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MAPPING THE ESG LANDSCAPE IN THE LOWER MIDDLE MARKET: EVIDENCE FROM A SURVEY OF SBIA MEMBERS

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Mapping the ESG Landscape in the Lower Middle Market: Evidence from a Survey of SBIA Members

Interest in ESG investing has exploded in the last few years, moving from what was mostly a niche market, solidly to the mainstream in a relatively short time period, with many investors increasingly focused on ESG value in private equity (PE) investments as a way to mitigate long term risk. Given the lack of hard data about current ESG policies, especially those of lower middle-market investors, the Small Business Investment Alliance (SBIA) and UNC's Institute for Private Capital (IPC) worked in partnership throughout 2022 to research issues of ESG for lower middle market private capital firms. This survey was designed to provide a meaningful reference point for the benefits and challenges to ESG adoptions, and especially to highlight those issues that are unique to small-business investors.

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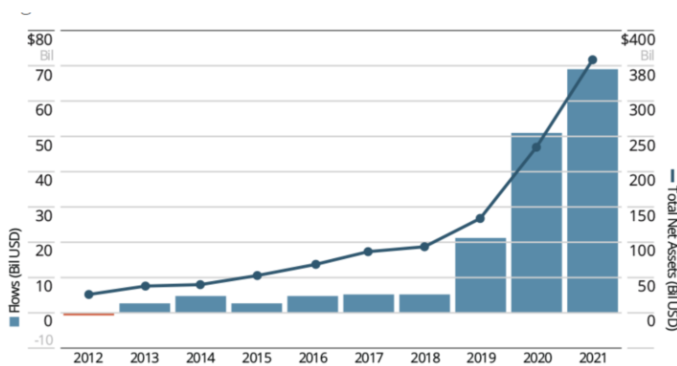
Introduction

ESG Investing represents an investment process that (in an ideal setting) integrates environmental, social, and governance objectives along with more traditional metrics estimating the potential return and risks of a company. Interest in ESG investing has exploded in the last few years: in the United States, ESG investing has moved from a niche market to the mainstream over the last two years with an exponential growth in fund flows to ESG-focused funds (see Figure 1). A broadening range of Wall Street firms have been advocating for investment strategies that include factoring in ESG-related characteristics, arguing these generate “more stable and higher long-term returns.”

Figure 1. Growth of ESG Investment in the US

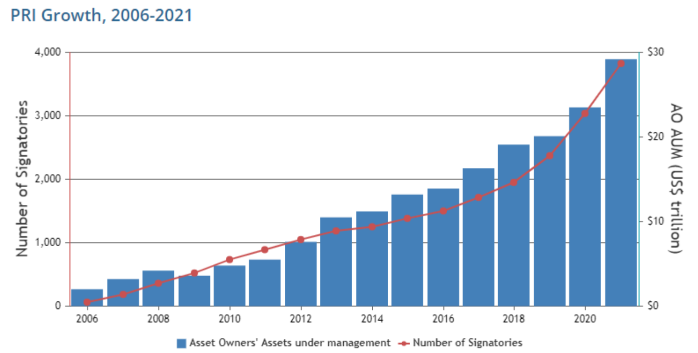


**Source: Morningstar Direct as of Dec. 31, 2021. Includes Sustainable Funds as defined in Sustainable Funds U.S. Landscape Report, January 2022. Includes funds that have liquidated, but excludes funds of funds.

The trend in ESG investing is a global movement. Internationally, there are now more than 3,800 signatories to the United Nation’s Principles for Responsible Investment, representing major asset owners, investment managers and service providers from around the world, with assets under management of almost $30 trillion USD and continuing to grow (see Figure 2).

Although “ESG” is often grouped into one style of investment, it’s worth defining and discussing the individual components and the sum of its parts. In particular, the E, S and G buckets are quite disparate and that they may themselves potentially engender challenging cross-bucket conflicts of interest. To better understand this, it is important to separate these out.

