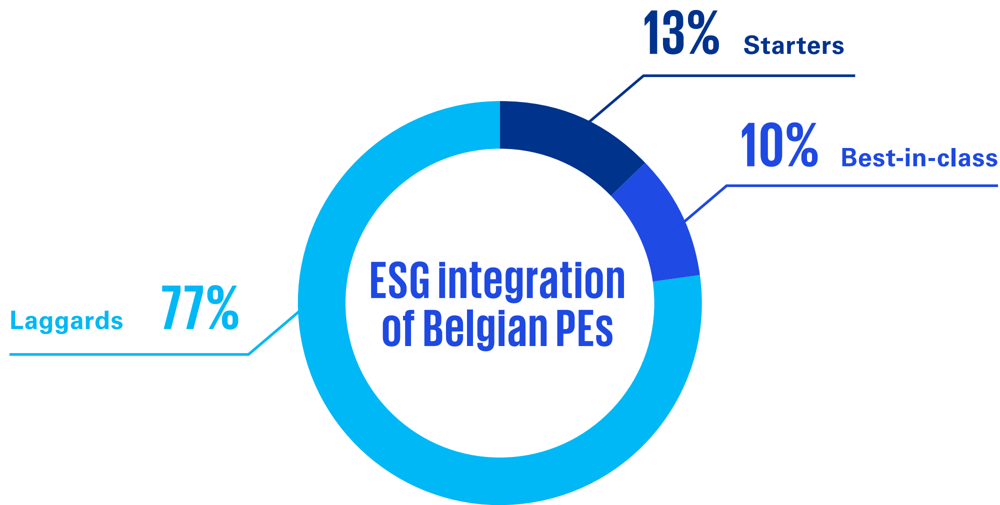

Figure 3: ESG integration of Belgian private equity firms categorized as laggards, starters, or best-in-class.

Differences and Similarities Within Categories

The analysis results show that there are three categories: laggards, starters, and best-in-class. Laggards meet fewer than 1/3 of the ESG criteria, starters meet between 1/3-2/3 of the ESG criteria, and the best-in-class meet more than 2/3 of the ESG criteria.

The vast majority of Belgian private equity firms are laggards in ESG. Based on the disclosure of ESG criteria, 77% of Belgian private equity firms qualify as laggards, 13% are starters in ESG, and only 10% are considered best-in-class.

The private equity firms qualifying as best-in-class and starters are all UN PRI signatories while none of the laggards are UN PRI signatories.

A vast majority of the private equity firms categorized as laggards do not meet any of the ESG criteria. In other words, **53% of private equity firms in Belgium do not disclose on the integration of a single ESG criteria in any of the phases of their investment lifecycle**.

None of the starters incorporate ESG criteria in their portfolio company onboarding phase. However, all starters include ESG criteria in the ESG strategy phase, origination and investment phase, ownership period, and exit phase.

The best-in-class private equity firms include at least one ESG criteria in each investment phase. All best-in-class private equity firms also include the carbon footprint of their portfolio companies.

Differences and Similarities Between Categories Across the Investment Lifecycle Phases

In the ESG strategy phase, all best-in-class private equity firms have an ESG policy and ESG governance framework in place. All starters have an ESG policy in place. Approximately 26% of the laggards also have an ESG policy in place.

The fundraising strategy phase has the lowest level of ESG integration across all categories. None of the Belgian private equity firms include Sustainability Linked Loans or a Green Bond strategy and disclosures in this phase.

In the origination and investment phase, all of the private equity firms in the starters or best-in-class categories include at least two ESG criteria. ESG screening and ESG due diligence are the most included criteria.

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Since only one ESG criteria is included in the portfolio company onboarding phase, namely the carbon footprint of portfolio companies, the private equity firms either score 100% or 0% for ESG integration in this phase. Only four Belgian private equity firms (13%) disclose that they consider the carbon footprint of their portfolio companies.

In the ownership period, there is no significant commonality in the ESG criteria disclosed across the different categories. What is noticeable is that only one firm discloses that it asks for decarbonization pathways in its portfolio companies. This firm is in the best-in-class category and includes ESG data monitoring and ESG reporting during the ownership phase.

