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OPINIONS ARTICLES

Can active partnerships produce triple bottom line results?

BY PHIL CASE AND LAUREN KOOPMAN

The business of business is business, the US economist Milton Friedman once insisted. "Particularly if private equity owned…" he might have more recently added, given the PE industry's reputation for business efficiency and short-term value creation, often through highly-leveraged business models. Friedman's opinion may be seen as an incontrovertible truth by many in the PE industry, but surely any debate turns on the definition of what constitutes 'business'.

That debate increasingly focuses on the contribution business can and should make to 'sustainable development' – which has been defined as "economic development that meets the needs of the present, without compromising the ability of future generations to meet their own needs". Of course, the concept of sustainable development has been front page news for some years, owing to the combined effects of several 'sustainability mega-trends', which cannot be ignored. Such seemingly long-term trends as climate change, water resource constraints, population growth and demographic change are beginning to have significant financial impacts in the 'here and now', causing many prominent businessmen to rethink their business strategies.

Corporate response to sustainability issues has evolved as companies recognise the financial impacts. Sustainability initiatives were historically compliance driven and concentrated on risk management. Companies were protecting their licence to operate as regulations became stricter and were guarding against negative public relations caused by environmental or social impacts. This risk focus shifted as companies realised new efficiencies by viewing business through a sustainability lens, achieving cost savings through energy and fuel efficiencies and waste reduction. Using sustainability to obtain new EBITDA enhancement opportunities is now being expanded beyond cost cutting to revenue growth. Companies are finding ways to use sustainability to create new products and services or to modify existing ones in order to attract and retain customers who are placing increasing importance on sustainability.

So, how does the creation of sustainable businesses coincide with private equity's focus on efficiency and profit? Increasing numbers of PE executives are recognising the overlap. Some PE houses, such as Climate Change Capital and Global Environment Fund are specialising in the opportunities generated by the global transition to a low carbon economy. Others, meanwhile, such as Generation Investment Management take a longer term view, integrating sustainability research into investment decisions. But what about non-specialist PE houses?

Until recently the 'responsible investment' (RI) agenda, which has emerged from the sustainable development trend, appeared to offer few advantages for private equity generally. It was chiefly seen as having a brand or investor relations benefit for companies in the public arena. Now this is changing, as sustainability issues look likely to have a major impact on the performance of portfolio companies, their valuations and therefore, private equity owners.

The emergence of the UN Principles of Responsible Investment, adopted by over 520 asset managers has served to catalyse action by PE houses to demonstrate their responsible investment credentials. Major signatories, such as the large pension funds and sovereign wealth funds, are asking questions of fund managers and focusing their investment strategy around more 'sustainable' propositions. Houses are having to respond with demonstrable RI policies and procedures for screening new investments – for a really fundamental reason: to preserve their access to capital.

For many PE houses, though, there is an equally powerful reason to act: sustainability is showing signs of affecting their ability – both positively and negatively – to deliver returns for investors. For example, environmental issues are creating both opportunities for businesses to grow and significant potential liabilities that have to be managed. The move towards a cleaner world is opening up whole new product markets, while at the same time gradually forcing companies to pay for their pollution.

Attributing a financial value to the 'responsible investment' dividend continues to prove challenging, with no widely accepted methodology yet emerging. In the public equity markets, there is plenty of evidence of 'correlation' between action on sustainable development and improved investment returns: research by AT Kearney in 2009 showed that companies committed to environmental, social and governance (ESG) performance (measured through inclusion in the Dow Jones Sustainability Index (DJSI) and Goldman Sachs SUSTAIN) achieved above average performance in financial markets during the economic slowdown. The performance differential cited in their research equated to an average of $650m in market capitalisation per company.

For some in the private equity markets, such 'correlation' is enough to persuade them to act, so as to generate 'triple bottom line' (economic, environmental and social) returns. For others, the search for firm evidence goes on, and valuation techniques are being developed to assist. The direct benefits, such as increased revenue from new 'responsible products' (such as Fair Trade, organic or energy efficient products), or from reduced costs through 'eco-efficiency' – doing more with less (such as energy efficiency or waste reuse) – are relatively easy to quantify. Indirect benefits such as improved brand and reputation, or greater employee engagement as a result of working for a 'responsible company', are less tangible and therefore

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more challenging to value. A third category – externality value – from environmental protection and socioeconomic benefits, is harder still to value, but techniques are increasingly available. Taken together, all three elements of the RI valuation equation make an increasingly powerful *financial* case to integrate consideration of ESG issues throughout the investment life cycle.

This process should start at the pre-investment stage if sustainable development considerations are to be truly integrated into the 100 day or 180 day plans for portfolio company performance improvement that are typically initiated on acquisition. Traditionally, the focus of pre-investment ESG due diligence has been on commissioning site-specific, environmental due diligence as part of risk management. For companies operating in environmentally sensitive sectors in particular, there is still a place for this – the quantum of environmental risk or contingent liability should certainly be ascertained in advance. However, today the scope of ESG due diligence has been extended to embrace both ESG opportunities and risks, and to cover the portfolio company's entire value chain. In short, ESG issue management has become a strategic consideration.

Having identified ESG opportunities for value creation at the pre-acquisition stage, it is imperative to ensure that they are realised during the PE house's period of ownership. Indeed, freed of the short-term spotlight of analysts in public equity markets, PE houses have a real opportunity to think and act on a slightly longer timeline – and gain a competitive advantage in the 'green race'.

Several PE houses have recognised the influence they can wield through having control – particularly in buyout situations – and are engaging not only via representation on the board, but increasingly through a deeper level of engagement with operational management teams too. Indeed, several houses are starting to work in active partnership with their portfolio company management teams to identify incremental ESG value. An example is KKR's Green Portfolio Program which applies the firm's approach of assessing, measuring, and optimising performance to help their portfolio companies manage their environmental impacts while also improving their businesses. Preliminary results have been impressive, with $160m in eco-efficiency cost savings realised in a pilot of eight KKR portfolio companies in the period 2008-9 alone. KKR is now rolling the program out to cover approximately 30 percent of companies in its global private equity portfolio.

Success in delivering value from ESG initiatives is not confined to those PE houses adopting a holistic 'cradle to grave' philosophy. Many are taking a 'retro-fit' approach. That is, they are reviewing their existing portfolios to identify opportunities to protect or enhance value which may well have been missed at a time when pre-acquisition ESG due diligence had a narrower scope. Timely action is then being taken, in concert with portfolio company management teams, to develop and deliver tangible value through sustainability programmes. Such houses then have a great value story to tell at the point of exit which resonates with investors and other increasingly interested stakeholders.

Not all PE houses are yet embracing the notion of 'active partnership' with portfolio company management teams on ESG issues. Nevertheless, there is evidence that consideration of environmental, social and governance issues is moving to centre stage. The business of business is becoming sustainable business. ■

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