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Private Market Talks:

Demystifying ESG Benchmarking with Novata's Alex Friedman

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In this episode of Private Market Talks, CEO and co-founder of Novata, Alex Friedman helps contextualize the evolving conversation around ESG and demystifies how companies and their investors assess ESG compliance and goals.

During our conversation, Alex talks about how Novata is working to develop objective data so that companies and their investors can set ESG goals, track progress and unearth how they've fared – all relative to their peers. He discusses how Novata's proprietary database aims to allow CEOs and investors to begin to set ESG benchmarks, which help public and private companies identify ESG risk factors and develop mitigation strategies.

Peter Antoszyk: Welcome to Private Market Talks, a Proskauer podcast. I'm your host, Peter Antoszyk.

ESG investing is now the fastest growing segment of the asset management industry. How do you define it? How do you measure it? How do you incorporate ESG into investing in a quantifiable and transparent manner? And, what is the future of ESG?

Here to help us answer some of these questions is Alex Friedman, CEO and co-founder of Novata. Novata is a mission-driven and technology powered public benefit company designed to improve the process of environmental, social and governance diligence in private markets. Backed by a unique consortium of companies, they have developed the means for private markets to collect, analyze and report on ESG metrics.

Prior to joining Novata, Alex was the CFO of the Bill and Melinda Gates Foundation, where he created its Social Impact Fund; Global Chief Investment Officer of UBS; and CEO of GAM Holding, a publicly listed alternatives asset manager. Alex co-founded Jackson Hole Economics and is a board member of Franklin Templeton.

You'll find a full transcript of this episode at privatemarkettalks.com, as well as links to other useful information. Please don't forget to subscribe and hit "like" after listening.

And now, my conversation with Alex Friedman. Alex, welcome to Private Market Talks. I appreciate you being here.

Alex Friedman: Thanks for having me. It's great to be here.

Peter Antoszyk: Today, we're going to talk about ESG: environmental, social and governance. ESG is an umbrella term that covers a broad range of ideas. To level set our listeners: what is ESG? How would you define it?

Alex Friedman: Basically, ESG is an acronym that stands for Environmental, Social and Governance factors, which lumps together an awful lot. One way to think about ESG is that it refers to all the material metrics that are non-financial that a company might care about, or that its stakeholders might care about.

Peter Antoszyk: Can you give some examples of what that might include?

Alex Friedman: Sure, some common examples of, say, metrics that are lumped under the acronym of ESG might include carbon emissions, clean water usage, what percentage of your energy is from renewables. What's the pay gap? What's the diversity statistics of a company? How about your worker safety record? How about your data breach record? Those kinds of questions.

Peter Antoszyk: About 30 years ago, I moderated a panel of corporate CEOs, both public and private, and what we talked about in that context was corporate responsibility, but at some point, ESG emerged as the vernacular. I'm kind of curious from your perspective, when did ESG emerge and why?

Alex Friedman: It's a great point that you point out that these issues have been around for a long time and arguably, they've been around as long as companies have been around. 100 years ago, investors would have cared about a lot of the same issues that today get lumped under the acronym ESG. They would have cared to know, "Do you have happy employees? Is there a lot of turnover net attrition?" all of which are ESG factors. They would have wanted to know "Do you have some big environmental liability?" because it's going to cost money to fix it. They would have wanted to know about worker safety. These are issues which have been around forever under different headings. CSR was certainly one, over say, 20-30 years ago. ESG became most commonly heard of in the last 10 years.

Peter Antoszyk: I was thinking that an outgrowth of the GFC, the Great Financial Crisis, when there was this economic upheaval of foreclosures, savings wiped out and effectively, no accountability – no material accountability – and ESG seemed to emerge as an influential way of addressing some of these perceived inequities.