Figure 2. Signatories to the United Nation’s Principles of Responsible Investing (PRI)



The environmental criteria that ESG investors may perceive as relevant range from energy use to pollution to natural resource conservation and more. Further, some investors may explicitly focus on downside environmental or climate risks, from the potential costs associated with negative climate shocks to perhaps more proximate adverse regulatory or policy changes. In contrast, social criteria can range from a company’s working conditions with regard to the safety of its employees to progress on workforce diversity to the engagement of the firm in the challenges of the community within which it operates. Finally, governance criteria focus on the degree to which companies engage in transparent accounting, facilitate board representation and ensure minority shareholders are well represented in important business decisions.

With the wide scope of the individual elements of E, S, and G, it is not surprising to find that ESG investing still means wildly different things to different people. ESG can reflect everything in between “socially responsible investment” and “impact investment” – and this wide variation in intention, coupled with an imprecision with which ESG is defined in practice, creates a challenging landscape for asset managers, investors, and portfolio companies.

Private vs. Public, Large vs. Small

ESG is not just an issue for public firms – many investors are focusing increasingly on ESG value in private equity (PE) investments as a way to mitigate long term risk, and as a consequence, the PE industry increasingly must factor environmental, social and governance issues into the way it operates with important implications for both fund managers and their portfolio companies.

Although ESG frameworks are rapidly gaining ground in PE, larger public companies have had a head start and have been considering issues of corporate responsibility and sustainability for some time. Larger firms have built dedicated teams to incorporate ESG-related issues into their operations and investment approaches, and most issue annual sustainability reports. In 2020, 92% of companies in the S&P 500 index published a sustainability report, according to the Governance and Accountability (G&A) Institute. The same G&A Institute report showed that less than half of public companies outside the S&P 500 issued a sustainability report in 2020.

Although most small and mid-size businesses are still developing their ESG strategies, given the growing evidence that suggests investors consider ESG factors in their capital-allocation decisions, how to integrate them efficiently and design a customized ESG playbook is increasingly top of mind for private equity firms.

Introducing the SBIA Investor Survey – Top-level Take-aways

Although ESG is increasingly top of mind for PE firms, there is little hard data about current ESG policies, especially those of lower middle-market investors. To shed light on the current state of play in the private-market ESG integrations, the Small Business Investment Alliance (SBIA) [1] and UNC's Institute for Private Capital (IPC) worked in partnership throughout 2022 to research issues of ESG for lower middle market private capital firms. Central to this effort was a detailed survey of SBIA's stakeholders. Working with SBIA members [2], the survey was designed to provide a meaningful reference point for the benefits and challenges to ESG adoptions, and especially to highlight those issues that are unique to small-business investors. A main goal of the effort is for the survey responses to help design an ESG framework that not only helps PE firms successfully incorporate beneficial ESG criteria and financial factors, but also provides a framework specifically focused on issues faced by smaller firms.

Overall, the survey indicated that there is young, but rapidly evolving, ESG landscape in the lower middle market. Although these funds are generally smaller in size than those operated by the large global private equity firms, they represent the bulk of PE deals. **Overall, firms report facing significant challenges in a variety of areas including sourcing deals with non-traditional owners and managers and ESG policy implementation, as well as their own DEI initiatives**.

The survey was structured to collect information on:

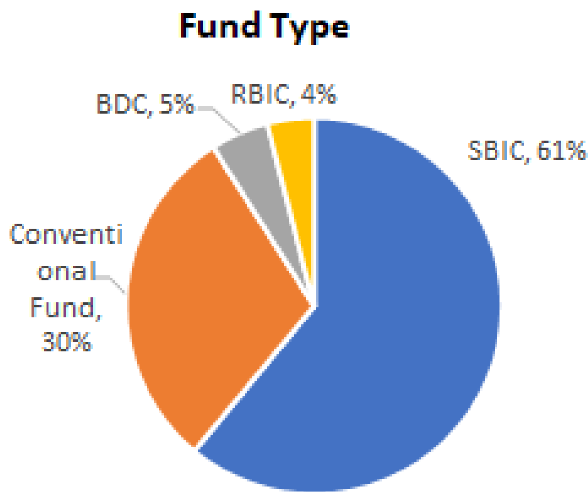
1. firm and portfolio characteristics
2. how firms identify, recruit, and retain talent
3. how firms source deals, and
4. the ESG metrics that are currently collected from firms' portfolio companies.

