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Promoting Sustainability Can Create Value For PE Firms

Recent surveys published by prominent private equity, accounting and consulting firms show that private equity firms increasingly are focusing on sustainability to generate value and attract investors. As David Rubenstein, managing director of Carlyle Group, told The Wall Street Journal, "if you are willing to put in the time to improve the sustainability principles of a company, you can in fact make more money."[1]

What Does "Sustainability" Mean for PE Firms?

For PE firms, sustainable business practices may be defined to include deliberate assessment and management of environmental, social and governance (ESG) issues throughout the investment cycle — diligence, acquisition, ownership and sale — to reduce risks and costs, and to create value and opportunity. Sustainability assessments look beyond legal compliance and liability risks to evaluate environmental and social impacts, directly at operating facilities, and indirectly through suppliers of products and raw materials.

Increasingly, adopting, implementing and reporting results of sustainability initiatives are becoming conditions and measures of eligibility, both for investors to contribute capital[2] and for significant customers to continue purchasing products.[3] Supply chain risks, in China and emerging markets, are becoming an area of particular scrutiny.[4]

When implemented diligently, sustainability programs can produce measurable value. In addition to avoided legal and reputation risk, key drivers for value from sustainability programs may include cost savings, revenue growth, market differentiation (e.g., "green products") and brand promotion. In a December 2011 report, Kohlberg Kravis Roberts (KKR) states that, since its inception in 2009, its Green Portfolio Program has resulted in $365 million in avoided costs, in addition to reducing environmental impacts of operations.[5] Doughty Hanson reported that its first round of sustainability initiatives generated savings and additional income of €18 million annually, and it forecast a further €21 million annually.[6]

U.S.-based PE firms are focusing primarily on "eco-efficiency" opportunities.[7] These are measurable opportunities, for example, to reduce use of energy, water and raw materials, and to minimize generation of solid, hazardous and other wastes. Eco-efficiency initiatives may include changing fleet logistics to reduce fuel usage; minimizing packaging to reduce materials costs; replacing chemicals and raw materials used to manufacture products with less toxic and costly alternatives; eliminating waste, through materials management and recycling programs, to reduce production and disposal costs; and conserving water and energy to reduce resource costs.

Where to Begin?

In general, PE firms and their investors in Europe have pursued sustainability initiatives more aggressively than have their American counterparts. Some European pension funds require sustainability or "responsible investment" commitments and programs as a prerequisite to engaging an asset manager. Because of investor concern, pressure to compete in international markets, and recognition that sustainability management can produce measurable value, U.S.-based PE firms now are trending toward adoption of sustainability programs, particularly at the larger cap end of the industry.[8]

Two protocols that establish criteria for framing and implementing sustainability programs are the United Nations-backed Principles for Responsible Investment (PRI Principles)[9] and the Private Equity Growth Capital Council's Guidelines for Responsible Investment (PEGCC GRI)[10]. The PRI Principles are six norms that asset owners and investment managers sign and "publicly commit" to follow, including to incorporate ESG issues into investment analysis and ownership policies and practices, and to publicly report the results of activities undertaken to meet sustainability objectives. The PEGCC GRI are less formal guidelines which, although modeled on the PRI Principles, are stated largely in aspirational terms and do not entail either signature or express declaration of public commitment.

Surveys indicate that, although most PE firms take ESG issues into consideration to some degree, few have made a public commitment or adopted formal policies and systematic procedures to do so.[11] With limited exceptions,[12] firms are integrating sustainability principles into the acquisition process on an ad hoc basis, with, perhaps, more systematic application during the ownership phase.

This may reflect reluctance to inject procedural formality and add costs at the front end of the investment cycle, and growing recognition that, once a portfolio company has been acquired, eco-efficiency projects may be implemented to realize value in the relatively short term prior to sale. Many firms, however, have found that integrating sustainability assessments into pre-acquisition diligence can have several potential advantages, including identifying initiatives at a stage when they can be reflected in the valuation model and targeted for action early in the ownership phase.

