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ESG: SUSTAINABILITY

in Private Equity Investing 2021



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ONCE A FRINGE CONCERN

FOR PRIVATE EQUITY FIRMS ESG IS RAPIDLY TAKING CENTRE STAGE

BY ROBIN PAGNAMENTA



These are boom times for private equity. In the first half of 2021, over USD500 billion worth of deals were announced globally, setting this year firmly on track to be the biggest in the industry's history.

With a wall of investors' cash parked in firms' coffers waiting to be deployed and amid rock bottom interest rates, which makes raising the debt required for leveraged buyouts easier to tap than ever, the sector is in rude health.

But as well as delivering healthy profits for investors, the industry is also becoming increasingly sensitive about something else: environmental and social governance (ESG) factors which are gradually being embedded in the way private equity firms evaluate future deals, manage their existing portfolio companies and consider an ultimate exit.

ESG has been shaking up the public markets for years, with board executives of listed companies spending more of their time and energy ensuring they deliver on things other than simple financial performance: cutting emissions, trimming waste, monitoring their supply chains for labour abuses, improving diversity and contributing more to the communities in which they operate.

Ahead of the COP26 climate conference in Scotland this October, about half of Britain's FTSE100 companies, including bluechip names like AstraZeneca, BT, Vodafone, J Sainsbury and Unilever, have signed up to plans to cut their emissions to net zero.

These days, private equity firms also are increasingly preoccupied with these matters, and it is not just a desire to make the world a better place driving them to do so, with a variety of powerful reasons propelling the industry rapidly down this path.

INVESTORS DEMAND CHANGE

First and foremost is the imperative of investor demand.

The big pension funds and institutional investors which pump billions of dollars into the private equity industry every year are hungry for good returns, naturally. But they are also becoming far more selective about what their money is used for and are unwilling



to endorse funding for private equity firms that cannot offer certain specific guarantees.

In turn, this is pressuring PE firms to sign up to new policies such as the United Nations Principles on Responsible Investment (UNPRI) or to proactively publish their own ESG reports to assist them in marketing their funds and tapping sources of cash they are keen to attract.

Just as importantly, the PE model requires an ultimate sale to a likely listed strategic buyer, another private equity firm or an IPO.

In every possible scenario, the portfolio company's ESG credentials are likely to be an important consideration which will help achieve a higher valuation.

The growing importance of ESG in the sector is well illustrated by research published in July by Investec, which showed that 62 per cent of general partners (GPs) at private equity firms declined to invest in a company due to ESG or ethical considerations in 2021.

That is a significant increase from 58 per cent of GPs interviewed last year and 55 per cent in 2019.

CHALLENGES PERSIST

The growing interest in ESG is not without its challenges, however.

For starters, the lack of standardised ESG reporting poses a headache for investors and private equity firms alike.

A global industry is therefore emerging to document and measure ESG performance more accurately and to report it in a consistent, reliable and understandable fashion.

"We have got it baked into the way we market funds and the way we satisfy our customers," says Robert Hirth of Protiviti, the management consultancy firm. "We have got it baked into the due diligence process as we evaluate each of our companies. And we have started to bake it into the portfolio company actually being ESG sensitive."

Given all this, there is little doubt that ESG is a topic that is not going away, and which private equity firms need to think long and carefully about as they go about sourcing deals, supervising companies they own and preparing them for eventual sale or IPO. ■

PROTIVITI

NO TURNING BACK

AS ESG CHANGES THE FACE OF PRIVATE EQUITY

BY ROBIN PAGNAMENTA





Private equity firms have been enjoying an unprecedented boom amid a frenzy of dealmaking over the past 18 months.

But as funds scramble to pursue target companies and bolster their portfolios, the industry is undergoing profound changes in the way it operates. This is because investments are no longer being measured by traditional financial metrics alone.

These days, the industry is thinking hard about the environmental, social and governance (ESG) factors underpinning every deal.

NO LONGER A 'NICE TO HAVE'

ESG is a trend that has become impossible to ignore and which appears set to intensify over the years ahead, says Robert Hirth, Senior Managing Director at Protiviti, the global internal audit and business risk consulting firm that works with PE firms in a variety of capacities. Hirth currently serves as co-vice chair of the Sustainability Accounting Standards Board (SASB), a leading voluntary sustainability disclosure standard setter.

ESG is no longer a "nice to have" consideration, says Hirth, but instead has become essential in order to attract funds into PE firms and ultimately to achieve their desired investment performance.

"Investors are saying to private equity firms: 'I'll give you this money, but I want to know how you're going to invest it, specifically using these ESG factors, and I would like my money to go into portfolio companies that consider these environmental and social and governance factors'", Hirth adds.

Increasingly, private and public pension funds have strict rules about what they can invest in. When they put their funds to work, the investment has to comply with the policies that a private pension or public pension fund has laid out.

These rules have changed the game for many in an industry which for decades was laser-focused on a few simple outcomes: boosting profits and ensuring a healthy return on investment (ROI).

