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Private markets rally to new heights

McKinsey Global Private Markets Review 2022

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More institutional investors are incorporating consideration of ESG factors in their investment decisions. Several US state pensions have recently introduced granular ESG targets or policies that exclude certain investments due to their environmental impact, while others have made the diversity of a GP's personnel a formal criterion in manager selection. In Europe, the first set of the European Union's Sustainable Finance Disclosure Regulations came into force last year, mandating firm- and product-level disclosures from financial market participants including GPs and LPs. By the end of 2021, over 3,500 investment managers—among them numerous institutional investors—had signed the UN-supported Principles for Responsible Investment, demonstrating commitment to ESG issues.[59]

[59] Signatory directory, Principles for Responsible Investment (PRI).

GPs have followed suit. In 2021, leading GPs and LPs came together to launch the ESG Data Convergence Project to standardize ESG metrics and reporting. Fundraising by GPs with formal, firm-level ESG policies increased to $630 billion, representing over half of total fundraising for the second year in a row. Larger players have led the charge: the average fund size of firms with explicit ESG policies is $1.1 billion, compared to $0.3 billion for those without such policies.

Fund vehicles with an explicit ESG mandate have also grown. Often referred to as "impact" funds, these vehicles have doubled in the last five years, with 73 funds included in the 2021 vintage.[60] PE deal activity for ESG-related investments has also grown rapidly, at 16 percent per annum since 2016 compared with 12 percent for PE overall.[61]

Fives stages of actioning ESG

Although ESG has been a point of emphasis in private markets investing for several years now, the landscape in 2021 is still one of transition. GPs are at various stages in their ESG evolution, with some just beginning to explore and others already seeking to capitalize on ESG as a competitive differentiator and driver of returns. We have observed that firms typically evolve in five stages as it relates to ESG:

1. *Acknowledging that ESG matters.* Most firms begin by a simple acknowledgment that ESG matters, often accompanied by a public declaration of ESG adherence, such as signing the PRI. This is a step beyond the initial "stage 0" that most firms occupied until recently, in which no attention is paid to ESG.

2. *Tracking ESG.* Firms start tracking, measuring, and reporting ESG factors within their portfolio companies and potential target companies, primarily using standard ESG metrics (for example, energy consumed, employee turnover, and anticorruption policies).

3. *Setting targets.* Firms establish ESG targets for their portfolios and develop plans to reach them—for instance, by adopting Science Based Targets[62] for emissions reduction.

Reaching net zero by 2050 may require an incremental $3.5 trillion per year in decarbonization capex, comparable to one-third of current private markets AUM.

[60] Preqin.
[61] PitchBook.
[62] The Science Based Targets initiative is a partnership between CDP, the UN Global Compact, World Resources Institute (WRI), and the World Wide Fund for Nature (WWF) that defines and promotes best practice in emissions reductions and net-zero targets, and provides companies technical assistance and resources to meet them. For more: https://sciencebasedtargets.org/.

4. *Investing on an ESG basis.* Firms integrate ESG into their investment processes and decision making. This process enables firms to make better investment decisions and capture value-creation opportunities from ESG while also controlling for risk.

5. *Transforming companies.* Finally, investors begin influencing and helping companies to improve on ESG as a way to capture value-creation opportunities. Our experience shows that this last phase is where investors can begin to find alpha. As we noted in our report last year, emerging data suggest that improvement in a company's ESG performance is positively correlated with shareholder returns.

An evolution from stage 1 to stage 5 does not happen overnight. A growing number of firms have migrated beyond the first stage, but while they would have been considered pioneers five or ten years ago, having a set of transparent ESG metrics or setting ESG targets is now merely table stakes. A small proportion of firms are at stage 4 or beyond—only 15 percent of firms report having investment policies that take ESG into consideration.[63]

Of course, the three components of ESG—Environmental sustainability, Social responsibility, and sound Governance—are distinct from one another. While private investors have long focused on the "G" as a driver of performance, it is the "E" and the "S" that have come into sharper focus in recent years. In the remainder of this chapter, we examine specific ways in which investors are addressing these two priorities.