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Alex Friedman: That's a great point and it speaks to the broader history of economic history around how new policies, whether from the government or from stakeholders, are adopted, and they tend to come from crises. If you go back to the Great Depression, it was out of that period that so much regulation was spawned that the SEC came about, that GAAP accounting and IFRS became the common standards which changed 100 years of capital markets. I think coming out of the Great Financial Crisis, there was an increase of what was already building, starting with Enron, MCI and some of the challenges around 2001 regarding confidence and what management teams were doing and then further amplified after the financial crisis, which pushed the ESG factors more to the forefront.

Peter Antoszyk: It's interesting. I was reading in preparation for this that Morningstar reported that global ESG fund assets reached about $2.5 trillion at the end of 2022, and ESG investing is now the fastest growing segment of the asset management industry. What do you think is driving that growth today?

Alex Friedman: It's a really interesting question. I think it's a bit of a fallacy to demarcate ESG investing as a specific kind of investing. I think what ESG investing is, is really just the recognition that there are factors beyond pure financial returns, which matter to whether a company is a good long-term investment or not. We maybe went a little off course with the Milton Friedman kind of paradigm, which was summarized as the only thing that matters is shareholder returns. That [paradigm] got interpreted over the generations to mean: "Okay, financial return, at all cost." Whatever else you have to do is fine. It was justified; ends justify the means. The problem is, over a long period of time, companies can't operate that way because they'll cut corners for short-term returns that eventually will catch up to them. So, I think what we're seeing with the kind of rise of ESG investing, is a catch up of recognition that those factors matter to a company's long-term success and therefore to investors' long-term interests.

Peter Antoszyk: Milton Friedman said the social responsibility of a company is to grow profits. But, he also said that within the basic rules of a society are those embodied in law and those embodied in ethical considerations. So, I think that even Milton Friedman would support as part of the profit motive, ESG considerations.

Alex Friedman: You make a great point. We tend to focus on just particular elements of big sayings or big people. I lived in Europe for 10 years where I ran an investment firm, and I would often find myself amazed at the backbone of the economy there, of a lot of these continental European countries like Germany, which had private mid-sized companies that have been around for like 50 or 100 years. They even had a name for them: the Mittelstand. And the reason they were around so long is because the way they ran their business was: if we want to be around in 50 years, how are we going to treat all of our stakeholders that matter? And they viewed how they treated their suppliers as just as important as the profits they made because they said, "Hey, we can't operate it [our business] if suppliers don't want to work with us." And somewhere, we lost that talk track, a bit in the US.

Peter Antoszyk: It seems common sense almost, doesn't it?

Alex Friedman: Exactly, which is why I think this political debate over ESG is really misplaced. The metrics that ESG is trying to highlight are common sense metrics that pretty much everyone was taught to care about 30 years ago, 50 years ago – well before there was this acronym.

Peter Antoszyk: ESG is not without its critics. In fact, it seems to be having some impact, at least in the United States, in terms of a net outflow of ESG funds to the tune of about $12.4 billion in the past 12 months. But in Europe, there has been a significantly greater inflow of ESG funds. What do you think accounts for that?

Alex Friedman: I guess the first point I would make is that if I go to a doctor and I say I'm not feeling well, and the doctor says, "Alright, I'm going to ask you a whole bunch of questions to try to understand what's causing you not to feel well, but I can't ask you some questions because I'm told they're not ones I'm allowed to ask." And I would say, "What are you talking about? You can ask me any question you want. You and I will decide what we want to do with the information." To me, the idea that political pressure in the United States in particular is saying, "Hey investors. You can't ask certain questions." To me, it's just misplaced. It doesn't make sense. Asking questions is not the problem. It's good to gather information. In Europe, I think what you're seeing is, point number two; the regulatory regime is driving the story. So, SFDR and soon-to-be CSRD now require private companies of certain size to start reporting on important non-financial metrics, and that's causing a lot of firms to say, "We can't ignore these kinds of ESG metrics. We've got to get our arms around them." The US has started a little bit down this path. But to your point, it's become very political, and so right now, there's kind of a pause, I guess is one way to put it.