Private equity firms may have been keeping track of some ESG measurements informally for years, but it is only relatively recently that these have become formally embedded into decision-making and fundraising processes.

In order to raise cash from investors, big firms like Carlyle, KKR, APAX Partners and Texas Pacific Group now produce detailed reports on their approach to ESG.

"Of course, they are doing that because they want to attract those funds that they know are more sensitive to those things," Hirth says.

"They have a story that talks about their ESG methodology or approach in order to attract those funds."

UN PRINCIPLES

Many PE firms have further bought into those commitments by signing up to the UN Principles for Responsible Investment (UNPRI), which commits them to consider ESG factors in their investment decision making and their own internal activities.

In fact, about USD100 trillion of assets under management and about 3,000 asset managers have now signed up to those principles, acting as a powerful force that is reshaping the world of finance in myriad ways.

Hirth notes: "These principles basically state: 'We will incorporate ESG issues into our investment analysis and decision-making processes'. As such, they will be active owners and incorporate these issues into their ownership policy."

Pressure from investors is not the only way that ESG factors are starting to influence the operations of private equity firms.

When those firms want to raise debt – usually an essential part of any deal – one of the methods they use is securitisation.

"Having an ESG stamp is beginning to affect securitisation pricing and that directly affects the return that a private equity firm receives on its portfolio company," says Jas Jalaf, Director of European Lender Due Diligence & Risk Management.

All of this means that ESG factors are increasingly being baked into the way private equity firms oversee their portfolio companies from the energy they use, to their supply chains, and considerations such as child labour and waste management.

There are other ways that ESG factors are coming into play for the sector, adds Hirth.

Private equity firms are famously focused on how and when they will ultimately exit an investment, and these days, the preparations for that process will almost certainly include a consideration of ESG factors.

"At some point, these PE investors want their money back," Hirth says. "And the way that they get their money back is that portfolio company gets sold, either to another PE firm or other private buyer, to a public company or through an IPO or other form of liquidity transaction.

"Preparing the portfolio company around these factors makes it more attractive and easier to sell, and if it is easier to sell, it likely gets a higher valuation," Hirth adds.

If the company is sold to a listed company, it will probably need to meet certain ESG standards because 90 per cent of S&P500 companies now have some form of sustainability report.

"It can't be too far off from being able to report the expected material factors when it comes to ESG," says Hirth.

Equally, if the portfolio company is floated in an IPO, it will also need to be compliant and transparent on material ESG factors in order to attract institutional investors.

REPORTING STANDARDS STILL NEED WORK

Although ESG reporting remains inconsistent, significant moves are afoot around the world to clarify standards and ensure a more reliable approach.

Since 2011, the US-based SASB has been pushing hard to "establish industry-specific disclosure standards across ESG topics that facilitate communication between companies and investors about financially material, decision-useful information".

> "Preparing the portfolio company around these factors makes it more attractive and easier to sell, and if it is easier to sell"

Similar efforts are underway in Europe under the auspices of the London-based International Financial Reporting Standards (IFRS) Foundation.

Although there are still big challenges to overcome, the direction of travel is clear: ESG reporting is becoming an increasingly important consideration for boards around the world and is being embedded in financial markets.

The next step is likely to be the role of big audit firms, which are starting to play a larger role in verifying compliance with and providing assurance on existing standards.

"We are all working on convergence and creating standardisation," says Hirth. "Institutional investors are looking for that standardised, comparable and consistent reporting."

SUPERIOR PERFORMANCE

There is another simple yet compelling reason why private equity firms are increasingly focused on ESG: performance. Hirth says: "There are some studies indicating that companies that effectively focus on material ESG factors and spend time thinking about how they impact the environment can use less materials and create less waste, treat their employees and their suppliers better, contribute to the community, and govern themselves, and that those companies clearly outperform companies that do not focus on these things."

The bottom line is that there are few better reasons for private equity firms to focus on ESG factors than these, so it is a trend that looks set to continue.

"That's very attractive, isn't it?" smiles Hirth. ■



ROBERT HIRTH

SENIOR MANAGING DIRECTOR, PROTIVITI

Bob Hirth is a Senior Managing Director of Protiviti, a global internal audit and business risk consulting firm. Prior to that, he was Executive Vice President, global internal audit and a member of the Firm's six-person executive management team for the first ten years of Protiviti's development. He has worked on assignments and made presentations in over 20 countries, serving more than 50 organizations and working closely with board members, C-level executives, University professors, finance and accounting personnel as well as public accounting firm partners and employees.



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Jas is a Director in Protiviti's Risk and Compliance solution, managing a team that specialises in the delivery of due diligence reports for a number of major bank and non-bank lenders, operating in a wide range of industries and asset classes. These due diligence reviews cover companies' internal processes and policies, with a detailed focus on credit handling and the order to cash life cycle. Jas has an in-depth knowledge of the risk profiles, architecture and servicing agreements surrounding a range of structured finance asset classes.

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