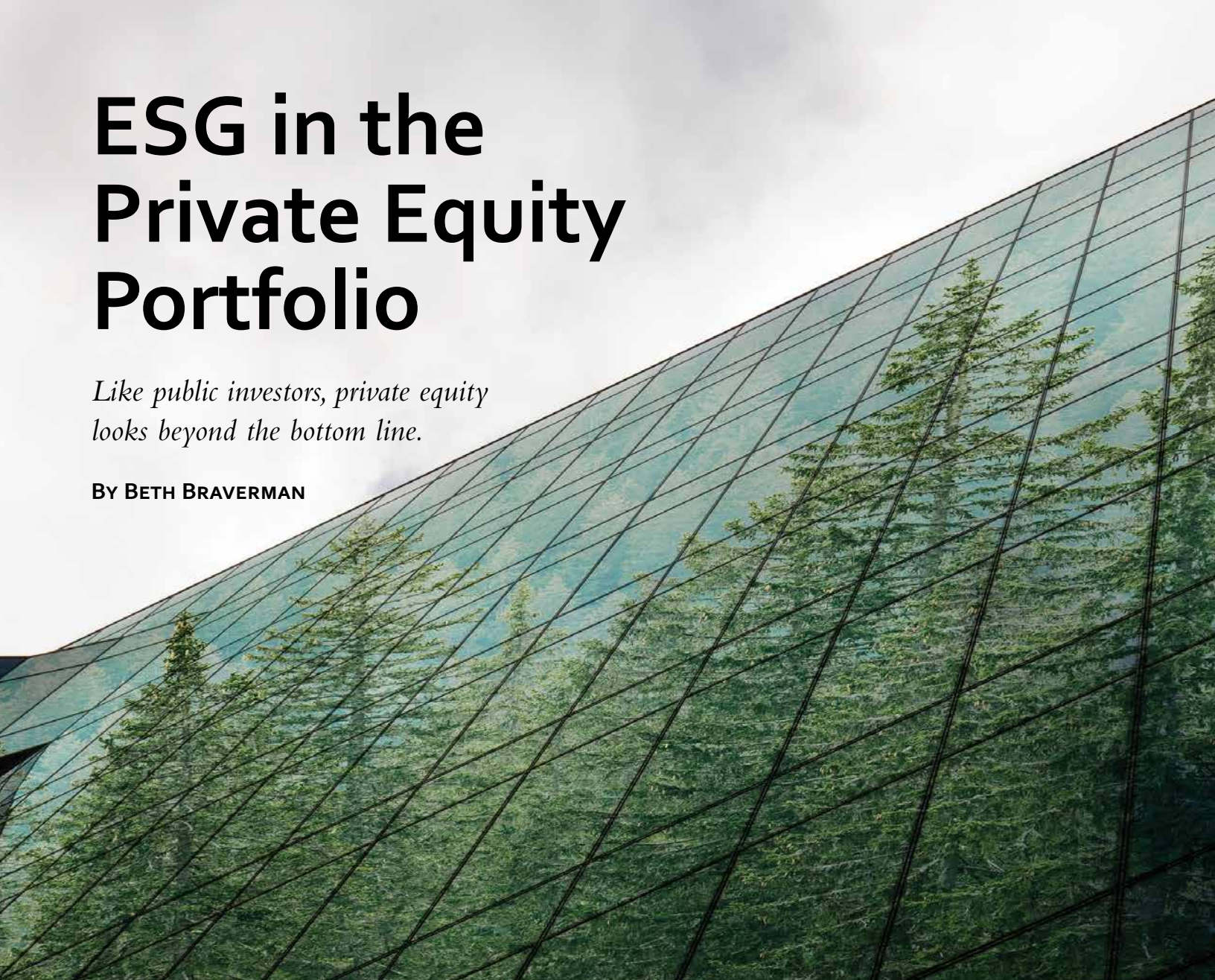


ESG in the Private Equity Portfolio

Like public investors, private equity looks beyond the bottom line.

BY BETH BRAVERMAN



MidOcean Partners has always taken a deep dive into factors that include environmental responsibility, employee diversity and safety management as part of its due diligence on investments.

This year, the private equity firm added a page specifically dedicated to such environmental, social and governance issues (ESG) to its investment committee memo.

“We’re looking at these areas anyway, but highlighting them in one section helps promote some additional conversations in investment committee meetings,” says Candice Richards, the firm’s compliance officer. “We’re seeing enhanced willingness to

talk about these issues across the industry. Post-acquisition, there is increased engagement with our portfolio companies and executives across the platform.”

MidOcean isn’t the only private equity firm that’s viewing its investment selection through a sustainability lens. Nine in 10 private equity firms recently surveyed by PwC said they have adopted or are developing a responsible investment policy, and more than a third have teams dedicated to making responsible investments. More than half of firms reported that their entire investment team receives responsible investment training, up from just 29% in 2013.



While responsible investing began decades ago with a focus mostly on excluding certain industries or regions (such tactics are widely credited as a factor in ending apartheid in South Africa, for example), the practice has evolved significantly since then.