The scope and sophistication of sustainability programs that PE firms adopt will vary depending on their size, sector focus, investor base and overall management philosophy and approach.[13] Large firms, like Carlyle and KKR, are more apt to adopt systematic written programs, and to retain a sustainability officer in-house to frame and implement such programs. Middle and lower middle market firms, by contrast, are more likely to implement programs on a less formal basis, and target resources to particular portfolio companies that present the greatest opportunities for sustainability evaluations and initiatives.

Fully realized, a comprehensive sustainability program generally would include the following elements:

- A formal policy that clearly communicates goals and standards for identifying and managing sustainability (ESG) issues;
- Written procedures for evaluating sustainability issues as part of the diligence process, including methods for identifying and valuing compliance, operational and supply chain risks, and potential eco-efficiencies;
- A clear framework for integrating sustainability findings into the overall management plan for the portfolio company post-acquisition, including plans and procedures for implementing sustainability findings, and targets against which to measure performance;
- Internal systems for tracking and reporting on sustainability initiatives, both to manage knowledge and stimulate creative growth, and to communicate with investors and future purchasers; and
- A network of professionals, external or in-house, to implement sustainability policies and procedures, and to inform investment and portfolio managers about material ESG risks and opportunities.

Institutional investors, a key constituency for PE firms, increasingly are demanding well-developed sustainability programs as a condition for investment. PE firms that have established sustainability programs continue to report success in managing risks, reducing costs, adding value and achieving competitive advantage, both in connection with fund raising and at the portfolio company level. As these trends continue, other firms are likely to follow. In the longer term, adoption and implementation of sustainability programs, in a form appropriate to the size and market niche of the PE firm, are expected to emerge as a new standard of practice for the industry.

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[1] "The Private Equity/Sustainability Link," Wall Street Journal (March 26, 2012), available at www.online.wsj.com.

[2] See, e.g., "ESG in Private Equity," Malk Sustainability Partners and Environmental Defense Fund (September 11, 2012), available at www.Malksp.com/ESG-Private-Equity/; "Reporting on Environmental, Social, and Governance Considerations in the Private Equity Sector," BSR (August 2012), available at www.bsr.org.

[3] Walmart is perhaps best known for its comprehensive supplier sustainability program, through which it uses detailed questionnaires to collect information, and to rank and reward competing suppliers based on its sustainability index. In a recent speech he delivered in Beijing, Walmart Chief Executive Mike Duke announced that, by the end of 2017, Walmart will buy 70 percent of the goods it sells in US stores only from global suppliers that use the company's sustainability index to evaluate and disclose information about their products. BNA Daily Environment Report (Oct. 29, 2012).

[4] For example, human rights complaints about labor practices and workplace conditions at FoxConn, one of the largest manufacturers of Apple's iPhones, has received widespread and sustained media coverage.

[5] "KKK Green Portfolio Summary" (December 2011) available at www.green.kkr.com/results

[6i] "Private equity and responsible investment: an opportunity for value creation," Doughty Hanson & Co and World Wildlife Fund at 27 (November 2011), available at www.doughtyhanson.com/responsible-investing/wwf-sustainability- report aspx.

[7] "Responsible investment: creating value from environmental, social and governance issues," PricewaterhouseCoopers at 2 (March 2012), available at www.pwc.com/sustainability.

[8] See "ESG in Private Equity," supra.

[9] Available at www.unpri.org/principles/

[10] Available at www.pegcc.org/newsroom/press-release/private-equity-council-members-adopt-guidelines-for -responsible-investment/

[11 See "Responsible investment" and "ESG in Private Equity," supra.

[12] Carlyle Group, for example, uses a diligence tool called "EcoValuScreen" that goes beyond the traditional focus on environmental compliance and risk mitigation to identify potential operational enhancements that will reduce both impacts and costs. The screen is designed to be flexible and broadly applicable to any industry sector.

[13] In their study, "ESG in Private Equity," Malk Sustainability Partners and the Environmental Defense Fund present a table of "best practices" that traces the trajectory that sustainability

programs at PE firms have adopted during the “emerging,” “developing,” and “leading” stages of program maturity.