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## Private Equity and ESG in Switzerland: A Lasting Union

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# Private Equity and ESG in Switzerland A Lasting Union

The integration of environmental, social, and governance (ESG) factors into private equity (PE) strategies has transitioned from a regulatory or reputational consideration to a cornerstone of long-term value creation. This evolution is particularly pronounced in Switzerland, a nation known for its economic stability, advanced financial infrastructure, and firm commitment to sustainability. Both international and domestic private equity firms are increasingly recognizing Switzerland as a prime investment destination, leveraging its innovation-driven economy while adhering to stringent ESG standards. This article explores the dynamic relationship between private equity and ESG in Switzerland, highlighting the growing importance of ESG considerations, and the regulatory frameworks shaping this sector.

**The Swiss Investment Landscape**

Switzerland's political neutrality and economic resilience make it a stable haven in a volatile global economy. It consistently ranks high in global innovation indexes, thanks to its top universities, numerous R&D institutions, and entrepreneurial culture. Sectors like biotechnology, cleantech, and fintech flourish here, attracting private equity firms seeking high-growth, ESG-aligned investments.

Despite aligning tax reforms with OECD standards, Switzerland remains tax-efficient for holding companies. Its cantonal tax regimes offer flexibility for optimizing structures while complying with international guidelines.

Switzerland's banking and financial infrastructure provides expertise, capital, and tailored services for private equity investors. This, combined with a highly educated workforce and advanced digital capabilities, ensures efficient capital deployment across various industries.

Switzerland offers access to major European markets while staying autonomous from the EU. Its extensive trade agreements and competitive regulatory framework make it a strategic hub for cross-border transactions and private equity investments.

**The Growing Importance of ESG in Private Equity**

Private equity has traditionally focused on maximizing financial returns, but the industry is experiencing a significant shift. ESG considerations are no longer secondary; they are now central to the investment process, driving value creation and competitive differentiation. This transformation is influenced by several factors:

Limited Partners (LPs), including pension funds, sovereign wealth funds, and family offices, are increasingly prioritizing sustainability in their investment allocations. These LPs expect General Partners (GPs) to implement robust ESG policies and provide transparent reporting on the progress of their portfolio companies.

Governments and international organizations are enforcing stricter sustainability guidelines, compelling private equity firms to integrate ESG factors into their investment strategies. This is particularly evident in

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Switzerland, where ESG reporting is becoming a fundamental aspect of corporate governance.

ESG frameworks enable firms to anticipate and mitigate risks such as supply chain disruptions, climate-related liabilities, and reputational damage. By proactively addressing these risks, private equity firms can protect the long-term value of their investments.

Moreover, ESG initiatives often lead to operational improvements, such as reduced energy consumption, streamlined supply chains, and enhanced employee productivity. These efficiencies directly impact financial performance, generating measurable returns for investors.

**ESG Reporting Obligations in Switzerland and the EU**

***Swiss Regulations***

In January 2022, Switzerland saw the introduction of new ESG regulations on non-financial reporting obligations as well as due diligence and reporting obligations in connection with child labour and mineral and metals from conflict areas. Depending on their size and significance, certain companies must adhere to these new ESG reporting obligations.

Swiss businesses of public interest must produce an annual, public ESG report addressing non-financial issues. This requirement primarily applies to listed companies and banks that, along with their controlled domestic or foreign businesses, have an average of at least 500 full-time positions annually over two years and either sales revenue exceeding CHF 40 million or a balance sheet total of at least CHF 20 million. The report covers non-financial issues such as business strategy, emerging environmental threats, employee and human rights concerns, and the due diligence steps taken to address ESG issues. Compared to companies of public interest, SMEs are not yet required to issue such an ESG report. However, additional due diligence obligations apply to companies (including SMEs) with their registered office, head office, or primary place of business in Switzerland that process or import specific minerals or metals from conflict or high-risk regions. Similar obligations apply to Swiss companies providing goods or services suspected of involving child labour in their production. SMEs are exempt from due diligence obligations regarding child labour if their balance sheet totals, sales revenue, and full-time employees fall below certain statutory thresholds.

Due diligence obligations concerning child labour are expected to be particularly significant for private equity firms looking to invest in specific businesses. Going forward, it is strongly advised that private equity buyers also prioritize the new reporting requirements during their due diligence analysis of potential acquisition targets.