Peter Antoszyk: One of the biggest challenges around defining ESG, or some of the challenges around ESG are compounded by the fact that there isn't a universal, objective, rigorous framework for measuring ESG. Is that what led you to found Novata?

Alex Friedman: It certainly has some elements of it. I first started working on these issues back in '07. I was at the Gates Foundation. I worked as the CFO, and I oversaw an investment fund where we tried to make investments for profit enterprises that were also consistent with the mission of the foundation. It's kind of a double bottom line approach. We struggled to identify what would determine factors that matter outside of pure financial returns, and over the subsequent decades, in various roles, I continued to struggle, because there has not been, as you point out, a clearly defined set of: this is good; this is bad. That's the crux of the issue, that there never will be those things. It's a relative kind of equation. So, how is one company doing versus its peers? The challenge is most of the time investors don't have that information, and that's especially true in the private markets, which is where the engine of capital really operates. The nine out of ten jobs or so or in private companies. Private companies exist in like a Plato's Cave – in isolation. They have very limited information about how they're doing.

So if you think of a company as having an effect on the community it operates in, in terms of say its environmental footprint or how it treats its employees or its stakeholders, it's really imperative to start getting accurate information for private companies and then enabling them to benchmark against each other, and that's what we set up Novata to do.

Peter Antoszyk: Before we get to *exactly* what Novata does, I understand it's a consortium? Can you describe that and how it came together?

Alex Friedman: Novata was designed to be kind of a neutral intermediary, almost like a stock exchange, that solves problems that are common problems that lots of participants in the private market's ecosystem face. In order to be truly neutral, we set it up as a consortium of players, all of whom were wrestling with these same issues where no one is a majority owner. They all own a piece of it, and it's both a public-private set of backers. So, for instance, the Ford Foundation, the largest social justice foundation, which leads on this on the foundation side, along with the Omidyar Network, and then it's companies like Hamilton Lane – the largest intermediary in the private markets – S&P Global, Microsoft.... We have about half a dozen clients of Novata that are private equity firms that invested from their partners' capital. And we have banks that have invested in Novata. So it's a public-private consortium setup where they've invested very long-term capital.

Peter Antoszyk: And what exactly do you do?

Alex Friedman: Well, we do three things. One, we make software that is designed for private equity firms and private credit firms, venture firms, growth, equity firms, to enable them to easily have their portfolio companies, groups they invest in, figure out which ESG metrics matter and how to calculate that data. That's number one. Number two, that data is then easily stored in a secure place where it can be contextualized. So, we provide benchmarks which allow users of the data to understand where they might have problems that they need to get better at, where they're doing really well. Third, we add a whole set of analytics on top of that to allow users to design action plans to solve problems, reach targets, and report to stakeholders.

Peter Antoszyk: Can you give me an example of how you know a private credit fund or private equity fund might seek information and how they might use data?

Alex Friedman: Let’s say you have a mid-size private equity firm. They own 50 companies or 30 companies. Let’s say, they would identify first, what are the metrics that we as the GP care about? Sometimes, those metrics are suggested to them by, say, regulators. So, under SFDR in Europe, there is a whole set of material metrics that they have to track, or in the United States, there is an industry group that tracks certain metrics. Our software will build a query based off those metrics, and for each of the metrics that GP cares about, there will be a paint-by-numbers type of process by which a user, each of their portfolio companies, almost gets their hand held to walk through and calculate each of the metrics with guidance with the integrated calculators, scope one through three emissions calculators, for example.

Then, it will produce a nice report, and the GP can then look at how their individual companies compare to each other, look at a particular metric that can say, alright, let me see my scope-to-emissions for all the companies I own, which companies are doing the best, and which are the worst? And then, once I figure out who’s good and who’s bad in my portfolio on this metric, let me see how they compared all my peer companies. We can do that, and then, they can say, let me see how they compare to their peer public companies.

