ERM Insights

Portfolio monitoring of ESG performance

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Private Equity (PE) firms are increasingly recognising the need to not just consider environmental, social and governance (ESG) factors as part of their investment process but also the need to effectively communicate their approach and the ongoing performance of their portfolios to stakeholders.

ERM has identified some strong market trends through the completion of over 250 ESG-related assignments across the globe for PE firms.

- The evidence that ESG factors impact company value continues to mount, stressing the importance of an integrated ESG approach. For example, environmental considerations revealed $13m of potential value lost from continuity of supply constraints and limits on growth in a recent food business acquisition diligence.

- Given the sustainability megatrends facing companies, such as climate change and water constraints, complex supply chains and human rights concerns, ESG issues have a strong potential to present both material risks and opportunities.

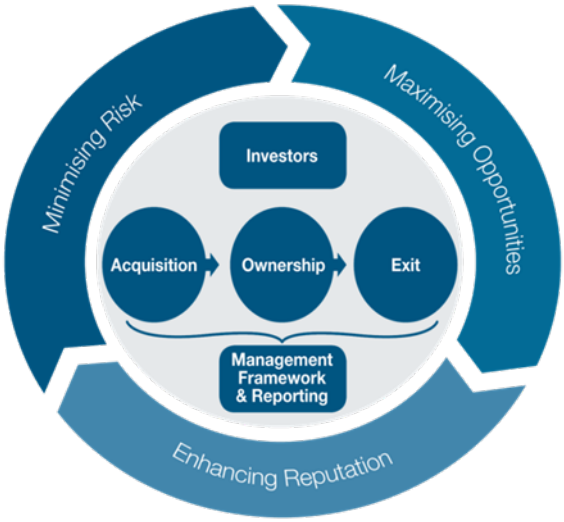
- Some leading companies are maximising value from proactively addressing ESG issues but in our experience more than 70 per cent of PE backed companies are yet to fully realise material ESG opportunities.

- Shaping an effective ESG framework, including processes and reporting, to align interests of stakeholders is critical.

- Applying a holistic ESG mind-set early in the investment process can help maximise business value.

- Focused engagement is needed with portfolio companies including improved visibility and reporting of ESG at board level to enhance performance and realise greater value at exit.

Companies that have proactively addressed ESG issues, have not only achieved significant financial gains, but have also achieved better competitive positioning with ESG-sensitive customers, some of whom may have very strict supplier requirements. Matt Klein, Head of ERM's Transaction Services, Asia-Pacific comments: *"A good example of a product focussed initiative is of a* *lifecycle assessment programme, which enabled a pipe manufacturer to gain significant market share at high double digit margins in Australia by demonstrating their products' better environmental credentials compared to competitor offerings."*



Private Equity — the investment perspective

Consideration of ESG issues is relevant at all stages of the investment lifecycle. From identification of material ESG issues during pre-acquisition to active engagement during ownership, the prudent investor looks to ensure risks are mitigated and opportunities identified are realised. Cristina Knapp, ERM's co-lead for M&A Transaction Services in the Latin America & Caribbean Region says: *"In Latin America, ERM has been working with a major buy-out firm to introduce an innovative ESG screen which not only informs the deal team of material ESG aspects early into the process but also, helps to focus the main diligence on the critical issues that can impact value."*

When exiting an investment there is an opportunity to demonstrate that ESG issues have been addressed and will not appear as liabilities in the next owner's due diligence. There has been an increasing trend of companies commissioning ESG vendor, or sell-side, due diligence reports as part of the exit preparation, Guy Roberts, ERM Partner, comments: *"In the UK, we have seen a 60% increase in the vendor due diligence work commissioned by PE backed companies over the last 18 months."* In a recent vendor ESG due diligence programme, a PE backed European manufacturer reduced potential exposure and capital outlay by $2.5million.

While Limited Partners (LPs) are clearly looking for favourable financial returns, their own diligence of the General Partner (GP) is increasingly requesting assurance that a formal management system is in place to ensure that risks associated with ESG issues are understood, mitigated and managed. European LPs have led the way in this regard, however this seems to be changing, Andrew Radcliff, Head of ERM's Transaction Services, The Americas says: "Up until the last year or so, European LPs have been driving the agenda for GPs to address ESG issues in their investments, however, in recent months we have seen more US and Canadian LPs focusing on ESG issues in their investment evaluations."

Julien Famy, Head of ERM's Transaction Services, Western Europe and North Africa adds: "We may also see a trend whereby some of the larger LPs may concentrate their investments in fewer managers. Hence, the ESG factors impacting such investments positively or negatively are likely to get compounded." Some of the larger and leading LPs are working on their internal assurance programmes to get comfort that the GPs and their portfolio companies are addressing such issues appropriately and proactively.

GP ESG Integration Stages

Managing a portfolio provides a challenge for GPs as they look to monitor performance against relevant and material ESG factors with the most potential to impact value of the investment and communicate to LPs how they effectively mitigate risks and realise opportunities to enhance value.

The GP approach will vary depending on where they are themselves in the process of integrating ESG in their investment management. This can be categorised broadly into the following three stages:

- *Stage 1:* **Early stages of ESG integration.**
  These PE firms will likely have limited internal ESG support and may have a limited experience or knowledge of ESG factors.

- *Stage 2:* **Developing or recently established ESG processes.**
  These PE firms will likely have some ESG framework in place through policies and process but may have limited internal resource or need technical support as they further develop the roll out of their policy and process, both in embedding ESG within their investment processes, and in their engagement with portfolio companies.