1 The Small Business Investor Alliance (SBIA) is the association of senior investment professionals focused on the lower middle market with membership across the entire private capital ecosystem

2 The three SBIA Working Groups included: Talent Sourcing; Deal Sourcing; and Reporting to LPs

The survey was distributed to a total of 184 SBIA member firms in June and July of 2022 with 44% of firms responding. The survey allowed several people from the same firm to respond to different sections and took about an hour to complete. The general demographics of the responses are presented in Figure 3.

Figure 3. Characteristics of Survey Respondents



Fund Strategy	Percent
Mezzanine/Credit	31.8%
Buyout	20.7%
Growth Equity	19.6%
Multi-Stategy	17.3%
Venture Capital	3.9%
Venture Debt	3.9%
ESOP	2.8%

Industry Focus (Multiple Responses Allowed)	Percent
Sector Agnostic / All Industries	21.7%
Energy	2.5%
Materials	5.9%
Industrials	9.9%
Consumer Discretionary	6.4%
Consumer Staples	5.4%
Health Care	10.3%
Financials	<1%
Information Technology	12.8%
Communication Services	8.4%
Utilities	2.5%
Business-to-Business Services	13.8%

At a headline level, the survey suggests that **ESG remains something of a black box**, with many respondents reporting a mixed adoption of ESG policies:

- 50% of respondents do not have a written policy or statement that addresses environmental impact or responsibility.
- 49% of respondents do not have a written policy or statement that addresses corporate social responsibility.
- 62% of respondents do not have a statement on diversity, equity and inclusion (DEI).
- There is more adoption around governance issues: 71% of respondents have a written policy or statement that addresses ethical conduct and/or proper governance practices.

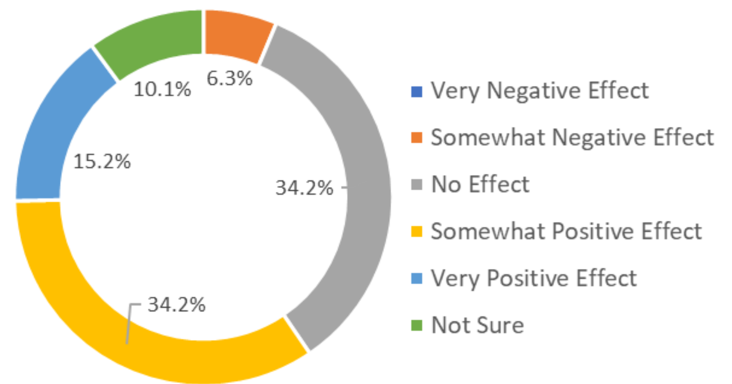
The most important ESG factors appear to be ones with real impact to operations and financial performance (like hazardous waste disposal and safety issues). Overall, ESG issues appear less related to broad societal goals and more integral to traditional business operations.

This mixed adoption makes sense, especially when taken alongside the view that the lower-middle-market investors are not broadly demanding adoption. Overall, only 17% of respondents think that there will be negative effects on fundraising related to ESG implementation. Even of the firms classified as "ESG-conscious" (those with at least one E, S, or G policy or statement), only a small majority (57%) think their ESG commitments will have a positive outlook on deal-sourcing.

Notably, 100% of firms lacking any ESG statements or policies believe their (lack of) ESG implementation will have no effect (74%) or a somewhat positive effect (26%) in successfully raising new funds for the next year.

