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Powerhouses In Private Equity

Private Equity as a Force for ESG Value-Creation

- An interview with Adam Blumenthal, Founder and Managing Partner of New York-based private equity firm Blue Wolf Capital Partners. Blumenthal discusses his firm's carefully constructed approach to adding value via ESG principles, as well as private equity's unique ability to influence the practices of its portfolio companies. Also discussed: the low-hanging fruit of governance improvements, the challenge of reporting ESG data and the slow progress towards standardized reporting. Interviewed by RSM's Anthony DeCandido.

Featured Experts:

Adam Blumenthal, Blue Wolf Capital Partners

Anthony DeCandido, RSM

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This report is based on an edited transcript of a recent Privcap podcast.
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Anthony DeCandido, RSM: Why is private equity ideally suited to promoting the principles of ESG?

Adam Blumenthal, Blue Wolf Capital Partners: What initially drew me to private equity along with most of my peers was the ability to control and influence critical factors of company behavior and performance. That really is what ESG is about. It's about how you're conducting the business, what opportunities you see, which ones you pursue.

If you're a public company investor, maybe you're screening and filtering and deciding what companies you want to be in. But if you're a private equity investor or control investor, you're talking about implementing and integrating ESG into corporate strategy, and really that's what it's all about.

DeCandido: In our practice work, too often we see companies look at ESG as a risk exercise. But if it's done right, the spirit of ESG is to transform organizational strategy, so I agree 100 percent with you on that. Tell us a bit more about your portfolio and the more significant ESG matters that you evaluate as part of your ongoing portfolio management.

Blumenthal: We're control investors in middle-market companies. Our portfolio is about half industrial and half healthcare-related. And, within healthcare, we typically are involved with delivery of healthcare services. In integrating ESG into our investment strategy, we've developed core competencies that allow us to identify opportunities and then help companies take advantage of them. An example of that in healthcare would be our belief that companies are well aligned when they have a "triple aim" in healthcare: delivering a higher quality service, at lower cost, with better patient outcomes and better impact on population health. That is always going to be an important value-creation strategy.

There are a lot of approaches to healthcare but, in our minds, triple aim is very consistent with the "S" part of ESG. We are improving the health of vulnerable populations—aging people, people with developmental disabilities—who represent a disproportionate part of healthcare spend, and who receive services that are often subpar. If we can manage companies that reduce that social problem, that's good for our investors, and it's very ESG-aligned.

DeCandido: You're speaking to an audience of other private equity managers out in the market. What do you see as some of the essential ESG items that every fund should be managing within its portfolio?

Blumenthal: ESG is environmental, social and governance. So, the easy one for private equity is governance. We're control inves-

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tors—we have to get governance right. Governance is a critical, critical success factor for us as investors and for the whole industry. So, what does governance mean from an ESG perspective? It means formal board processes. It means boards that include DEI considerations, and boards with real committees and structure and function, which oversee the company through a series of protocols. It means a board with an authority matrix that controls the way the enterprise works, rather than viewing itself as informal. Everybody knows that if you devote yourself to actual governance implementation, that has a very positive impact on performance—that's pretty broadly acknowledged throughout the private equity community.

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On the environmental side, it's not quite as easy. But there's an advantage of control and the ability to prioritize energy conservation or environmental remediation. There are lots of aligned ways to look for opportunities to drive environmental value creation and to improve the ESG footprint. Pursuing those in a disciplined way across the portfolio is critically important.

On the "S" side, we're big believers in the health and safety of our employees as a KPI, and that's very tied to the "S" part of ESG. So, we incorporate into every company in which we invest our "SHE" program, which is "safety, health, and environmental." The goal is that, over the tenure of our ownership, every company in which we invest will end up in the first quartile of its industry from a SHE perspective. There are operational, financial, multiple expansion and predictability improvements from being able to manage safety. But, of course, there is also a huge social impact from operating with that philosophy. Those improvements are industry agnostic and all of them create value.

DeCandido: Tell us a bit about the data tools that you're using and the assimilation of information from a portfolio level to a fund level to evaluate ESG on a perpetual basis.

Blumenthal: Because we believe that ESG principles should be integrated into the value-creation plan for each investment from inception, they have to be important contributors to value creation. There have to be key milestones as to whether or not they've been accomplished. We track that as part of our regular portfolio review process for every company. So, every quarter, when our team sits down and says, "What's our three-year plan, and what did we get done in the last three months?", that's relevant. Of the value-creation drivers, some are ESG-related, some are not, but they get picked off in the same comprehensive review process as everything else. I don't know that an ERP implementation, or a de novo expansion strategy, is an ESG strategy—these are more broadly value-creation strategies. We're going to check on those every quarter, just like we check on the health and safety initiatives, and environmental remediation initiatives.