- *Stage 3:* **Fully established investment process that includes engagement on ESG matters across the portfolio.**
  These firms have implemented strong ESG pre-acquisition diligence processes, collect portfolio wide data on a regular basis, monitor progress and support companies (where this is possible), prepare for exit and report on ESG performance to investors and other external stakeholders.

Invested Company ESG Maturity Phases

We have also identified that invested companies themselves go through an evolution in their approach to managing ESG issues (*Figure 1*). This consists of four phases:

1. Companies need to understand and **identify the material issues.**

2. Having identified the 'material' issues, companies then need to **develop a response.**

3. The next phase is to **measure and monitor performance** so that effectiveness of management controls and progress of performance improvements can be defined.

4. The final phase involves **communication** of approach and results; firstly internally and then externally.

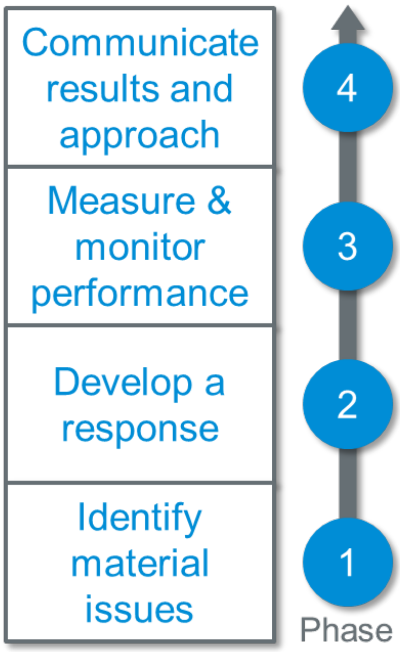
Karen Aitchison, ERM's EMEA Transactions Services Lead comments: "*The assessment of material issues requires the identification and engagement of stakeholders, both internal and external – to ensure ESG issues can be identified across the full value chain of the company.*" These issues then need to be assessed in terms of their importance to the key stakeholders and their potential to impact the business' strategy and goals. Right through these maturity phases, there are ample opportunities for PE backed companies to draw from lessons, both positive and negative, from other corporate sustainability leaders in their respective sectors, who have already been through a similar journey and reporting process.

Demonstrating ESG Management

Effective management of a diverse portfolio recognises the company phases of maturity as GPs work to engage their portfolio companies to ensure that the *procedural measures* are in place and are robust, i.e., material issues identified and management policies and programmes maintained; and that *performance improvement measures* have been implemented.

Irrespective of the stage PE firms are at, it is important that they look for some level of assurance that their portfolio companies meet basic standards of ESG performance and therefore need to have effective and efficient processes for communicating with their portfolio companies.

ERM has developed an *ESG Reporting Approach* that supports the integration of ESG considerations in the GP investment process in the following ways:



1. Early assessment of ESG awareness and maturity among portfolio companies by collecting:
   - Gathering information to demonstrate adequacy of management of ESG (such as percentage with policies, percentage with ESG committees, with ESG board representative, percentage with ethical products etc.)

2. Identifies the material ESG issues for each company/sector.

3. Monitor and supports exit preparation by
   - collecting data to demonstrate improvements in ESG performance
   - resolving ESG issues during ownership

4. Provides a repository so that the company or GP can review each company's status at a given moment in time.

When a PE firm (GP) is at *Stage 1* or early *Stage 2* the approach can provide a structured mechanism to provide an initial assessment at a portfolio and/or company level and can support ESG policy and practice development at both.

The approach further supports PE firms at *Stage 2* as they work to put ESG polices into practice and engage as owners in an appropriate way to promote the development of relevant ESG metrics at a portfolio and/or company level.

For PE firms at *Stage 3* the approach offers a streamlined process to measure and record progress core metrics and/or improvements in ESG performance over time at a portfolio and/or company level.

In addition to internal monitoring and communication with investors, both LPs and GPs may have additional external reporting expectations or requirements, for example, reporting requirements of the Principles of Responsible Investment (PRI). *"The impact of PRI has been significant in promoting the ESG agenda within the financial community,"* says Jens Wrabel, ERM Partner, Central Europe. Arguably real value from ESG initiatives is generated at portfolio level and hence it will be interesting to see how the PRI further develops its reporting and assurance process to include portfolio company ESG performance indicators.

Conclusion

ESG issues have been proven to have the potential to present material risks and opportunities to companies and to their stakeholders. However, there are still a large number of PE-backed companies that are yet to fully appreciate the impact of sustainability mega trends and associated ESG issues on their operations and markets.

Portfolio companies are likely to be at different phases of maturity in terms of their approach and performance on ESG issues, largely driven by their industry sector and customer expectations. An effective GP strategy for engagement takes account of the portfolio company's maturity and adapts to provide a level of support and engagement that is appropriate in terms of the maturity but also commensurate with the extent of risks and opportunities.

The *ESG Reporting Approach* provides a framework for effective communication with portfolio companies, investors and other external stakeholders. Firstly by assessing ESG maturity, for example, have companies identified their material issues, do they have policies and management procedures. Secondly, it assesses ESG performance in terms of efficacy of processes and ongoing management of ESG issues.

Considering the potential ESG can have on investment value GPs are left to assess their stage of ESG integration. Are they able to engage effectively and efficiently with their portfolio companies and assess their ESG maturity? Are they well positioned to take advantage of opportunities to enhance business value? Are they able to proactively communicate with their LPs and to build confidence in their ability to manage the portfolio in accordance with LP's own commitments on ESG and to protect their LPs from adverse media attention and associated erosion of value?

Mark Errington, ERM's Global Head of Transaction Services comments: *"Whilst initially LPs may be satisfied to see some minimum ESG standards or commitments from GPs, over time, it will be interesting to see how LPs recognise ESG out-performance or under performance, and establish incentives accordingly."*