In the exit phase there is also no significant commonality in the ESG criteria disclosed by Belgian private equity firms. Within the best-in-class category, all the private equity firms include at least two ESG criteria, but only one firm includes all ESG criteria. One starter also meets all the ESG criteria in the exit phase.

Figure 4: Highlights of the differences and similarities between categories across the investment lifecycle phases of private equity (PE) firms.

Example of best practices by private equity firms categorized as best-in-class

Phase 1: ESG strategy

Publication of an ESG report including a description of their ESG strategy, how it is implemented in their portfolio companies and their ESG governance framework.

Phase 2: Fundraising strategy

Creation of an article 9 fund and TCFD compliance.

1

2

Phase 3: Origination and investment

Performing ESG screening, ESG due diligence, impact fund-specific due diligence and providing deals team with ESG training & support.

4

3

Phase 4: Portfolio company onboarding

Monitoring the carbon footprint of portfolio companies.

5

6

Phase 5: Ownership period

Performing a climate risk assessment and monitoring and reporting on relevant ESG data and indicators.

Phase 6: Exit

Engages portfolio companies in ESG value creation projects.

Figure 5: Examples of private equity firms best-in-class practices across the ESG lifecycle

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Top private equity firms integrate ESG for value creation

Top ranking private equity firms with billions of US dollars in AUM are embedding ESG into their investment lifecycle. For these firms, ESG is no longer just about compliance but rather a lever to create value. Below a non-exhaustive list of how top-ranking PEs are approaching ESG.

A leading global alternative asset management business	*"… strives to be an industry leader in ESG data collection, transparency, and engagement with portfolio companies."*
The world's largest asset manager	*"Our investment conviction is that climate risk is investment risk, and that integrating climate and sustainability considerations into investment processes can help investors build more resilient portfolios and achieve better long-term, risk-adjusted returns."*
The world's largest alternative asset manager	*"… believes that Environmental, Social, and Governance (ESG) principles are crucial to developing strong, resilient companies and assets that deliver long-term value for our investors."*
The world's largest and most diversified global investment firms	*"We believe that integrating ESG into our investment activity leads to better investment results and more sustainable returns for our investors and shareholders."*
A leading global investment firm	*"Sustainable investing is a key lever of our approach to value creation and a way of doing business that we believe helps us make better investments. By assessing and managing ESG, regulatory, and geopolitical issues, we strive to create stronger, better business outcomes while also having a positive effect on the companies in which we invest and our stakeholders."*

Based on the research results and KPMG's expertise in sustainable finance and private equity, a list of recommendations is made for Belgian private equity firms to further integrate ESG. The recommendations are specified for each category in ESG integration as different steps need to be taken at different stages.[10] Find more information on how we can support you in implementing these recommendations in our portfolio of services.

Laggards

Start your ESG journey with these steps:

- Set up an ESG committee including various functions throughout the firm
- Write an ESG policy for the firm itself
- Create an ESG scorecard

Starters

Continue improving the integration of ESG with these steps:

- Improve the quality of ESG data
- Set up a dedicated ESG team
- Use tools for ESG reporting

Best-in-class

Take the lead in ESG with these steps:

- Obtain an ESG label at entity or product level
- Include ESG clauses in portfolio company contracts
- Become a member of UN PRI

10 *Note that this is a non-exhaustive list of recommendations and may not be directly applicable to individual firms.*

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Conclusion

ESG integration in Belgian private equity firms is low, as **53% of the Belgian private equity firms we analyzed do not disclose any ESG criteria in their investment lifecycle**. Furthermore, there are many differences in the ESG criteria that Belgian private equity firms choose to disclose, even within the starters and best-in-class categories.[11] **This indicates room for improvement (to varying degrees) within all Belgian private equity firms.**

It is time for Belgian private equity firms to evaluate their ESG integration and begin developing their ESG strategy - if not for value creation, then for value protection in the face of strengthening ESG reporting requirements.

KPMG has created a simple and **quick self-evaluation checklist so you can find out where you rank amongst your private equity peers.**

Check your ranking to establish your ESG baseline and where to start improving your ESG integration.

For more tailored support in ESG strategy, KPMG's ESG and sustainable finance specialists are ready to assist you. Get in touch with our team to discover our end-to-end personalized services.

11 *The ESG score refers to the scores allocated in KPMG's methodology for this report and not to the ESG rating performed by any other party.*

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