“In the early days, when institutional investors began to focus on ESG issues, exclusion was the easiest way to make portfolios more ESG compliant and address headline risk,” says Nitin Gupta, a managing partner at Flexstone Partners, the private investment arm of Natixis Investment Managers. “But exclusionary approaches are inherently passive and a bit of a blunt instrument, which might unnecessarily limit both investors’ returns and their ability to make a positive impact.”

In the private equity world today, firms are considering ESG factors as a means of adding value to both current and potential portfolio companies. They are also launching impact funds, which are devoted to purchasing companies that are making a measurable impact toward a specific goal.

While it may have begun in niche funds or firms, responsible investing is now becoming a ubiquitous part of portfolio analysis throughout the industry. Momentum has picked up considerably among American PE firms, experts say, following a trend that’s already taken hold in Europe and Japan.

“There are a large number of impact funds being developed, but even funds that are not specifically des-

FINDING THE POTENTIAL ESG VALUE

The more that private equity firms make ESG factors a part of their due diligence process, the more value they see in the process.

"It becomes self-perpetuating," says David Korngold, a director at BSR, a nonprofit that works with companies on sustainable initiatives. "What might have started as an [investor] request grows into a recognition of the ESG business value and risk management value and the ancillary value created by ESG efforts."

He points to a Harvard Business School study that found companies with sustainability strategies that target material ESG issues outperform with estimated annualized alphas of 4.83%.

PE firms aren't simply looking for companies that perform well on ESG factors. There may be more opportunity for them to zero in on those companies that have a less-than-stellar track record on such factors.

"There's a case to be made for looking at companies that aren't faring as well on the ESG side, and then bringing our expertise to advocate for meaningful change once under our ownership," says Candice Richards, compliance officer at MidOcean Partners. "While implementing change can take time, hopefully there is a great story to tell at exit, not just for our LPs, but for management teams, employees and broader communities where our portfolio companies operate."

It's also a trend that's likely to continue. In a recent McKinsey study, 83% of C-suite executives and investment professionals said that they expected the impact of ESG programs on shareholder value to increase over the next five years, and that they'd be willing to pay a 10% median premium for a company with a positive record on ESG issues.

Private equity firms, by nature, are less transparent than companies in the public market, and the amount of information that they share varies significantly by firm. Still, they're increasingly measuring (and sometimes reporting) not only how a company performs on specific ESG measures, but also how those measures translate to operational efficiencies or add reputational value. Investors want to see how much a company has reduced its carbon footprint, for example, as well as how that reduction has lowered energy. They want numbers around how improving workplace safety has lowered insurance and health care costs.

Some firms have found that focusing solely on companies that are making a positive impact (rather than firms that can use ESG factors to boost their bottom line) can be a profitable niche.

"Nowadays, with high valuations and super-competitive rounds, being a mission-aligned impact investor can give you a leg up," says Emma Sissman, an associate at SJF Ventures. "People want to partner with you. They see you as someone who is going to add value to the core mission of the investment. They see that you're not just in it for the returns, even though you are also in it for the returns." — *Beth Braverman*

ignated as impact funds are still looking to measure impact," says Emily Mendell, Washington, D.C.-based managing director of the private equity investor industry group Institutional Limited Partners Association. "That's an up-and-coming trend."

A growing field

Nearly \$600 million, or 5% of all ESG-related investments, was managed via alternative investments such as private equity and venture capital funds in 2018, according to US SIF: The Forum for Sustainable and Responsible Investing. That's more than double the amount invested in 2016, an upward trajectory that is expected to continue.

The growth reflects an increased awareness that ESG can have a material impact on a firm, a boom in the availability of data to measure those factors, increased regulatory pressures, and a cultural change around what society expects from its corporations in terms of both actions and transparency.

"There's a shift from a more reactive and efficiency-driven approach to ESG toward a more proactive and ambitious effort to address sustainability and impact in society," says David Korngold, a director at BSR, a nonprofit that works with companies on sustainable initiatives. "If the first-generation sustainability efforts were focused on operational efficiency and risk mitigation, PE firms are increasingly recognizing the economic and policy trends that are affecting businesses in the next five to 10 years. It's important for firms to think about those things on a strategic level and how they can influence and address those sustainability themes."

There's also more demand from institutional investors for portfolios that align with their mission or values and engage in good corporate stewardship, even as they

continue to deliver the outsize returns for which they often rely on private equity.

Pension funds and college endowments aren't the only ones driving private equity to consider impact when evaluating an investment. Family offices are also increasingly demanding reporting around ESG, particularly as decision-making authority begins moving to a younger generation and to more women. (Nearly two-thirds of women and nearly nine in 10 millennials are interested in impact investing, making them the biggest drivers of the trend, according to U.S. Trust.)

One in three family offices now engages in sustainable investing, according to UBS research. About a fifth of the average family office portfolio is dedicated to sustainability, a number expected to rise to one-third over the next five years. Family offices want to invest with PE firms that not only incorporate ESG factors into their due diligence but also use them internally, making efforts to increase their own diversity and conduct business in a sustainable way.