E: Sustainability calls for a new set of priorities

Considerations around environmental sustainability, particularly those related to energy transition and the decarbonization imperative, have profound implications for the private markets ecosystem. The sheer amount of capital required to facilitate the energy transition alone is staggering: estimates suggest that reaching net zero by 2050 will require an incremental $3.5 trillion per year in decarbonization capital expenditures, comparable to one-third of current private markets AUM.[64]

As GPs grapple with this transition, they should consider three key priorities: investing in companies that support the sustainability transition, changing how they value assets to factor in climate-related downside, and decarbonizing portfolio companies and assets to help limit risk exposure and open new avenues for value creation.

Investing in companies that accelerate the sustainability transition

GPs seeking to invest in the sustainability transition can employ a range of strategies:

— *Brown-to-green* strategies focus on transforming "dirty" business models to be more environmentally friendly, typically by refocusing product, technology, or service offerings. For example, refineries can be retrofitted to ethanol plants, and offshore services businesses can pivot away from offshore oil and gas and toward offshore wind.

— *Supply-chain decarbonization* consists of investing in companies that provide critical inputs in the decarbonization value chain—for example, companies that supply businesses with advanced materials, components, or equipment required for decarbonization.

— *Green growth* consists of creating new green products. Examples include recyclable plastic packaging, sustainable textiles, green steel production, and carbon-neutral fuel.

— *Enabling technology* focuses on emissions measurement, accounting, and mitigation support to help emitting companies manage

[63] Preqin.
[64] *The net-zero transition: What it would cost, what it could bring*, McKinsey Global Institute, January 2022.

and abate their carbon footprint. Examples include emissions accreditation and trading platforms as well as ESG/HSEQ[65] software.

— *Investing in winners* involves scaling businesses that already have proprietary or leading decarbonization technology or capabilities. Potential targets could include manufacturers of EV components (including batteries) or low-carbon agriculture products.

Most investors today recognize the importance of sustainability. To capture full value from the sustainability transition, investors will need to deepen their insights into green technologies, regulations, and market demand.

Rethinking valuation: The example of real estate
Factoring sustainability-related risk into asset valuations is becoming increasingly critical for investors, especially in asset classes such as real estate, where there is increasing concern that climate change introduces significant risk. Leading real estate players can respond by developing capabilities to quantify climate change's impact on values and using this insight to inform investment and portfolio management decisions.

There are two major sources of climate change risk that impact the value of a given building and affect investors' calculus on what to buy, sell, or retrofit.[66] These are physical risks, both direct (affecting a building) and indirect (affecting the market in which the building exists). There are also sustainability transition risks, which include changes to the economy, regulation, consumer behavior, and technology; these can also be direct and indirect.

Direct physical consequences can be conspicuous: for example, the value of homes in Florida exposed to climate risks are depressed by roughly $5 billion relative to unexposed homes. The indirect impacts of physical risk on assets can be harder to perceive. For example, climate-change-induced flooding could impact transportation arteries to and from

To capture full value from the sustainability transition, investors will need to deepen their insights into green technologies, regulations, and market demand.

[65] HSEQ = health, safety, environment, and quality.
[66] Brodie Boland, Cindy Levy, Rob Palter, and Daniel Stephens, "Climate risk and the opportunity for real estate," McKinsey, February 4, 2022.

a city center without directly affecting major corporate headquarters. The water may never enter the lobby of the building, but neither will the tenants.

Among the most direct sustainability transition impacts are regulatory requirements to decarbonize buildings. Since standard property valuation models generally do not account for decarbonization costs, investors and operators may be confronted with an unexpected major capital expense or tax. There are also a host of less direct but potentially more significant transition risks that affect whole real estate markets. In downtown Calgary, for example, the combination of oil price volatility and market access issues (driven by climate-change-related opposition to pipelines) has contributed to vacancy rates of about 30 percent as of January 2021.[67]

To adequately respond, real estate owners and investors will need to understand the potential impacts of these four risk dimensions on revenue, operating costs, capital costs, and capitalization rates.

Decarbonizing portfolio companies

Another key component of investors' sustainability strategy is decarbonizing portfolio companies. This is particularly important in sectors that face the most exposure to climate change: power, transportation, buildings, industry, agriculture, and infrastructure.

