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How LPs Approach Diligencing the ESG Capabilities of Prospective GPs

While LP approaches to ESG diligence vary, GPs should be proactive in developing ESG plans in line with their business objectives

Lucien Cipollone

Associate Partner

Capstone Partners

There has been substantial growth in the number of LPs increasing the weighting of an ESG review in their overall diligence, such that it's now one of LPs' top gating factors before adding new GP relationships to their book. Capstone tracks diligence trends as part of our engagement with LPs, and the number expanding their GP due diligence to include an ESG review has increased significantly since the start of 2020.

But not all ESG reviews are equal. Effectiveness is a product of several factors: the LP's own team's understanding of its ESG aims, the quality and quantity of ESG datapoints that satisfy those aims, and the GP's ability – both technically and legally – to provide that data.

There are differences of emphasis in ESG diligence across LP types and by geography. For example, our recent survey[1] of 140 LPs found that the majority of LPs in North America and Asia still conduct their ESG analysis through documentation review, which could imply a risk-management approach to ESG, rather than a fundamental search for the GPs with the highest ESG competencies. Only one in 10 North American LPs would accept lower returns for backing managers with excellent ESG credentials, while more than half prioritize higher financial returns at the detriment of lower ESG competencies.

LPs in Europe have a more integrated approach. They most frequently question GPs live during 'on-sites,' but the analysis is ongoing during the investment-monitoring phase of their commitment. A higher proportion (29%) would trade lower returns for better ESG credentials, with a further 29% not prepared to compromise on either returns or ESG credentials.

In terms of data gathering, nearly two-thirds of LPs globally limit their ESG review to the integration of ESG in investment processes. Just one in 10 looks at the ESG 100-day plans for investments. The remainder of LPs evenly split their focus between ESG analysis at the GP level, and specific ESG metrics that are important to them.

There are still substantial improvements that can be made. On the LP side, the persons responsible for ESG scrutiny aren't always clear about what their investment committees, stakeholders, or clients want them to achieve. Therefore, while many GPs field ESG information requests to the best of their

[1] *https://www.preqin.com/insights/research/reports/preqin-picks-capstone-partners-esg-trends-and-considerations*

ability, they often receive neither standalone nor comparative feedback on their efforts.

The lack of feedback loops between LPs and GPs is a missed opportunity. Without constructive feedback from their LPs, it's harder for GPs to improve and work toward best-in-class standards. GPs should also be proactive in developing their ESG plans in line with their business objectives, so as not to have terms that don't make sense for their businesses dictated to them through generalist approaches to ESG.

ESG is a journey, not a destination. Understanding where both LPs and GPs are on their individual paths – and what they need to do to move forward – will continue to increase the effectiveness of ESG standards across the industry.

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Lucien Cipollone joined Capstone in 2015 and is responsible for client strategy and execution for European mandates, and for distribution and client origination in the UK and Ireland.

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