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EXPERT DISCUSSION

ESG in Private Equity: A 'Tipping Point' in Risk and Opportunity Assessment

Three private equity value-creation experts discuss the rise of ESG in private equity and how it is increasingly being used by GPs for risk assessment and value creation. The conversation includes an overview of Bregal Partners' history as an ESG-centric investor, aligning with ESG-focused founders, measuring ESG impact on financial performance and setting carbon-neutral goals.

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FEATURED EXPERTS:

Charles Yoon

MANAGING PARTNER

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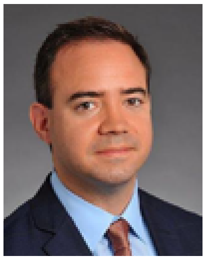

Michael Fanelli

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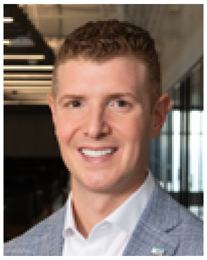

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Privcap

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>
> - CHARLES YOON, BREGAL PARTNERS

Privcap: Charles, why don't you begin with how your firm, Bregal Partners, came to be a leader in ESG applied to private equity investing?

Charles Yoon, Bregal Partners: Our largest and sole investor in our fund is a charitable organization of the Brenninkmeijer family. The entire fund and the platform was started with ESG as a core mandate. It's involved in how we make investments and what we do after the investment. They backed us to make sure ESG became a prominent portion of how we invest in how we manage our businesses.

Privcap: More generally, how have ESG considerations become more prominent within private equity?

Michael Fanelli, RSM: ESG is coming to a tipping point. It feels like cyber did a few years ago, where people knew they should do something about cyber from a diligence perspective, but were slow to respond because they didn't think it impacted them. Now, more and more firms are implementing cyber strategies throughout their portfolio. We are proactively reaching out to all of our clients and prospects to discuss ESG, and they are more interested to hear about it now than ever.

Anthony DeCandido, RSM: I boil it down into three broad categories of how ESG integrates into private equity. These start with pre-screening—meaning, are there any ESG risks the company identifies that are aligned to its organizational policies and strategies and other mandates? Second, ESG shows up a lot within initial investment analysis and that usually can be conducted through a variety of sources: it could be by way of industry data, publicly available company reports, third-party research.

Last is around the diligence itself. If, through that initial investment analysis process, diligence is determined to be required to better understand risks and opportunities for ESG, the groups we work with often will do targeted research around certain documentation requests. They might also conduct interviews and stakeholder mapping exercises. They could do materiality determinations. They could consider whether certain policies and procedures are required over the diligence process itself.

Yoon: We started immediately with ESG as a core focus back in 2012, 2013, when no one was talking about it. We have a separate team that focuses on ESG. One reason for this is that a lot of us don't actually know how to do ESG. I've been doing private equity for almost 30 years. I don't know how to do ESG. Most people in the U.S. haven't done it before. People in Europe are further ahead.

> One of the things we've seen in our practice, that's gotten a great rouse, has been our 'societal return on investment' methodology."

ANTHONY DECANDIDO, RSM US LLP

We have professionals in portfolio services—for example, operating partners—who might help with finance. We also have a portfolio services team that focuses solely on ESG. Most of them got their experience in Europe. They're like compliance in that they are independent and able to say, "Yes, I know that investment looks really interesting from a returns perspective, but it doesn't fit ESG."

Privcap: Let's focus more on the risk side of things. What are some typical flags or warning signs that come out if you use an ESG risk filter?

DeCandido: We usually see materiality boil down into two separate components: one is progressive risks, meaning they can happen over time. The other is acute risk—things that can happen in a short period and have material significance. The risks we see most often are things like greenhouse gas emissions, labor practices, training, employee safety, workplace safety. On the social side, diversity and inclusion is a big one, as well as cybersecurity of privacy and data.

Then, we move into governance risks like business ethics. Lately, we've seen supply chain management issues come up because of what's going on in the global supply chain.

Fanelli: Understanding what the suppliers and customers are thinking on this topic ends up being interesting because, in doing all this risk mitigation analysis, you need to understand the "why" behind it. We're seeing more and more people changing their preferences. These could be people at your company, employees, customers, vendors, suppliers. The financial ROI of adopting ESG might be long-term in nature, but will be impacted by our customers and suppliers ultimately demanding these processes and procedures. So, growth and margin improvement are going to hinge on this as well.

Yoon: We start at a much higher level. I was at a traditional private equity fund where the LPs said, "You cannot invest in tobacco, guns, porn." But if you are fully committed to ESG, that list is a lot longer. There are some industries that you can't invest in, because there's a conflict between ESG and making money. For example, there are some healthcare investments we don't do, because our head of ESG will say there is a conflict between quality of care and making money. How can you be ESG friendly if there's that conflict? So, we don't invest in it. There may be a consumer business with a finance division that is charging ridiculous interest rates to the poor. That is an example of where the conflict is inherent. We've passed on food businesses that provide sugar water to kids, adding to obesity. So, the filter at the top of the funnel becomes broader.

Sometimes, we can take a business that is not very ESG friendly, where we know we can reduce risk, making the company more valuable. If you pass the screen, you can go deeper into improving the business.

Privcap: If a GP that embraces ESG is very open about it, does that provide an advantage with CEOs who are also very ESG-oriented?