Finally, we find only 30% of respondents have policies in all ESG dimensions – this indicates that the market is not demanding smaller investment firms to be alert in all ESG fronts … at least not yet.

Figure 4. Thinking about the next year, how do you think your firm's ESG implementation will affect the ability to successfully raise new funds?



Talent

Even with a lack of formal DEI statements or policies, roughly 86% of respondents consider diversity in hiring practices (see Figure 5). These considerations are included either as one of the primary factors (e.g., a candidate's experience and education) or as a tie-breaking factor. Consistent with diversity being a priority, 66% of respondents agree or strongly agree with the following statement (see Figure 6): "our firm puts substantial effort into recruiting and retaining a diverse team."

Nevertheless, fewer than 10% of firms have a Black or African American partner and only 27% have one or more women partners. The percentages more than double for non-partner positions including other investment professionals and operations teams.

Respondents believe there is a pipeline constraint for recruiting diverse talent: 60% say that the limited referral pool they have access to is a challenge. Other issues cited include a lack of onboarding programs and limited HR resources, as well as a rigid organizational structure.

Figure 5. Role of Diversity in Recruiting and Hiring Decisions

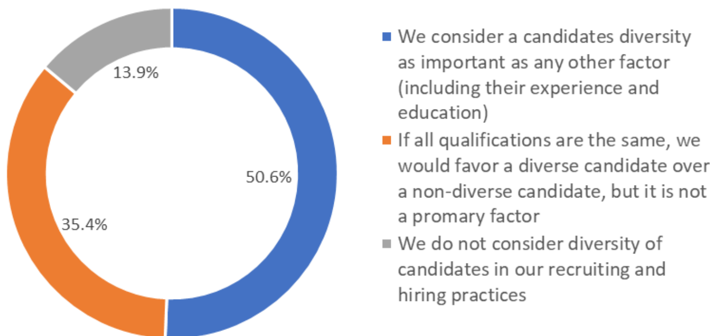
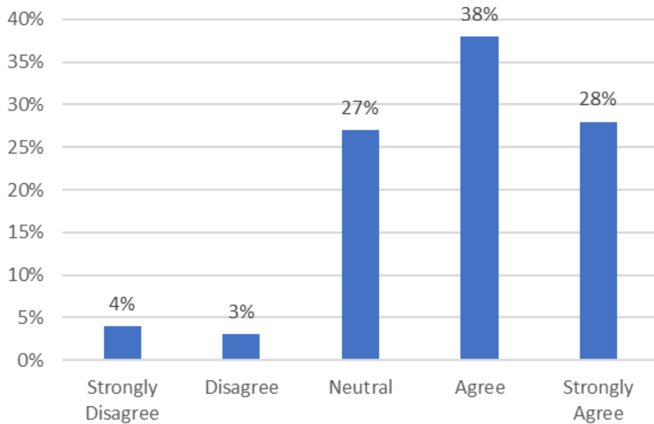


Figure 6. Respondent Replies to: "Our firm puts substantial effort into recruiting and retaining a diverse team."



Deal Sourcing

Respondents express a desire to broaden sourcing, but in practice, it appears to remain a challenge:

- Only 14% of respondents set explicit diversity goals for the composition of their investment portfolios.
- 77% of respondents do not track or do not know if portfolio companies are majority-owned by women. There are similar patterns about portfolio companies majority-owned by underrepresented racial or ethnic groups, as well as veterans.
- There seem to be more efforts (or perhaps more data collected) toward sourcing deals outside major metropolitan areas. Only about 13% of respondents either do not track or have minimal contribution to such companies, and 43% of respondents feel that they put substantial effort into sourcing investments located outside of major metropolitan areas.

Figure 7. At the current time, is your firm setting explicit diversity goals for the composition of its investment portfolio?