Integrating ESG

“What we are seeing now is that the majority of private equity firms have an ESG strategy, most of the major limited partners have an ESG policy, and — as investors — limited partners are asking far more questions about ESG when they're making investment decisions than they ever have before,” Mendell says. “The questioning in the due diligence questionnaires has become more robust than in the past.”

In turn, PE firms are asking the same questions of the companies in which they invest. It's become common for PE firms to post their ESG policy on their websites and to include it with all fund literature. The focus on ESG issues is more than simply a public relations stunt — both investors and PE firms increasingly have financial motivations for considering ESG that go far beyond assuaging their conscience.

Ignoring ESG has become a material risk to a company's bottom line, making it an unacceptable risk for many institutional investors who have to maintain their funded status.

“At the end of the day, there's a fiduciary responsibility to generate returns on behalf of their beneficiaries, and

that's one of the reasons that they invest in PE,” Mendell says. “They're looking for outsized returns.”

ESG may be able to deliver those as well. A recent Bain analysis of PE-led exits in the Asia Pacific region found that the median multiple on invested capital for deals with social and environmental impact was 3.4. That compares to a median multiple of 2.5 on other deals.

A unique position

PE investors also have an opportunity to effect change at their portfolio companies in a more direct way than many public company investors can. Since PE funding tends to come with outright ownership or at least a board seat or two, PE has more clout to demand management changes or policy shifts.

“We're tracking [our portfolio] companies and looking at both financial and impact performance, and how they're integrated,” says David Kirkpatrick, managing director and cofounder of SJF Ventures and founding cochair of Impact Capital Managers, a network of private capital fund managers. “We try to bring all of that into the boardroom and into board discussion. We're questioning and thinking about changes in strategy and whether they may have unintended consequences.”

While PE has long focused on finding organizational efficiency and on many of the “G” factors that go into ESG investing, PE firms also increasingly look for ways to improve a company's performance on environmental and social measures. That can encompass a variety of activities, such as reducing waste or improving diversity levels. The 17 Sustainable Development Goals introduced by the United Nations in 2017 — including objectives such as the elimination of poverty and the protection of forests — has served as a road map for many investors.

“The challenges of our world have become more self-evident,” Kirkpatrick says. “Climate change has become more salient than ever; income inequality has been highlighted. The political environment in the United States has caused people to look at what they can do with their money if the government isn't doing much.”

The most relevant factors for a specific company vary depending on its sector, size and market posi-

tioning. Investors in a manufacturing or retail company might look for potential labor issues in the supply chain, for example, while investors in a transportation company might target fuel use.

“There’s a recognition ESG can be part of the brand of a company,” says Craig Metrick, chief investment officer at impact investing advisory firm Cornerstone Capital Group. “Good environmental or good social policies — that aren’t just compliant — can add value out there in the market or to the right buyer.”

Easier exits

That not only drives up the value of a PE firm’s port-

folio, but also potentially makes for an easier ultimate exit. Prospective buyers want to see data around ESG measurements and are eager to hear a company’s “ESG story.”

The requirement to think long term when considering sustainability has some PE firms adjusting the way they view the time horizon of investments, considering both their own hold period and the next owner’s, whether that’s another private buyer or an eventual IPO.

“In general, sustainability takes time,” says Meg Voorhes, director of research at US SIF. “Sure, companies can make some changes relatively quickly, but it’s also a question of keeping at it and being consistent. A private equity manager who is investing for

WHILE PE HAS LONG FOCUSED ON FINDING ORGANIZATIONAL EFFICIENCY AND ON MANY OF THE “G” FACTORS THAT GO INTO ESG INVESTING, PE FIRMS ARE ALSO NOW INCREASINGLY LOOKING AT WAYS TO IMPROVE A COMPANY’S PERFORMANCE ON ENVIRONMENTAL AND SOCIAL MEASURES.



a relatively short period and then exiting from projects may not be around to continue the work. There could be a tension there, but sustainability should be the consistent goal for whomever is managing the operations.”

To meet the growing demand in the market, PE firms are creating their own ESG framework, hiring staffers to manage it, and pushing their portfolio companies to do the same. More than 60% of firms plan to expand their in-house ESG resources this year, and another 5% are going to appoint their first dedicated resource, according to a report from Collier Capital.

Looking ahead

While there’s broad agreement that the focus on ESG will continue to grow going forward, challenges remain. Among them: concerns about “greenwashing,” or making an investment appear more environmentally friendly than it actually is, and a lack of best

practices around collecting and sharing data on the company’s impact.

“Right now every firm has their own ESG strategy, and what they measure and what’s material to one firm might not be the same at another,” Mendell says. “It’s hard in these early days to standardize, only because it hasn’t been done before. We need a little bit of a runway to start measuring these things.”

Mendell says she expects the industry to coalesce around the best practices over the next few years and for broadly accepted metrics to emerge once a baseline has been established. Going forward, transparency around such investments will remain key.

“It’s not enough to just say that you’re doing it anymore,” says Paige Chapel, president and CEO of Aeris, a rating and information service for impact investors. “It’s about proving it.” ■

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