The new executive regulation on climate reporting in Switzerland, effective from 1 January 2024, mandates large companies, including public companies, banks, and insurance firms with 500 or more employees, at least CHF 20 million in total assets, or more than CHF 40 million in turnover, to disclose their climate-related activities. Companies must report on the financial risks they face due to climate change, the impact of their business activities on the climate, and their targets for reducing direct and indirect greenhouse gas emissions along with the strategies to achieve these targets. The regulation aligns with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD), ensuring that the disclosures are comparable and transparent. Additionally, companies need to consider both the

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financial impact of climate risks on their business and the impact of their business on the climate, following the principle of double materiality. This regulation aims to enhance transparency and accountability, helping stakeholders make informed decisions and promoting sustainability in the financial sector.

***EU Regulations and Future Developments***

The EU has positioned itself as a leader in implementing comprehensive ESG reporting regulations, aiming to enhance transparency, accountability, and sustainability in corporate practices.

One of the cornerstone regulations is the Corporate Sustainability Reporting Directive (CSRD). This directive mandates that all large companies with over 250 employees, EUR 50 million in turnover, or EUR 25 million in total assets, including listed companies, must report on their environmental performance, social responsibility, governance structures, and risk management. The phased implementation of the CSRD began in January 2023, with full compliance expected by 2025.

Another significant regulation is the Sustainable Finance Disclosure Regulation (SFDR), which targets investment managers. The SFDR requires these managers to disclose how they integrate ESG risks into their investment decisions. Currently under review, the SFDR may undergo changes to align more closely with the UK's Sustainability Disclosure Requirements (SDR).

The Corporate Sustainability Due Diligence Directive (CSDDD) focuses on companies with significant operations in the EU, requiring them to identify, prevent, and mitigate adverse sustainability impacts. Companies with over 5,000 employees and €1,500 million in turnover have a three-year timeline to comply with these requirements. The CSDDD holds significant relevance for Switzerland, particularly for Swiss companies operating within the EU market. Although the directive is an EU initiative, it also applies to non-EU businesses that meet certain criteria, such as having substantial operations or turnover within the EU. This means that Swiss companies with significant business activities in the EU will need to comply with the CSDDD's requirements to identify, prevent, and mitigate adverse human rights and environmental impacts in their operations and value chains. For Swiss businesses, this directive represents both a challenge and an opportunity. Compliance will necessitate robust due diligence processes and may involve additional administrative and operational costs. However, it also offers the chance to enhance corporate reputation, build customer trust, and align with global sustainability standards. Furthermore, aligning with the CSDDD can help Swiss companies stay competitive in the EU market by meeting the growing demand for sustainable and responsible business practices.

Looking ahead, the EU is considering consolidating various ESG reporting obligations, such as the CSRD, the EU Taxonomy Regulation and the CSDDD, into one single regulation to simplify compliance for businesses. New regulations are also on the horizon, such as the Green Claims Directive, which aims to prevent greenwashing by ensuring environmental claims are clear and substantiated, and the Deforestation-Free Products Regulation, which imposes due diligence obligations on companies importing critical commodities to ensure they do not contribute to deforestation. Efforts are also ongoing to align EU regulations with global standards, such as those set by the International Sustainability Standards Board (ISSB), to facilitate global compliance.

***Switzerland's Alignment with EU Standards and Future Developments***

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Switzerland is actively aligning its sustainability reporting standards with the EU's CSRD. The Swiss Federal Council has initiated a consultation process to further align Swiss sustainability reporting obligations with the EU CSRD, aiming to enhance transparency and comparability of non-financial information, which is crucial for stakeholders.

One key development is the increased scope of entities required to report on sustainability, expected to rise significantly from around 200 to approximately 3,500. Additionally, Swiss companies will need to provide more detailed sustainability disclosures, potentially aligning with the EU's European Sustainability Reporting Standards (ESRS). Sustainability reports will need to be published in an electronic format that meets international standards, and there will be a requirement for external verification to ensure their reliability.

The consultation process is set to conclude in 2024, with new requirements potentially coming into force by 2027. Swiss companies are advised to start planning for these changes now, including assessing current reporting practices and identifying areas for improvement.

The EU Sustainable Finance Disclosure Regulation (SFDR) is also relevant in this context. The SFDR aims to improve transparency, reduce greenwashing, and promote sustainable investments by requiring financial service providers, asset managers, and owners of financial products to assess and disclose ESG considerations publicly. This regulation helps investors make informed decisions by providing clear information on how sustainability risks are integrated into investment processes and the potential adverse impacts of investments on sustainability.