To develop the most appropriate path, private markets players need to understand the range of decarbonization options and their financial and strategic costs and benefits. The specific path to decarbonization will vary by industry and a firm's specific context, of course, but the following steps can help improve the sustainability across investors' portfolios:

— *Quantify the baseline emissions of each asset.* A data-driven understanding of the starting point is necessary to prioritize decarbonization initiatives and measure progress.

— *Decide which type of decarbonization target to set.* A range of potential target-setting standards exist: for example, measuring absolute emissions versus emissions intensity or setting targets at the sector level versus asset level. Players should develop a "house view" on target-setting standards that achieve business, investor, stakeholder, regulatory, and other objectives.

— *Identify decarbonization levers.* Build an asset- or portfolio-level marginal abatement cost curve that accounts for various market and policy scenarios.

— *Set up mechanisms to effectively deploy the decarbonization plan.* These may involve changes to financing and governance, stakeholder engagement, and a range of operational, risk-management, and other programs.

— *Build the ability to monitor emissions reductions.* Much of the value of decarbonizing will come from the ability to communicate progress to stakeholders, thereby creating market differentiation.

S: Private markets firms are making progress on diversity

The business case for diversity in private markets investing is clear.[68] Increasingly, institutional investors are demanding that GPs provide diversity metrics for their firms and portfolios. Progress on this front is fast becoming table stakes to successfully raise capital. But the need to cast a

[67] Dan Healing, "Calgary's downtown office vacancy rates hit record levels amid oilpatch woes," *Global News*, January 26, 2021.
[68] Sundiatu Dixon-Fyle, Kevin Dolan, Vivian Hunt, and Sara Prince, "Diversity wins: How inclusion matters," McKinsey, May 19, 2020.

US PE firms have increased the percentage of ethnically diverse talent and women at their junior levels. Work remains to be done.

broader net for talent goes beyond fundraising: there is also early evidence that diversity can enhance performance.[69] Diverse deal teams bring a broader set of relationships, perspectives, and experiences that can be crucial to relating to management teams and, ultimately, to closing deals. In a highly competitive industry, diversity is an edge that counts.

In the last year, numerous private markets firms have accelerated efforts to advance diversity. Several pieces of recent data point to progress: US PE firms have increased the percentage of ethnically diverse talent and women at their junior levels. They have also made strides in rates of female promotion and retention in midlevel roles.

Work remains to be done. Ethnic diversity in North American PE consists primarily of Asian employees, with low representation from Black and Hispanic/Latinx populations. Gender parity for promotions is still lacking at most step-ups in the pipeline, and the count of women in the uppermost roles, particularly the C-suite, continues to be underwhelming. Furthermore, firmwide diversity statistics tend to mask the disparity on deal teams (and hence in pay parity), as greater gender and ethnic diversity typically exists in non-investing and support functions of PE firms.

In a data set drawing from an analysis of 30,000 private equity employees and a broader sweep of corporate America,[70] we examined the state of gender and ethnic diversity by level at PE firms and corporate America. We also reflected on the practices of private markets firms that are leading in improving diversity and looked for ways other players can follow suit. Following are the results of this analysis and reflection.[71]

Ethnic diversity: Some progress, with important caveats

The US PE firms we analyzed have been more ethnically diverse at entry-level through principal/director roles than corporate America for the past few years. PE also roughly matches the corporate world in the percentage of ethnically diverse managing directors (MDs) and MD equivalents.

Some meaningful caveats temper the success of these firms in achieving ethnic diversity. First, representation by people of color remains limited and below that of corporate America. PE's ethnic heterogeneity is due primarily to the hiring of Asian professionals, who constitute more than 60 percent of ethnically diverse employees in PE today. Looking at junior roles in PE, Asian employees'

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[69] David Baboolall, Alexandra Nee, and Lareina Yee, "How private equity can catalyze diversity, equity, and inclusion in the workplace," McKinsey, March 1, 2021.

[70] Data come from the 2021 Women in the Workplace report, by McKinsey & Company and LeanIn.org. Private equity data come from analysis of 18 large and mid-sized US-based private equity firms, encompassing roughly 30,000 employees, and is part of a larger data set that looked at 34 banking and consumer finance companies, as well as 49 asset management and institutional investor firms. Corporate America data come from analysis of 423 firms, encompassing roughly 12 million employees.

