Expert Discussion

How ESG Improves Portfolio Companies

Three veterans of environmental, social and governance value-add in private equity discuss best practices and share notes. (This report is based on the transcript of a Privcap thought-leadership webinar held in November 2019.)

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Privcap: Let's start at a high level—can you articulate what the benefits are of having an ESG program in a private equity investment program?

Lauren De Paola, First Reserve: ESG is a very hot topic, and if you go back and you look at where the term ESG came from, it actually is about 15 years old and initially came from a report by Kofi Annan at the U.N. Annan brought together 20 different banks and financial institutions to talk about how the investment community could invest more responsibly. The title of that report was literally "Who Cares, Wins." I wish sometimes that they hadn't actually come up with the term ESG, because it's this kind of an amorphous acronym that people often really don't understand.

I would argue that you don't need to make the case for why ESG is important. It literally is the business that we do as private equity investors. PE is exceptionally well suited to ESG factors and considerations. We're looking at control investments in a heavily diligenced portfolio. We're focused on topics like the environment, health, safety, cybersecurity, AML, FCPA, UKBA, accounting standards, governance, community risks. Most of us in the investment community would say that how we drive value in the portfolio is all under the heading of ESG. I think it's not just important—it's literally daily business and the way that we return value on behalf of our investors.

Elizabeth Lowery, TPG: I totally agree with Lauren with respect to how important this is for driving business results in the private equity setting. Very much from the very beginning, you need to look at risk mitigation, value creation and the due diligence efforts. Once we invest, we focus on the important ESG aspects to drive business value during our investment period.

Governance has always been critical to private equity investments. In fact, Jim Colter often talks about it as GES—that if you don't

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get the governance right, you really don't get to look at the environmental or social issues. We've been doing this since the founding of the firm. We did get a little more systematic about 10 years ago, just making sure that we were focused on all the right aspects of ESG through the due diligence process. I've had a particular focus on portfolio company engagement, which means an annual assessment of our portfolio companies, making sure we're engaging with them regularly through a sustainability leadership counsel, webinars to share our best practices and making sure we're giving them the tools that they need in order to be successful and build sustainable businesses.

Privcap: Anthony, as you're working with clients, some of whom may have ESG programs, some of whom may not, what's the sell for establishing an ESG program?

Anthony DeCandido, RSM: The way we look at it is this—the groups that we work with need to better understand their ultimate stakeholders. We're part of a society today where people want to know more about what they're doing and how and not just what they are doing. They also want to know with whom they are doing it. That's not a trend that will go away. We find that our clients and their stakeholders are much more mission-based, much more value-based, and when we look to the why behind that change within industry, to me, it's really the shift of demographics with millennials.

Millennials are now the largest workforce in the U.S. economy. They are set to inherit something like $30 trillion of assets from their forefathers. Their prior generations were much more interested in return profiles, but I think today, in this investment community, you have to be focused on the return profile, but also the why. We find that, for a lot of the clients we're talking to, they're sometimes willing to sacrifice those basis points of return to be able to market themselves in more of a favorable light and to raise the public profile of their business.

If that feels anecdotal to you, then I'll tell you that a lot of this is really supported by data. In the U.S. now, there's about $12 trillion of U.S. public equity assets. There's about 26 percent of that tied to sustainable criteria. There's about $5.8 trillion in the buyout, venture and private debt space. There are critical themes that our PE clients are seeking our advisory on. We take a deeper look underneath the hood. When we think about the environment, it's things like climate change, water and waste, product and worker safety. Social gets a lot of press just by way of media, but it includes diversity, inclusion, talent management, human rights, health—and then governance. You've got the labor practices, executive comp, political contributions or board composition.

De Paola: The role of private equity firms as well as the role of the businesses we invest in have really changed. And so the focus is on what's important for employees, what's important for the various stakeholders, customers. They are very much interested in a focus on ESG or whatever you might call it—corporate responsibility, social impact. Increasingly, businesses understand their role in society from the broader stakeholder perspective. And, for the ESG practitioners in the world, that's something we've focused on a lot. But now, to see it really take off has been very refreshing.

Privcap: This has been touched on a bit, but Beth, can you talk about the fact that a good private equity firm is probably already pursuing ESG objectives, whether or not they call it ESG?

Lowery: Both within the firm and within our portfolio companies, we try to use terminology that will work for the portfolio companies. So we may go and invest in a portfolio company and we might not use the term ESG, but we will look and see what they are doing from a corporate responsibility standpoint, what they have in place for environmental programs, what their employee engagement diversity issues might be. It doesn't mean that, all of a sudden, you have to change everything that you're doing. It really is focusing on what you're doing that might fit into the ESG space as well. We learned that you have to get systematic about it and both from integrating it into the firm from a due diligence standpoint. You also need to have some toolkits to be able to work with the portfolio companies.

De Paola: Beth, I would agree with that. I think that being systematic is key. I sound like I'm railing on ESG as a vocabulary term here, but it scares both investors and portfolio companies sometimes. They think that they need specialized practices when, really, the framework around ESG is the knowledge of frameworks and looking for collaboration with other firms and agencies around the world. The practices themselves, like I said before, are essentially just strong business.