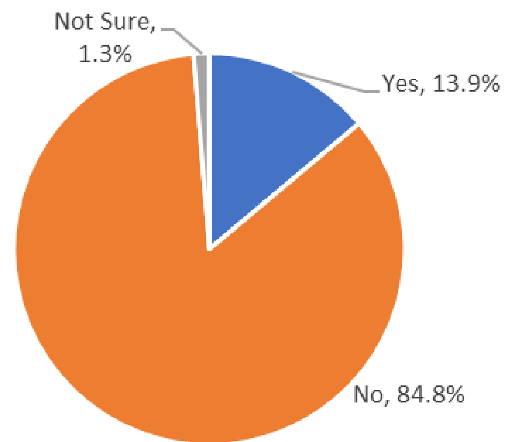


Figure 8. Approximately what percentage of your funds' portfolio companies are majority-owned by women?

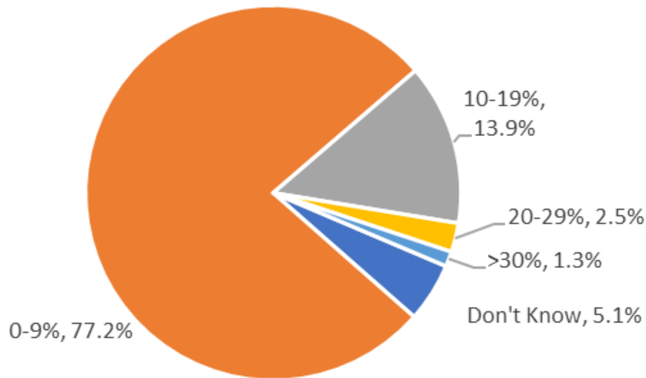


Figure 9. Respondent Replies to: "Our firm has been successful in reaching its goals for sourcing investments in companies located outside of major metropolitan areas."

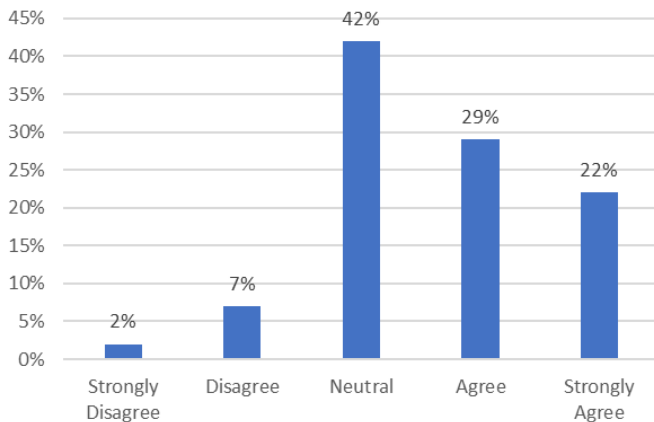
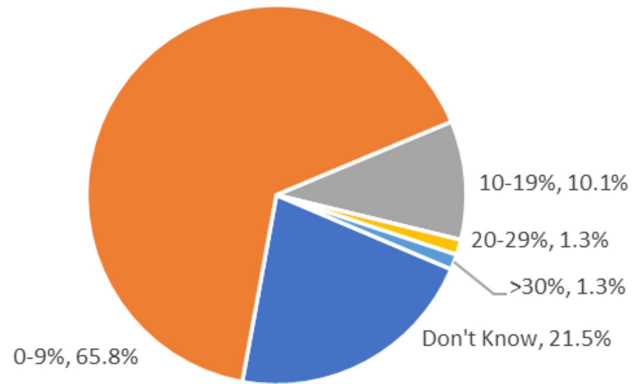


Figure 10. Approximately what percentage of your funds' portfolio companies are majority-owned by veterans?