[71] Alexandra Nee and David Quigley, "The state of diversity in private equity," McKinsey, March 2022.

share of the workforce is close to double the percentage in the corporate sphere.

Second, although PE matches all US companies in terms of how many ethnically diverse people hold MD or equivalent roles, this is not in itself overly impressive: in both sectors, only about 16 percent of men and roughly a fifth of women in such roles are diverse. Third, PE is still far behind US corporations in terms of ethnic diversity in the C-suite (Exhibit 33).

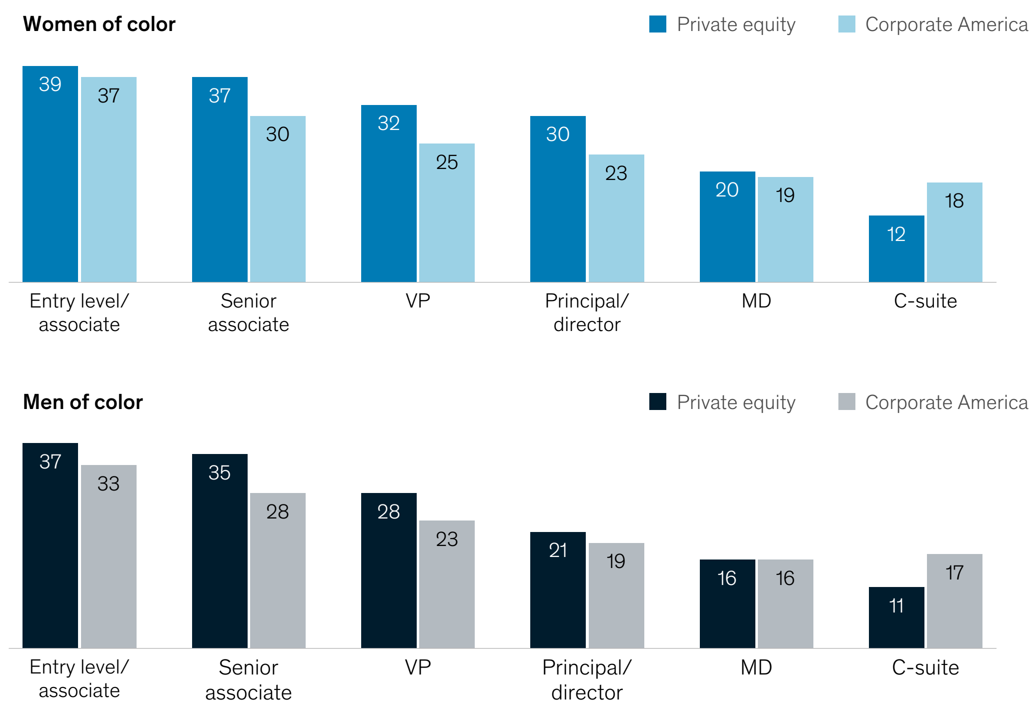
Gender diversity: More women work in PE, but few get to the highest levels

Entry-level roles in our US PE data set are now majority female. Entry-level gender diversity continues through senior associate, vice president, and principal/director roles. Female representation drops, however, at principal/director level and above, in what has been termed “the broken rung” of the career ladder—a phenomenon that occurs in corporate America overall, although not to as great

Exhibit 33

In ethnic diversity, US PE leads corporate America at junior levels but falls behind in the C-suite.

Ethnic diversity in US PE vs corporate America, 2020, % of ethnically diverse employees vs total workforce of the same gender, by role[1]



[1]Levels listed are based on McKinsey's 2021 Women in the Workplace Private Equity Industry data, and correlate to corporate America pipeline roles in the following ways: entry level/associates are entry level; senior associates are managers; vice presidents (VPs) are senior managers/directors; principals/directors are VPs; and managing directors (MDs) are senior VPs in corporate America pipeline.
Source: Women in the Workplace study, 2021