So, integration of ESG into the overall portfolio review process becomes natural. Once you think that what you're doing is driving value creation, and that ESG is in service of that, then your portfolio reporting flows out of that. ESG becomes both financial performance and progress along key milestones to value creation, which is, of course, what your limited partners are most interested in.

I will say, on top of that, because we're monitoring so many of these things—whether it's employee turnover, health and safety, board diversity, environmental remediation—all of that does lend itself to a metrics-based approach. We can tell you portfolio-wide the impact on worker health and safety of our SHE initiative every quarter. We can tell you, whether we look backward or forward, what quartile everybody's in.

DeCandido: Can you draw a straight line from ESG data to company performance? And what would you say to folks about the ability to do well financially, but at the same time do good for society?

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Blumenthal: I don't think there's a magic formula around ESG any more than there is around anything else. Growth is good, unless you grow unprofitably, right? There are no straight lines. There's no magic about any of this. I will say that if, for example, you buy a company with environmental issues, which would normally trade for six times EBITDA and you buy it four times EBITDA because it's got a lot of funky environmental issues to remediate, and you remediate them and then you sell it for six times, you're pretty clear that the multiple expansion is entirely due to resolving the problems that allowed you to get the discount. So, we look for opportunities to do that, where the tie is immediate, concrete and demonstrable. Having that kind of catalyst and the core competencies to address it is squarely in our wheelhouse and is something our investors expect from us.

More broadly, we have found across our exit processes that 90 percent or more of our exits have been to strategic acquirers, where they've outbid the financial buyers every time. And we believe part of the reason that's true is that public company levels of governance and worker safety facilitate the integration of middle-market companies. If you don't have those things, it becomes a heavy lift, so as a seller you get a discount. So, we do think there is a clear multiple-expansion reason to take these things seriously.

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DeCandido: What piece of advice would you offer to the private equity groups that are just beginning their ESG mandate?

Blumenthal: You have to start by asking yourself what you believe. Do you believe that if your portfolio used less energy, reduced its carbon footprint, it would be more valuable? Do you believe that if you had control over your operations, such that your worker health and safety performance was top quartile, that it would have an impact on productivity and on employee retention? And do you believe those things are good things to do, regardless? Do you believe that they're integrally related to how you want to run your portfolio? If the answer is “no,” you shouldn't do it.

If the answer to those things is “yes,” then it becomes about operations and execution. What we’ve found is, if you find things you believe, then your management teams and the operators associated with your firm will embrace them. There are direct operational ties between the changes that you make to the business—if you believe those things are important—and ultimately the value that people are going to derive from having been associated with the impact.

DeCandido: It seems like you have to always consider what your own enterprise missions and values are, and then to align those missions and values to things that you want to track going forward.

Blumenthal: That's 100 percent right. If you start with the question of [whether] there some formula out there, some overlay that LPs are demanding because of their own pressure, and you have to find a way to comply with it, it's not going to end well. Because it's not integral to the performance of your firm. You want to avoid making commitments to do things that aren't organically driven by your organization. If a board imposes a mandate, or a CEO says, “We're going to do something, but it's really not related to the organization,” in the end, it's not going to happen. It's going to fall by the wayside.

DeCandido: Tell us what might change at Blue Wolf Capital in the event that there was a universal reporting mandate.

Blumenthal: It’s a great question, and one we're trying to get ahead of. Increasingly, some LPs really do think it's important, and [they] want to create a single, standardized method of reporting that's going to meet everybody's needs. There are a number of competing approaches to reporting structures. But something to keep in mind is that double-entry bookkeeping took many thousands of years to develop. The Mesopotamians developed double-entry bookkeeping many centuries ago and we've been

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developing it since. Now, we have three standard financial statements and people pretty much agree on [it], although some people have even rethought that. ESG reporting does vary from country to country. We are at the very initial stages of reporting on ESG issues, and we're not going to get from, "Gee, we've never done this before," to a one-size-fits-all answer that takes one ESG unit and converts it into a dollar. We're not going to get there in a couple of years. It took us a long time to get to GAAP.

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Blue Wolf has a lot of metrics internally. We publish them every quarter. We send them to our LPs. We can capture more metrics, and we will come up with a standardized set as people have a broader set of interests. But we're going to err on the side of reporting on things that are critical to the value-creation plans of our portfolio companies. Plus, we know that we and our management teams are going to pay attention to them. We're going to report them consistently over time, and we're not going to let the perfect be the enemy of the good. We're not going to wait for everybody to agree on the GAAP of ESG reporting, because we'll all be long gone by the time that agreement and consensus emerges.

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