Reporting to LPs

Limited partners (LPs) have faced increasing pressure from various sets of stakeholders in recent several years on issues of ESG, and large institutional LPs are more likely to be signatories on ESG related initiatives (e.g., UN PRI, SASB, CDP, etc.). Indeed, many LPs now explicitly state their aim to not only to optimize their risk-return tradeoffs using traditional risk factors, but also to hedge against ESG-relevant risks and align their portfolio with ESG principles. It makes sense then, that these LPs are asking their GPs for data on ESG at the portfolio level.

The survey suggests that these preferences have not yet percolated to lower middle-market firms as the vast majority (92%) of firms report that they hear concerns from their existing LPs about their ESG implementations only occasionally or never. However, surveys of larger GPs suggest a rapidly growing demand by LPs for ESG data on portfolio companies. For example, large LPs rolled out the Data Convergence Project in 2021 and the initiative now has more than 250 GP firms participating and reporting ESG data on over 2,000 portfolio companies.[3]

3 See https://www.esgdc.org/ for additional details

A substantial part of the survey was dedicated to determining what ESG metrics are currently being tracked by investment firms, and also what metrics are seen to be the most important to track. Below we've outlined the factors across the Environmental, Social, and Governance categories that received the highest (most important) and the lowest (least important) rankings. Although there is no standard set of metrics that LPs require from their GPs, the list below serves as a good starting place for developing a priority list for reporting.

Highest Ranking	Lowest Ranking
Environmental Factors	
Hazardous waste streams	Tracking its carbon emissions
Hazardous & non-hazardous waste streams management & disposal	Primary energy and water sources
Environmental impact and responsibility policy	
Social Factors	
Gender & race/ethnicity of executives and management team	The breakdown by sexual orientation of employees
Gender & race/ethnicity of company owners	The total number of promotions given each calendar year by gender
Reportable safety incidents per year	DEI training
Total annual turnover, by voluntary and involuntary separations	Include of DEI language in its job postings
# of employees by facility location by LMI zone	
Governance Factors	
Data/security breach in the last 12 months.	Dedicated resource for companywide ESG efforts
Active cyber insurance policy in place	Company-focused ESG policy
Third party annual audits (e.g., customer site audits, licensing audits).	

Implications and Conclusions

These challenges suggest that private equity firms and portfolio companies (and really any smaller company) should consider ESG differently than a large public company. Specifically, the trade-offs between benefits and costs of implementation are more likely to limit the scope of ESG-related policies for smaller companies. PE portfolio companies must carefully consider where their more limited resources will have the greatest advantages. With this in mind, we propose a simple model for prioritizing ESG issues. Specifically, companies should evaluate issues based on a combination of implementation cost and impact. The 2-by-2 matrix below provides a simplified way to view the implementation decision.

Cost\Impact:	Low	High
Low	PE firm should have a strategy, but only larger companies implement	Likely to be "win-win" and should be primary focus of PE-backed companies
High	Only large companies should do these	As PE-backed companies grow, these are next priority

PE-backed companies starting to consider ESG implementation should focus primarily on low-cost, high-impact issues. These are initiatives with the potential to improve both the bottom line for equity-holders and that most-likely would be viewed positively by other stakeholders. This survey suggests that lower middle market PE firms should focus on projects such as improved waste stream management, equitable compensation practices, employee inclusion and retention initiatives, worker safety programs, and cybersecurity investments.

As resources grow at private-equity-backed companies, ESG priorities can expand to include higher-cost, but still high-impact, initiatives such as targeting new investments in low-to-moderate income areas, expanded employee benefits, and energy or water sourcing policies. Only after these opportunities have been developed should small and mid-sized companies consider initiatives where their efforts will have more modest impact. Of course, the specific trade-offs will depend crucially on the industry, location, and size of operations

While it is often difficult to argue against undertaking actions intended to make the world a better place, the reality is that resources are always finite. For smaller private-equity-backed companies, the constraints will tend to be more binding, increasing the need to carefully consider the trade-offs of competing ESG priorities. It seems likely that LMM firms will end up with a very different ESG playbook, regulations, and priorities than those for larger companies – as it should be.

References and Resources

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