And then they say all right, I want to design an action plan to reduce my scope-to-emissions for these three companies. What will the action plan look like? What are the targets? When should they be achieved? How do we do it? Those are the kinds of things they use this for.

Peter Antoszyk: I think you mentioned equality and compensation or other factors like that. How do you gather that information? How does that information get developed?

Alex Friedman: Each company has that information. They report it. We anonymize it. It all gets built into benchmarks. So, then a user can see, alright, for my kind of diversity of say, my management team, how do I compare to 30 companies in my industry that are also private and about the same size? And they can see the anonymized data, which is the first step in deciding: Do I think I’m well positioned? Do I want to make a change? Do I have to get better?

Peter Antoszyk: Is this also used in the diligence process in addition to the monitoring?

Alex Friedman: Thanks for bringing that up. It absolutely is. When investors and private equity firms are considering making an investment, they will use the software to look at the particular company they're considering investing in, to try to identify the key risk factors. They might not be called ESG factors, but they're risk factors, and then understand how this target company compares to its peers because there is going to be a financial impact. The key piece here is that these ESG metrics have material financial implications, but in order to try to understand what they are, you have to be able to benchmark what the data means. Let me give you an example. Let's say a private equity firm is thinking about buying a company that makes widgets, and when they do their ESG analysis, it turns out that the factory uses all of its energy from, say, coal – which has no renewable energy. They know that over time, the pressure to have some of their energy sources be from renewable energies is going to grow. That's a very clear secular tailwind. If that's the case, they're going to have to start modeling into their financial assumptions what the cost implications are. Put another way, let's say there is a big worker safety issue. They're going to have to improve on that. Or a data breach issue. They have to improve on that. Those are real financial costs. So, they have to potentially adjust their assumptions on earnings and those are quite material.

Peter Antoszyk: My understanding is that you have just developed some data that you're going to be releasing to your clients, is that right?

Alex Friedman: Yes. We have about 4000 companies using this platform and contracted to use the platform, and we build benchmarks off of the data that they contribute. We anonymize it, and we're releasing about 250-odd benchmarks next week, about 40 universal metrics, and then 200-plus sector-specific metrics, which will be the broadest set of ESG metrics in the private market. We're really excited about that because it becomes the beginning of shedding light on this Plato's Cave problem.

Peter Antoszyk: How does what you produce (your metrics) compare to some competitors? For instance, the regulatory agencies are presumably producing data on this as well. Can you compare and contrast?

Alex Friedman: We set up Novata because there was a missing key, which is actual data contributed by the data owners and then anonymized to create benchmarks. The data that exists today is largely data that's been hypothesized or scraped, and the way it works often is, big companies, ratings agencies, big data companies will take public company data, public company information, and they'll then try to normalize it. For private companies, they'll say, alright, if you're in the same industry, and you have a smaller number of employees, and you're basing these regions, then your mission should look like this. Or we think your diversity numbers look like this. That tends not to be very accurate, but it's all that has existed to date, because if you're a private company, you don't report this anywhere. So, until efforts like Novata reached critical mass, there has been no way to actually create accurate benchmarks around material, non-financial data, which is why this is such an important kind of inflection point for the issue.

Peter Antoszyk: Interesting. Is it fair to say that the data existed previously was well-defined or better defined for public companies, but for the private companies, less so?

Alex Friedman: Not even.

Peter Antoszyk: —Not even. Okay.

Alex Friedman: Even for the public companies; it is really poor. Let me give an example. If you take the top four groups that do, say, ESG rankings for a Fortune 100 company, and you look at the correlations on a particular ratings report. The correlations tend to be around .5, so that's like flipping a coin. If you take bond ratings for that same company, the correlations are like .92 and up .95, etcetera. So it's very poor information, and that's often because it's a combination of guessed, hypothesized, scrubbed, some combination thereof, and then the rankings themselves are quite subjective because it depends on what the group doing the rankings decides are the most important factors. So, we don't do rankings. That's a critical point. Novata is a set of tools to enable benchmarking off actual data. It's very different than a third party saying "here's what's important."

