

## DRIVING GROWTH

# The recipe for ESG success

*A survey by ERM demonstrates how ESG factors are being used to create value*

Just how important are environmental, social and governance factors in driving value? Very, suggests ERM's latest survey of worldwide investors. Seventy percent of respondents told us that ESG opportunities and risks have a material impact on their investments. Interestingly, over 95 percent of the 60 general partners (GPs) and limited partners (LPs) interviewed believe there is significant untapped value from ESG within their portfolio companies. The respondents from 17 countries represent \$1.3 trillion in private equity assets under management.

The survey comes as pressure on private equity firms continues to grow as the expectations of LPs advance beyond simply looking for ESG policies as part of a compliance-oriented data gathering exercise. Many LPs are now looking for real evidence of how ESG management is being implemented and 'hard wired' into processes to deliver as well as to protect value. We are also aware of LPs consolidating their capital to fewer firms because they require a greater degree of confidence in their GPs. ESG is one of the key factors driving this change.

In addition, LP expectations of private equity firms are changing rapidly spurred on by initiatives such as the UN Guiding Principles on Business and Human Rights, the UK Modern Slavery Act and rankings that show ESG efforts in supply chains. The Montreal Carbon Pledge, the UN Sustainable Development Goals and the OECD Guidelines for Multinational Enterprises to the financial sector are also helping change attitudes.

In conversations with private equity clients after publishing the survey results, we found that many deal teams and ESG

practitioners want to hear more about how environmental, social and governance factors are being used to realise value. Our survey revealed that the following five ingredients contributed to ESG success within investor firms.

## 1 SENIOR MANAGEMENT LEADERSHIP ON ESG

# 85%

of respondents believe senior management buy-in is key to ESG success

This ties in with our experience. As one of the world's leading sustainability consultants, ERM works with a wide range of private equity firms each with a unique culture and variable levels of senior management buy-in on ESG. Where there is a relatively high level of senior management engagement, we see evidence of more consistent integration of ESG in deals, the operational management of portfolio companies and the communication of successful outcomes to stakeholders, including LPs, customers and employees.

## CASE STUDY: ESG performance boosts access to funds

One large cap firm was specifically chosen by investors for a greater capital allocation in light of case studies illustrating the tangible results of ESG programmes. These proved the firm had delivered sustained and portfolio-wide ESG out-performance – not just 'one-off' results. Another private equity firm

generated over \$60 million in operational savings from energy efficiency through disciplined resource management. Without senior management support, this kind of sustained performance, which involved embedding a firm's ESG expectations with new acquisitions as well as the existing portfolio, is hard to deliver.

## 2 ACCESS TO ESG EXPERTISE

# 77%

of respondents thought that developing ESG competence and/or having access to expertise were key to success

We have observed that the private equity firms that make the most progress have common characteristics: they have nominated formal accountability for ESG; engaged and empowered ESG expertise; and built ESG relationships or ensured effective engagement with portfolio companies. The ability to influence can be dependent on where the expertise sits within a private equity firm. In our experience, ESG teams work most efficiently if they have direct access and close working relationships with both the deal teams and the portfolio companies; especially if they can engage regularly with portfolio companies, provide expertise, and collaborate and share best practice. Successful programmes are often funded by the private equity firm initially, with responsibility shifting to the portfolio company during implementation when the commercial benefits become clearer. »



**CASE STUDY: Avoiding the commercial consequences of emerging social issues**

The ESG agenda is constantly evolving and often framed in the context of fast-paced social media and online campaigns, such as those relating to supply chain and human rights. This is set to continue with so-called ‘soft-law’ and legislation such as the UK’s Modern Slavery Act, which requires companies with a turnover in excess of £36 million to publish an annual statement detailing what the company has done to assess and tackle modern slavery within its supply chain and its own business. In October 2016

the Financial Times reported that M&S and SABMiller “rated highly” and Babcock International “scored the lowest” in a civil society ranking of early reports.

SportsDirect and ASOS have also come under fire for labour conditions in their operations. This can lead to legal action as shown by the KIK Germany payout regarding a Pakistani supplier, the ongoing \$2 billion Canadian case against Joe Fresh and the slavery claim by Eritrean miners.

**3 INTEGRATION OF ESG IN DEAL AND OPERATIONS TEAMS**

**75%**

of respondents thought integration was key to ESG success

In our experience, what also sets leading firms apart is their ability to embed responsible investment considerations in the deal process, ensuring that ESG aspects

are documented in investment committee papers and that material aspects are factored in to the development and delivery of value creation programmes. Systematic consideration of ESG ensures that appropriate action can be taken where it is material to either creating or protecting value.

We are also seeing a change with regard to the scope of work which deal teams want

to address, with climate change and the transition to low carbon energy; human rights and modern slavery; and sustainable products and product stewardship all featuring regularly in due diligence and value creation/protection strategies. Some of these have implications to enterprise value beyond the hold period, with potential implications to exit values and therefore exit planning.

**CASE STUDY: The transition to low carbon energy**

Looking beyond the hold period, PE firms are identifying ESG risks and opportunities that could impact PC revenue and therefore value. For example, the transition to low carbon energy has been triggered by climate policy and technology advances. The low carbon energy transition will impact the value of companies across a number of sectors, including those associated with carbon emissions and those which service or depend upon high carbon emission sectors for their revenues. In this context, it is critical to consider not just first order (i.e. direct) exposure to high carbon sectors, but second and third order (i.e. indirect) exposures to high carbon sectors, including service-related industries. Investor pressure is mounting for companies to evaluate and disclose the potential financial impacts from the transition to low carbon energy. In December 2016, the Financial Stability Board Task Force on Climate-related Financial Disclosures (TCFD) published their recommendations to the G20 for companies to assess and disclose these risks, in the expectation that this will result in some material company valuation adjustments. ERM was engaged by the TCFD to help it develop a recommended approach for assessing the commercial impacts of different low carbon transition scenarios on companies’ portfolios and their future prospects.