Switzerland is working to align its standards with the SFDR by adopting similar transparency and disclosure requirements. This includes ensuring that financial market participants and financial advisers disclose how they integrate sustainability risks and consider adverse sustainability impacts in their investment decision-making processes. The alignment will also involve adopting the SFDR's requirements for pre-contractual and periodic disclosures, which will help improve the comparability and reliability of sustainability-related information across the financial sector.

This alignment with EU standards is seen as a logical step for Switzerland, given the interconnected nature of the European and Swiss economies. It also provides Swiss companies with the opportunity to enhance their sustainability practices and gain a competitive edge in the market.

## ESG Integration in Private Equity Investments

***Due Diligence and Valuation***

Incorporating ESG considerations into private equity due diligence has significantly expanded the scope and complexity of the process. Traditional due diligence, once focused on financial metrics, operational performance, and legal risks, now includes a thorough examination of ESG factors. These elements are increasingly recognized as critical to understanding a target company's long-term viability and risk profile.

Private equity firms need to assess the regulatory compliance of target companies, focusing on Swiss and EU ESG regulations. This includes identifying potential liabilities like environmental remediation costs and

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human rights violations, and evaluating the target's readiness for reporting obligations. Non-compliance or ESG-related litigation can significantly impact deal valuations and future cash flows.

Reputational risks related to ESG performance are increasingly important. Stakeholders are scrutinizing corporate behaviour more closely. Companies with strong ESG profiles are less likely to face reputational damage, while poor practices can lead to public backlash and loss of market share. PE firms now include ESG reputation analyses in their due diligence to ensure targets align with their investment principles and LP expectations.

ESG factors are now seen as value drivers, not just risk mitigators. Companies with strong sustainability practices benefit from better operational efficiency, customer loyalty, and employee engagement, leading to improved financial performance. Investors are willing to pay a premium for companies with robust ESG credentials, recognizing their potential for long-term resilience and growth. For PE firms, showcasing a target's ESG maturity can result in better negotiation terms and attract more investors for future exits.

Poor ESG performance can lead to valuation discounts or extra costs during transactions. Addressing ESG shortcomings, like upgrading environmental standards or improving workforce policies, can reduce deal margins.

#### *Portfolio Management and Exit*

Post-acquisition, ESG considerations are crucial for private equity firms in managing portfolio companies. These requirements shape both operational strategies and exit planning.

PE firms often identify ESG initiatives to enhance performance and reduce risks. For example, upgrading facilities or using renewable energy can lower costs and carbon footprints. Improving workforce diversity can boost morale, productivity, and reputation. Implementing sustainable sourcing practices can mitigate risks tied to supply chain disruptions or regulatory scrutiny.

ESG KPIs are used to track progress, comply with reporting obligations, and demonstrate measurable impact to investors. A strong ESG profile can lead to favourable financing options like sustainability-linked loans or green bonds, aligning financial terms with ESG performance.

PE firms can command a valuation premium by highlighting their achievements in ESG areas. These achievements include compliance with global standards, improved operational efficiency, and enhanced brand reputation. Conversely, poor ESG preparedness can limit exit opportunities and reduce valuations.

At the exit stage, ESG factors significantly influence a portfolio company's attractiveness to buyers, particularly large corporates and institutional investors. To maximize exit value, PE firms integrate ESG considerations from the outset. This integration involves developing long-term ESG roadmaps, engaging third-party experts to validate improvements, and crafting ESG narratives that align with market trends and investor preferences.

### ESG Challenges for Private Equity

Integrating ESG principles into private equity presents several challenges. One major issue is data

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management. Collecting and managing ESG data across diverse portfolio companies is complex because each company operates in different sectors with unique risks and regulatory requirements, making consistent, high-quality data aggregation difficult.

Standardized ESG reporting is also a significant hurdle. The lack of harmonized reporting standards complicates ESG reporting, especially for firms with international investments. Different regions have varying regulatory requirements, making it challenging to maintain consistency.

The scale and composition of portfolios add another layer of complexity. Large, diversified portfolios require tailored ESG strategies. The material ESG factors can vary significantly across industries, making it difficult to apply uniform metrics.

Perception and buy-in are also critical issues. There is sometimes a misperception that focusing on ESG is at odds with fiduciary duties. Additionally, the risk of "greenwashing," where ESG measures are seen as superficial, can undermine genuine efforts.

**Focus: Adoption of AI for ESG**

As ESG considerations rise to the forefront of PE transactions, the adoption of AI is proving transformative. With mounting regulatory pressures, increasing investor scrutiny, and a global focus on sustainability, AI offers PE firms the ability to manage ESG challenges with greater precision, efficiency, and insight. From due diligence to portfolio management and exit planning, AI is reshaping how ESG factors are integrated into the private equity lifecycle.