Peter Antoszyk: So, you're releasing this data. What would you say are some of the key takeaways?

Alex Friedman: We've had a really a great time trying to scrub the data and take out a lot of insights. A few key takeaways are private equity is an engine of net job creation, which is a surprise to a lot of folks who read the media and might think, well, private equity is about buying a business and firing lots of people and cutting costs, a big destruction of human capital. It's actually the opposite. We see huge net job creation numbers. There are a whole bunch of other insights which we're going to release, but I probably should wait until we put the report out.

Peter Antoszyk: You can give us a few, but I will tell you on that last point that you just said, that it's been my view that private equity industry at large has done a poor job — and I don't like the word "marketing" itself — but private equity hasn't done a good job of explaining what it does well, and I think some of the metrics that you're talking about really bring to light the private equity industry being job creators, which is contrary to the narrative that is generally out there for private equity funds.

Alex Friedman: The thing you have to remember, Peter — perhaps you know it already — and in our case, we learned it this time, is that most of the firms we work with, this is the first year in which they're collecting a lot of this information. So, these thousands of companies that are reporting through Novata, this is their first reporting season of trying to get their arms around this set of metrics.

Peter Antoszyk: How do you think ESG will impact the future of business over the next one to three years?

Alex Friedman: Well, one to three years is a very near-term time horizon. Can I take a little bit of a broader time horizon?

Peter Antoszyk: Of course.

Alex Friedman: Let’s say like five plus years. I guess I think this is a very analogous period to where we were in the early ‘30s, with the introduction of GAAP accounting. So, before GAAP, companies reported on whatever they wanted; they might have reported on their revenues, their profits, number of employees they had, literally anything they wanted, and with GAAP accounting, there was kind of a standardization, which enabled for really the supercharging of the capital markets, because you had trust and confidence. There were entire industries spawned out of it. The accounting industry became what it is and so many other services. To me, what we’re seeing right now, especially in Europe, is a period of time just like that, where all of a sudden what a company is expected to report on changes fundamentally, and there’s no going back. And this time it’s not just public companies. It’s private companies, too. And that makes a lot of sense from the perspective of good public policy because, as you know, the tragedy of the commons issues, they’re not affected just by public companies, right? It’s anyone who is an enterprise. So, for example, climate issues: every company has a role to play in solving climate problems. Social justice issues, stability of society issues, all of that. I think we’re at an inflection point where business changes in terms of what it reports on, and therefore ultimately how it will address its own areas of challenge, because you can’t improve on something you don’t measure, as so many people have said, such as Peter Drucker and others.

Peter Antoszyk: For someone, either capital allocator or CEO, if they want to start getting smart on ESG, would you suggest a book, or a way to get started?

Alex Friedman: Shameless plug. Go to Novata.com. We have an incredible resource library, free resources, and e-books on all these issues. And we can get you up to speed, real fast and free.

Peter Antoszyk: Great. Fantastic. What non-ESG book or podcast would you recommend to a friend?

Alex Friedman: I think it would have to be yours.

Peter Antoszyk: [Laughter] There you go. I do appreciate that, but there are others. Do you have any others?

Alex Friedman: Well, if you're going to reach way down there, I mean, I like *The Daily* from *The New York Times*. *Smerconish*, I think is pretty good. There's no shortage of them.

Peter Antoszyk: Excellent. I appreciate your time. I appreciate you spending the time with us and explaining Novata to us. I think that your mission is really important. We'll have a very material change on the future of the businesses, certainly those that subscribe to your platform, so congratulations, you're doing good work.

Alex Friedman: Thank you so much, and thanks for having me.

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