Enhancing Portfolio Strength

Private Equity, ESG, and Value Creation

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The rise of Environmental, Social, and Governance (ESG) performance as a critical input to investing decision making is undeniable. The momentum is clearest in the public markets: ESG investment vehicles have seen more than $30 trillion of inflows, creating an evolutionary shift on exchanges like NASDAQ and NYSE and getting regulatory attention from the SEC.

While the private equity arena responds differently than mainstream asset managers and investors, ESG presents the same potential for value creation. Firms that understand ESG maturity in their portfolios have an opportunity to decrease risk and enhance value by seeing investments through a more comprehensive lens.

Yet adoption by private equity firms is lagging thus far. The world's largest players led the way with early impact funds and are now applying ESG criteria across vehicles, but small to middle market firms have been hesitant to follow suit.

> *41 percent of firms with more than $15 billion in assets said ESG was one of their top three priorities, right behind asset growth and talent. But only 29 percent of firms with between $2.5 billion and $15 billion in assets said the same. For the smallest firms, those with $2.5 billion or less, the figure plummets to 14 percent.*
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> **2021 Ernst and Young Survey**

The reluctance among smaller players may simply come down to stakeholder pressure. Large firms that take center stage have more exposure to scrutiny from public institutional investors, government, NGOs, and media. Further downstream, the ecosystem is more contained. Without a spotlight being directed on portfolios, this smaller universe is in some respects structurally opposed to the spirit of ESG.

> *By its inherent nature of privacy, private equity purposely shuns the sunlight of disclosure, transparency, and accountability upon which ESG assessments depend. Thus, while ESG seeks to diffuse shareholder power through the inclusion of more voices, private equity by definition concentrates shareholder power through the exclusion of potentially dissenting ones, starting with public shareholders.*
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> **Morningstar**

The Opportunity: Protect the Portfolio

ESG is not a shiny new object driven by social agendas. When applied correctly, it is business tool that helps paint a truer picture of a company's health, resiliency and long-term viability. Smart integration of ESG supports the ultimate goal of the private equity investor: value creation. ESG provides investors with insight into a broad range of issues that are material to the business by gauging factors such as energy management, waste stream reduction, product innovation, workforce retention, optimization of raw material sourcing and use, supply chain resilience, and sustainability through the value chain.

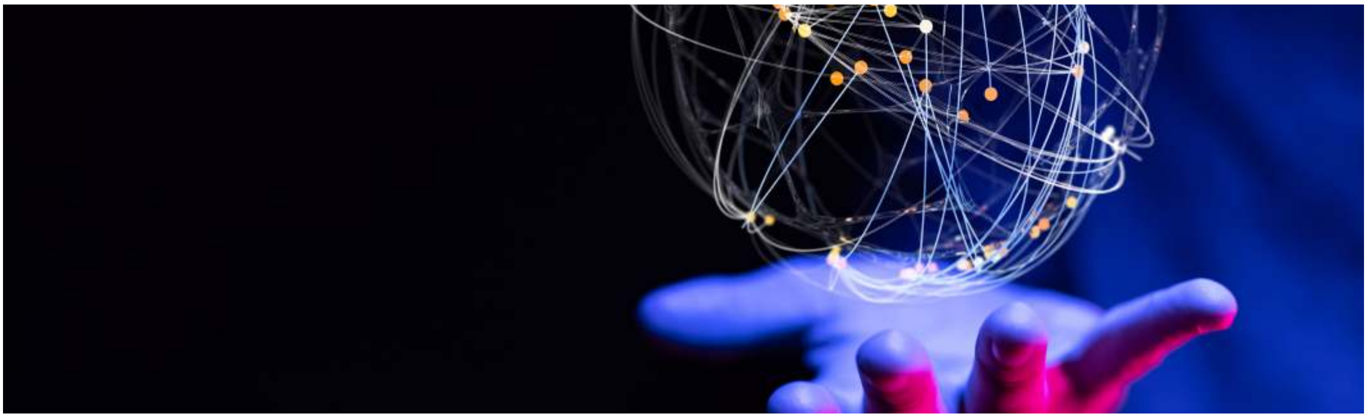
On the flip side of the coin, ESG is an excellent guide for risk mitigation. At a minimum, companies should be positioned to reduce exposure to the risks of climate change, to reputational risks in the supply chain, and to stakeholder concerns with diversity at the C-suite. An embedded ESG program can assure viability in the long run by preventing, for example, supply chain pinch points, avoiding stranded assets due to water insecurity, and preventing data breaches of confidential customer data.

On the climate front, companies are seeing the financial consequences of inaction more clearly each day. There is a growing list of companies negatively impacted by increasingly frequent and massive storms that insurers now attribute to the affects of a changing climate.