**TYPICAL CATEGORIES OF CLIMATE-RELATED RISKS AND OPPORTUNITIES**

<p><b>Market and Technology Shifts</b></p> <p>Policies and investment to deliver a low carbon emissions economy.</p> <ul style="list-style-type: none"> <li>■ Reduced market demand for higher carbon products/commodities</li> <li>■ Increased demand for energy-efficient, lower carbon products and services</li> <li>■ New technologies disrupt markets</li> </ul>	<p><b>Reputation</b></p> <p>Growing expectations for responsible conduct from stakeholders, including investors, lenders and consumers.</p> <ul style="list-style-type: none"> <li>■ Opportunity to enhance reputation and brand value</li> <li>■ Loss of trust and confidence in management</li> </ul>
<p><b>Policy and Legal</b></p> <p>An evolving patchwork of requirements at international, national and state level.</p> <ul style="list-style-type: none"> <li>■ Increased input/operating costs for high carbon activities</li> <li>■ Threats to securing licence to operate for high carbon activities</li> <li>■ Emerging concern about liabilities</li> </ul>	<p><b>Physical Risks</b></p> <p>Chronic changes and more frequent and severe extremes of climate.</p> <ul style="list-style-type: none"> <li>■ Increased business interruption and damage across operations and supply chains with consequences for input costs, revenues, asset values and insurance claims</li> </ul>

Source: TCFD Technical Supplement: The Use of Scenario Analysis in Disclosure of Climate-Related Risks and Opportunities

#### 4 THE NEED FOR PORTFOLIO COMPANY MANAGEMENT TO PROACTIVELY ADDRESS ESG

# 65%

of respondents thought proactive portfolio company management was key to ESG success

For the board, having a regular review and prioritisation of ESG issues can make all the difference. Quantifying the commercial value impact of an issue ensures that ESG risks and opportunities – which are often known about within a portfolio company – can be prioritised and addressed via a practical solution that both generates value and meets increasing LP expectations.

#### CASE STUDY: How product stewardship strategies can fuel business growth

Product regulatory compliance presents a key threat to business as increasingly complex legislation to manage environmental and social issues is rolled out around the globe.

If not properly managed, compliance issues can ground product launches to a halt, result in fines and damage customer relationships.

At the same time, business value generated through improved brand image and entry into new markets can be realised through effective product stewardship programmes.

Nielsen's 2015 survey of 30,000 consumers in 60 countries provided firm evidence that consumers favour brands that have a track record on addressing environmental and social issues. It found that brands with a demonstrated commitment to sustainability have grown more than 4 percent globally, while those without grew less than 1 percent.

#### 5 SHARING OF BEST PRACTICES BETWEEN PORTFOLIO COMPANIES

# 39%

of respondents thought sharing best practice was the key to success

Some private equity firms commented that it can be hard to share best practices between their portfolio companies, especially when they operate in different sectors. Other private equity firms nevertheless spoke highly of the value of sharing best practice, particularly for more generic challenges or opportunities, such as supply chain human rights and resource/energy efficiency opportunities, as this allows firms to focus time and resources on more important efforts to assess and drive improvements/reduce risk. Many private equity firms now organise regular conferences for their portfolio companies and provide both technical briefings on specific ESG issues such as climate change, water risk and supply chain management, as well as showcasing successful case studies and solutions implemented by their portfolio companies.

#### INGREDIENTS FOR SUCCESS

When we asked GPs what, beyond positive LP recognition and senior management buy-in, would really 'move the needle the most' in unlocking further value, they suggested three key success factors: identify, engage and communicate.

The ability to identify material issues early on in the investment process and to conduct holistic due diligence is key to identifying the material ESG opportunities and risks. ESG leaders noted the benefits of being able to identify value creation initiatives systematically at the onset of new investments, so that actions can be

integrated in the value creation plan and timed accordingly during the hold period.

Proactive engagement with portfolio companies at board level, and with operations teams at private equity firm level, where these functions exist, ensures that material business improvement initiatives are implemented. Further scalable opportunities may exist to drive successful pilot projects programmatically across the broader portfolio.

Our survey indicated that only a small minority of private equity firms are currently at the point where they can articulate the value impact of ESG initiatives and improvements in their portfolio companies. However, robust methodologies which link ESG with commercial impact, enable private equity firms and their portfolio companies to communicate credibly with their stakeholders. This can be powerful, especially with LPs, as well as portfolio company customers and employees.

Evidence is increasing that investment firms which explicitly consider ESG are realising financial and non-financial value both during ownership and at exit. We also see private equity firms 'changing gear' in terms of their level of ESG leadership and commitment. The fact is, ESG is moving from a 'tick-box' exercise, towards robust ESG management which is 'hard wired' into processes in order to both deliver and protect value. ■

To read the full report visit [erm.com](http://erm.com)

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# Responsible Investment: Delivering Value from ESG for Private Equity Firms

- 20 senior leaders supporting the private equity sector on ESG issues and 4,500+ professional staff to draw on
- Team members with a unique blend of technical environmental and social, private equity, limited partner, lender, accounting and advisory backgrounds
- Holistic service offering covering full breadth of PE ESG needs across the investment lifecycle
- Bankable reporting with lenders and pension funds, who are comfortable placing reliance on ERM findings
- Leveraging learnings from 40 years of supporting corporate leaders in embedding sustainability
- Over 500 ESG-related projects completed annually for PE sector
- Over 160 offices in 40 countries

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ERM offers the following environmental, social and associated governance support across the investment lifecycle.