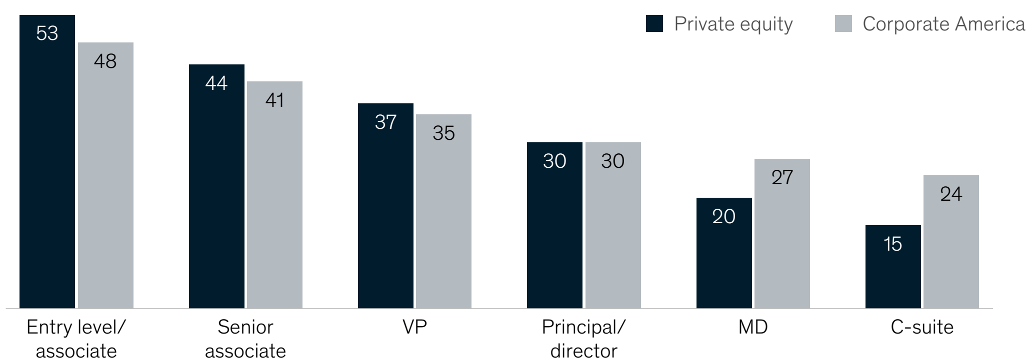
an extent at this point as in PE's talent pipeline (Exhibit 34).

Gaps in promotion parity along the pipeline limit the number of women who rise to upper management. Over the last two years, men were promoted at higher rates than women in almost all roles, with only the percentage of women promoted into the C-suite surpassing the rate of men (Exhibit 35). Statistics on the promotion of women into PE's senior ranks do suggest some positive signs: at each level above VP, the gap in percentage points

Exhibit 34

US PE is behind corporate America in gender diversity of senior leadership but leads for earlier roles.

Gender diversity in US PE vs corporate America, 2020,
% of women of workforce, by role[1]

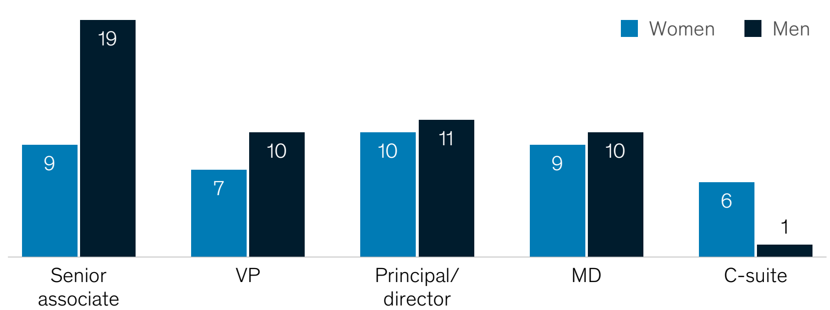


[1]Levels listed are based on McKinsey's 2021 Women in the Workplace Private Equity Industry data, and correlates to corporate America pipeline roles in the following ways: entry level/associate are entry level; senior associate are manager; VPs are senior manager/director; principals/directors are VP; and MD are SVPs in corporate America pipeline.
Source: Women in the Workplace study, 2021

Exhibit 35

In US PE, men were promoted at higher rates than women in almost all roles.

US PE promotions by gender,[1] % of employees promoted into each level, 2020



[1]Promotion rate defined as the number of people promoted into the level over the number of people at the beginning of the year in the previous level. Entry level excluded because employees are typically hired externally at this level.
Source: Women in the Workplace study, 2021

between eligible men and women being promoted narrowed in 2020 (with the gap in promotion rates growing for earlier-tenure roles).

How private markets firms are making progress
Private markets firms that lead on diversity, equity, and inclusion are focused on recruiting diverse profiles for all roles and are actively taking steps to debias hiring and promotion processes. These firms zero in on attracting talent of various ethnicities, especially those less represented in the profession, as well as retaining and promoting their strong-performing women.

One successful strategy to debias hiring and promotion processes is to be transparent about desired skills, capabilities, and above all, outcomes for each position in the investing hierarchy. By pinpointing the expected outcomes for each level, firms minimize the primacy of the style with which success is achieved, and zero in on actual achievements. Defining the results that matter for each role is crucial to broadening the lens, without lowering the bar, for candidates to receive equitable sponsorship, mentorship, debiased feedback, and ultimately, fair promotion.

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