Yoon: It's self-selecting. Almost 100 percent of our businesses have been founder-owned, and they choose to partner with us. ESG is important to them. If it isn't important, they don't want the burden. If the founder doesn't care, we're not going to be the winners. But, these days, they do care. Because of that, we win businesses. It is a competitive advantage.

Privcap: It is important to note that private equity firms are using ESG principles to improve the businesses they invest in. Hopefully, this improves the businesses not just from an ESG perspective, but also financially. Charles, would you see something like a recycling program as being not just good for the environment but also good for the financial performance of the company?

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Yoon: ESG is a lot more comprehensive than recycling. There are so many opportunities. Take food and beverage, for example. If you put in a rigorous process around food safety, your company is going to be more valuable. If you're a food company that has never had recalls—salmonella or any of those things—because of your focus on safety, the company is more valuable. Same thing with employee safety. If you put the emphasis on employee safety, your insurance costs go down, because you have fewer incidents. You have happier employees and less turnover. All of these actually increase your profitability. So, it's a win-win. Not only is it an improvement in ESG, but it actually increases the value of the company. Trust me, your cost of insurance and hiring goes down. All these things matter when you can exit your investment at much higher valuation.

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DeCandido: This is where the rubber hits the road: how do we quantify ESG exercises? Most people listening can buy into the ideal that we're doing all these corporate behaviors because they drive societal outcomes. Yet, we also know that the private equity community is focused on short-term and long-term results. How do we put these opportunities in front of managers in a way that ties changes in behaviors to improved financial performance?

One of the things we've seen in our practice, that's gotten a great rouse, has been our "societal return on investment" methodology. This is the correlation and monetization of changing corporate behavior to changes in financial and non-financial performance. We work with companies to help them tell the impact story they're trying to address. We begin to identify pathways for them to do it, and then assess the breadth of each one of those impacts. So, how can we monetize that in a way that demonstrates immediate ROI so that it shows up in the performance of the business?

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Yoon: It's not easy. Most people don't know how to do it. I don't know how to do it. In private equity, everything is measured. It's all performance-based. Bregal started with one person in portfolio services. Now, the ESG team has grown to four, and they manage consultants. It is very specific to each company. This team needs to figure out what the project is in a given year, and how it is going to be measured. Figuring it all out is both an art and a science. They also need to figure out what the management team is capable of because, if you don't have the team to do it, you can't do it.

Privcap: Charles, your firm quietly provides grants to many of the companies in which you invest. Can you walk us through that process?

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Yoon: Everyone joining our firm knows ESG is a priority. We have an LP that is more of a charitable organization, so there are several pockets of money the portfolio company can tap for things they're passionate about in their community. To start with, each portfolio company has to fill out a grant application. If they get approved, it can be anywhere from $25,000 to $200,000.

In addition, the charity itself has very large funds to help different causes for the portfolio company. Then, there's a third fund, which is for big projects about carbon footprint neutrality.

Privcap: All three of you have said there is a sense of momentum around ESG in private equity. Anecdotally, what are you hearing from clients and investors that supports this?

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DeCandido: It wasn't so long ago that some among our clientele were questioning why we would even

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MICHAEL FANELLI, RSM US LLP

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bring an ESG discussion to the table for traditional onsite diligence. That narrative has changed a lot. We spoke earlier about the need to quantify the results and integrate ESG into corporate decision-making. ESG is effectively a new business language that corporate leaders need to learn. Where it's beginning to show up differs based on the profile of the company and the private equity group. For example, a financials business has different risks and opportunities than an industrials business. But there's no doubt in my mind that the community has been enlightened around the pro-societal outcomes of ESG. The work to be done is around the quantification and integration of ESG into investment decisions.

Fanelli: There are more and more people asking about ESG and wanting to hear a dialogue on this topic. But there's still some skepticism in the marketplace. More people are requiring it of GPs, LPs, lenders and, ultimately, consumers and suppliers of products. That's what's going to move the needle. We are at a tipping point here. These constituents are going to continue to ask about and require ESG strategies. The more the marketplace can come to a more consistent approach to reporting on the results of ESG impacts—that's where we're going to see this topic skyrocket.

Yoon: The impediment is people. There are not enough people trained to execute on ESG. It's hard to find folks who know how to go and implement the things everyone knows about at a high level. How do I do this? How do I measure this? That will continue to be the bottleneck. The folks who are specialized at ESG—there are not that many people with real experience doing it. There's the Dutch, the Germans and the Swiss. But, in the U.S., the lack of people will make it hard to go at a fast pace.

Bregal is committing to reducing emissions by 50 percent by 2030. Not only for our firm, which already is carbon footprint neutral. We want all our portfolio companies to get to a 50 percent reduction in emissions.

Privcap: Charles, if Bregal as a private equity firm is carbon neutral, what is different about your day-to-day work life versus someone at a private equity firm that is not carbon neutral?

Yoon: It's fairly easy for a private equity firm to be carbon neutral. What is our carbon use? It's mostly travel. And during COVID, it was easy to not travel. We offset travel by planting trees in different parts of the world. Getting to our goals by 2030 for our portfolio companies will be harder. These companies are involved in manufacturing, and they have distributions and logistics involved. Getting them to reduce their carbon footprint is harder.

Privcap: So, Charles, if someone meets you in a city other than New York, they should rest easy that there's a tree growing somewhere to offset the travel that brought you there?

Yoon: That is correct.