Paint company Sherwin-Williams, for example, cited Hurricane Ida when cutting its third-quarter sales forecast after previously projecting a recovery from the supply woes amid the Covid-19 pandemic. At the same time, paint and coatings company PPG warned that due to Ida-related supply chain disruption, sales would come in between $225 million and $275 million lower than **previously expected**.

ESG also helps companies combat talent shortages. Consider that 71 percent of employees and employment seekers surveyed by IBM say that environmentally sustainable companies are more attractive employers – and nearly half would accept a lower salary to work for such **organizations**. As the current talent war rages across industries, purpose-driven, ESG conscious organizations have a distinct competitive advantage.

ESG opens a window into management issues as well. A well-run and transparent company lowers frictional costs from NGOs, legal challenges, and expansion permitting, while simultaneously reducing the chance of negative reputational issues and community sentiment. Indeed, research from State Street on publicly listed companies showed a direct tie between **reputation and performance**. During the initial pandemic response in 2020, ***"firms experiencing more positive sentiment on their human capital, supply chain, and operational response to COVID-19 experienced higher institutional money flows and less negative returns."***



Four Steps to Effectively Managing ESG Risks & Opportunities

Understanding where and how to elevate ESG maturity within a portfolio requires additional due diligence to help identify material factors and chart a course to value.

Step 1: Understand

The initial step seeks to build understanding by defining the material business challenges and identifying any gaps in knowledge or action. By actively and meaningfully engaging with a portfolio company's stakeholders (both internal and external), a firm can identify the ESG topics that most significantly impact financial performance. This process if often referred to as a 'Materiality Assessment.'

This understanding then serves as a foundation for clear organizational ESG strategies and performance objectives. Material topics will likely change and evolve over time as issues mature, drivers fluctuate, and understanding improves; however, with clarity of direction, management and investors will know how the issues and company value impact one another.

Step 2: Integrate

Embedding ESG will impact all parts of an organization, and it therefore demands engagement across functional areas. Critical to this effort is identifying who (or which functions) should be involved in addressing the ESG business challenges/opportunities. Once accountability is in place, cross functional teams can provide the data and understanding needed to evaluate the current state and any gaps to be addressed.

Step 3: Prioritize & Monetize

With value creation and risk mitigation as the goal, companies can now determine an appropriate course of action to address the targeted ESG business challenges/opportunities. This involves assessing the business impacts of a variety of possible actions, establishing ambitious but achievable targets and goals, and aligning actions with existing organizational strategies and operations, availability of resources, internal management/reporting schedules, and relevant regulatory reporting requirements.

Methodologies exist today that allow corporate leaders and investors to quantify their proposed ESG investments, including the ability to monetize the types of benefits that were once considered purely intangible. For example, the NYU Stern Center for **Sustainable Business' Return on Sustainability Investment** (ROSI™) Framework has been developed specifically to help bridge the gap between ESG strategy and financial performance, thus facilitating more informed business decision-making.

Step 4: Act

The foundation is laid, the stage is set, and organizations can now plan, execute, measure, and communicate on progress as they address relevant ESG business challenges/opportunities. Solutions may require establishing policies, objectives and targets; enhancing governance structures; advancing management systems and processes; developing action plans; engaging stakeholders; measuring and monitoring performance and impacts; reporting; issuing communications; and conducting assurance.

An embedded ESG strategy results in:

Direct financial benefits through a lower cost of capital and higher credit ratings

Less risk through increased long-term business resiliency

Social license to operate and enhanced relationships with external stakeholders such as NGOs, regulators, community, and customers

Greater returns, consistent with ESG equity indices that have outperformed non-ESG peers

Better performance, with ESG improvements boosting operating profits and enhancing productivity across a more engaged employee base

Increased competitive position, allowing for attraction and retention of top talent, strengthening of customer allegiance, and improved attractiveness to suppliers, M&A suitors/candidates, and partners

Communicating the Course to Value

As material factors are identified and goals established to advance the company, reporting and communications become imperative. Keeping stakeholders – employees, customers, partners, vendors, and investors – informed about vision and progress enhances credibility and engagement across the ecosystem.

At its core, reporting and communications are about transparency. To use this transparency in their favor, companies must own the narrative – they should prioritize telling their own stories in their own way. To create appropriate and impactful visibility of ESG performance, it's important to proactively identify compelling proof points associated with ESG initiatives, milestones, and overall performance. Translating that into consistent content and communications will allow all parties to understand the value of an organization's programs.

In the immortal words of Yogi Berra,

"

When you come to a fork in the road, take it.

For private equity, all roads eventually lead to embracing ESG. The good news: no longer seen as a bolt-on cost center, ESG can add significant value for stakeholders, a windfall that drops directly to the bottom line while helping to build the top line. Incorporating ESG into portfolio decisions will help to safeguard the future by aligning a firm's approach with investor demand, institutional requirements, and the overall direction of the financial marketplace.

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