In the middle market, one of the great investment models is investing in niche businesses that are often buy-and-build opportunities, or where you're getting behind a management team and a proof-of-concept model. In all of those, you need to create institutional structure and best practices that, in the end, you're hoping are going to arbitrage to some sort of increase in exit multiple and create the value that you're looking for as a private equity investor. Things like ERP implementation and sound accounting practices, cybersecurity regiment. All of those go under this broad heading of ESG and are not necessarily something brand new for management teams or for investors alike. They are essentially the day-to-day business model.

DeCandido: There is a storyline that's attractive to many investors that's still untold. The GPs historically have already done things that they can feel proud of. But now I think there's this growing need and desire for there to be more transparency and more showcasing of what has been done and what needs still to be done.

There are different types of managers. There are the ones that do ESG because they think they should, but maybe their hearts aren't

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really in it. There's the other side of the fence, which are the ones that know it's the right thing to do and their hearts are in it and they are trying to drive positive change. All these managers are simultaneously trying to raise the public profile of their business. If you're an early-stage fund, maybe you're looking to fundraise. Later-stage groups may be looking to raise their public profile.

If you consider just one fundamental type of strategy change you could make, whether it's on occupational matters within one of the portfolio companies that you work with, if it's creating a more healthy work environment for your employees, well, you can check a box that you're doing the "S" on the social front. If from a governance lens and there was some strategic decision-making behind it, maybe you check the "G". These are the types of things that these funds have already been doing, but may now just have to present in a different light to gain that type of attention.

Privcap: I'd love to hear from Beth or Lauren about the range of views that LPs attach to ESG.

De Paola: A lot of the motivation for GPs to focus more intensely on ESG is coming from the LP community. That largely originated in Europe and Canada and is now really spreading to Asia-Pacific and now North America. They are looking for integration of ESG concepts, monitoring of ESG standards and, ultimately, reporting. And some of the concepts that Anthony touched on—transparency, feel-good, wanting to make sure that you're doing business with people who are aligned with you philosophically—are infused throughout all of those.

Last October, there was an SEC petition from investors totaling $5 trillion in AUM—including New York, Illinois, Connecticut—asking for the SEC to become involved in ESG disclosure items and to go beyond just line-item and anti-fraud considerations. There's clearly pressure coming from the LP community. I personally think it's a great opportunity for the GP community to showcase all the ways in which they are already focused on ESG considerations and the ways in which we're already pushing to be stewards of responsibility and sustainability in our portfolio companies. The question is, who will get further first?

Privcap: Beth, to the extent that you interact with the limited partners of TPG, what are their concerns, questions, mandates?

Lowery: We have seen an increased interest from our LPs, both in the number of inquiries but also in the level of detail that's requested. I was fortunate to present to our annual LP meeting for TPG Capital an overview of what we do on the ESG initiative. And I agree with Lauren that it did start in Europe and Canada, but we see it now as a global interest. Our LPs across the U.S., in addition to Asia, et cetera, are very much interested in what we're doing in the ESG aspects of our business. It's really important to align with your LPs on what ESG means and how it's defined and how it works within your firm. One of the mistakes that was made early on was people just basically changing terminology and not really getting deep into what it means from a cultural standpoint, both within the firm and with portfolio companies. What's really important is this not be window dressing or greenwashing or whatever the terminology is, to make sure that this is core and fundamental to the business. We've seen great progress on that, and there are a lot of resources out there to help people both define and put programs in place to really drive the ESG aspects of both the due diligence, as well as the working with portfolio companies.

Privcap: The low-hanging fruit of ESG is often described as cost savings. Ultimately, ESG should be a lot more than that—it should be about adding value beyond the cost savings. But, Lauren, can you give a few real-world examples of various ESG strategies being applied to a portfolio company that result in cost savings?

De Paola: I'm going to broaden that out from not just cost savings but to risk mitigation. Firms should think about ESG as mitigating risk, both from the perspective of driving down line items and increasing margins, and also decreasing exposure to litigation, employee concerns, community concerns. If so, the internal sell on the importance of ESG would be a lot easier. And when you look at it from that perspective, all of us can come up with easy examples in our own portfolios.

There are two examples of utility services companies, one in Europe and one largely in the southeast region of the U.S. Both were buy-and-build models. There was a large degree of integration that needed to be done. They both completed five-plus add-on acquisitions during our ownership, and making sure that integration was done in a way that didn't impede the business and in fact continued to make it attractive as a service provider was part of the value that a private equity firm should bring. But we were also extremely intensive on a variety of ESG topics, particularly in the S and the G realm.

One of the things that I personally think people don't talk about enough when they think of ESG is that a lot of the focus is on due diligence and then monitoring during the ownership period. But it's extraordinarily helpful at exit. Both of those companies were sold to European entities, where we've said that the ESG focus has been historically a little bit deeper. One was a French conglomerate, and the other was a European-based private equity firm that both were exceedingly focused on ESG-related issues. This ultimately helped drive a better exit multiple.