***AI in ESG Due Diligence***

The due diligence phase of private equity transactions is increasingly influenced by ESG factors, but traditional methods can be resource-intensive and subjective. AI-driven tools can address these challenges.

AI algorithms can analyse vast amounts of structured and unstructured data—including regulatory filings, news reports, social media, and ESG ratings—to uncover hidden risks. For instance, natural language processing (NLP) tools can detect potential controversies related to environmental practices, labour conditions, or governance issues that might not be apparent through conventional research.

As ESG regulations evolve, AI ensures that due diligence processes remain aligned with the latest legal and reporting standards. Machine learning (ML) models can flag discrepancies between a target company's ESG disclosures and regulatory requirements, helping PE firms identify potential liabilities.

AI tools enable the comparison of a target's ESG performance against industry peers, providing PE firms with a clearer understanding of the target's relative positioning and long-term sustainability. By using AI to quantify ESG risks and opportunities, firms can make more informed decisions about valuation and negotiation strategies.

***AI for Portfolio Management***

Once a deal is closed, AI becomes essential for managing and enhancing ESG performance across

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portfolio companies.

AI platforms automate the tracking of key ESG metrics, such as carbon emissions, energy usage, workforce diversity, and supply chain risks. This enables consistent, real-time reporting and reduces the administrative burden on both portfolio companies and fund managers.

Machine learning models identify patterns and correlations that inform ESG strategies. For example, AI might reveal that investments in energy-efficient technologies lead to faster cost recovery in certain sectors or that improved employee retention rates correlate with specific workforce policies. These insights empower PE firms to implement targeted ESG improvements that drive both impact and financial returns.

Climate risk is a critical ESG concern, especially for industries exposed to regulatory or physical climate challenges. AI can model various climate scenarios, enabling portfolio companies to stress-test their operations and develop mitigation strategies. This reduces risk and aligns with investor expectations for proactive climate governance.

AI-powered platforms simplify ESG reporting by consolidating data from various sources and aligning it with global frameworks like the Task Force on Climate-related Financial Disclosures (TCFD) or the EU Sustainable Finance Disclosure Regulation (SFDR). By automating data collection and reporting, PE firms can ensure accuracy and consistency while freeing up resources for strategic decision-making.

***AI in Exit Planning***

AI also enhances the exit process by maximizing value and broadening buyer appeal. AI tools help PE firms craft compelling ESG narratives backed by robust, data-driven evidence. For instance, AI can showcase improvements in a portfolio company's sustainability metrics over time, illustrating its alignment with market demands and regulatory expectations.

AI-driven market intelligence helps PE firms determine the optimal time to exit based on ESG trends and market sentiment. Companies with strong ESG performance are more attractive to institutional investors and strategic buyers who prioritize sustainability. AI tools can identify and engage with potential buyers whose ESG objectives align with the portfolio company, increasing the likelihood of a successful transaction.

***Challenges***

While AI offers transformative potential, its use in ESG for private equity comes with challenges. AI's effectiveness relies on high-quality ESG data, which can be inconsistent or incomplete across industries and geographies. Ensuring AI models are free from bias is crucial, especially when evaluating qualitative ESG factors like diversity and inclusion. Additionally, implementing AI-driven ESG tools requires significant investment in technology and expertise, which can be a barrier for smaller PE firms.

## Conclusion

Integrating ESG into due diligence, portfolio management, and exit planning has shifted from compliance to a strategic necessity. Firms embedding ESG throughout their investment lifecycle mitigate risks and

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seize emerging opportunities. The regulatory landscape in Switzerland and the EU highlights the need for robust ESG frameworks and transparent reporting. Embracing these changes enhances investment strategies, drives sustainable growth, and fosters a resilient financial ecosystem.

AI adoption in ESG management is transformative. AI tools enhance due diligence by uncovering hidden risks and ensuring regulatory compliance. In portfolio management, AI tracks ESG metrics in real-time, identifies improvement patterns, and simplifies reporting. During exit planning, AI crafts compelling ESG narratives and identifies optimal exit opportunities. However, AI's effectiveness relies on high-quality data and unbiased models, requiring significant investment.

The evolving union of private equity and ESG in Switzerland, supported by AI innovations, sets a global standard for sustainable investment practices.

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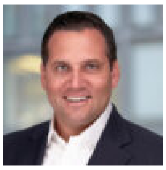


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