Lowery: The low-hanging fruit is still out there. Focusing initially on energy reduction and cost savings—getting both the deal and operations teams focused on how you can contribute from a cost savings standpoint—is a good way to start the discussion. Obviously, there is very much a focus on climate change and everything you can do to reduce carbon footprint. It is increasingly important to find a number of ESG opportunities with a portfolio company. But no matter what sector you're in, there is some use of energy—and getting a handle on that spend and then translating that into the environmental benefits is a good way to start.

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DeCandido: You made a comment earlier about the need to execute cost savings but also drive long-term value. Most middle-market business owners want to do both. If you consider the carbon footprint, it's probably one of the biggest societal issues we have going on. And yet, in the business community, despite many technology-enabled ways for us to communicate with one another without having to physically be on the same site, so few companies really capitalize on these. Imagine the amount of excess and waste of travel within sales departments. If you were able to reduce that by 10 percent, 15 percent, those could create dramatic financial results but also non-financial benefits.

Beth mentioned the concept of energy efficiency. That's another area where technology has really helped us. If you walk into any office environment today that's been rebuilt in the last three to five years, there is energy efficiency—for example, lighting. If you walk into a men's or women's bathroom, you most likely have timers. The point is that organizations should really be doing better today. For the private equity groups that are investing in these companies, it's one other opportunity for them to drive operating agendas and drive both financial and non-financial profiles.

Lowery: When I was at General Motors, we spent a lot of time on advanced technology and figuring out how to move the internal combustion engine to alternative fuels. Then, when I came to TPG and its 200-plus investments, I focused on things such as changing the light bulbs, sensors, and turning off computers when you're not working, or shutting off the lights in the parking lot when everybody is gone, no one's working. Things like that. I used to say at GM, this is not about changing light bulbs, this is about changing the internal combustion engine, major changes in infrastructure. And then, I realized that there is still a lot of changing of the light bulbs that needs to take place. This does make a difference in some of the critical issues we're facing on the climate change side.

Privcap: Final question—let's discuss the relative sizes of TPG and First Reserve. TPG is quite large, First Reserve is smaller. Please discuss the importance of scale and size when building an ESG program.

Lowery: It's essential that, no matter what size of a firm you are, there is a focus on ESG. That doesn't mean necessarily building in-house resources. It's using consultants that are out there getting some understanding of what it means for your firm and the culture of your firm. There are some great frameworks out there, like the GRI frameworks or the TCFD on climate change. I always say to folks that this is not about trying to do everything at once. You need to get started, and you need to focus on the things that are important to the investment cycle, along with the portfolio companies. I don't think that size matters in this case. I think that everyone has a role, and private equity should have a focus on ESG. It just makes for better investment decisions and builds better businesses to create value and returns for your customers and your LPs.

DeCandido: It's important to address the fact that most of the middle-market clients that we work with don't always benefit from having that large financial resources or even people resource to drive these changes. They have to be more creative and a little bit more nimble, because you've got people playing a lot of different roles and wearing a lot of different hats. A lot of the service providers have developed their own benchmarks. Benchmarking to me is really, really important, because what you can't measure, you can't really evaluate. So whether it's data collection, reporting systems, strategy and processes and governance. . . I understand that some groups are much smaller and are just trying to figure out how to get started. As they evolve, they want to stress-test the design of that infrastructure and they want to be able to measure their data. One of the things that we've been fielding more and more of in the last year alone has been around our attestation services. It could be things like simply performing review procedures over a sustainability report. So maybe you're a private equity group that is sophisticated enough that you've developed your own sustainability report or ESG special report, which you plan to deliver to LPs. There are now organizations that are able to provide basic levels of assurances on those reports to ensure that some of the information has been independently verified. Because, of course, one of the challenges of information that's being pushed to the ultimate stakeholders is that a lot of it is self-reported. And knowing how one can benefit from the marketing of a story, an ESG story, begs the question of validity. That, to me, is more of a common issue we face within the middle-market clients that we serve.

De Paola: To me, the concept of ESG is almost evolving similar to how GAAP procedures did when that was first theorized. You need to have some sort of codified approach to ESG as a private equity investor. It's important to create frameworks that are important for your philosophy as an investor and especially for your portfolio. Some of the organizations that Beth mentioned may not be relevant for an all-energy portfolio like First Reserve. Or maybe you have a much more diversified portfolio. One of the things that we found with a lot of our portfolio companies is they already have standardized reporting that they are required to do through industrial memberships. If you're going to be a practitioner within a certain area of the energy industry, you have to be a member of the American Chemistry Council, for instance.

There should not be a rush to slap an ESG label on everything that you do and put out a sustainability report year one. I would start with finding internal resources who are knowledgeable or passionate about what you're doing and about the topic of responsible investment, who especially understand operationally how the firm works from an investment perspective. And, once you start doing that, use some of the resources that we've mentioned here—GRI and GRESB, PRI, SASB, TCFD, you name it. Start from there, figure out what your responsible investment approach is and then start to work on codifying that through your processes and policies. The next step beyond that is, okay, now how can we start to enact change and drive KPIs in the portfolio? But you don't have to do it all at once. ■