THE BUSINESS CASE

1. INTRODUCTION

1.1 Why investors are concerned about ESG

ESG aspects are often represented as risks to business, however, there is also growing evidence across all industry sectors that when ESG aspects are proactively managed and integrated into business strategy and operations, they can generate opportunities to realise financial or other business benefits. Private equity (PE) funds are often well placed to catalyse such opportunities and PE investors cite a range of benefits to proactively addressing ESG opportunities throughout the investment cycle. According to a study published in 2014 by the Coller Institute of Private Equity at the London Business School, ESG has become a, “core value-creation strategy at private equity funds in portfolio companies”.

Furthermore, a 2012 PWC study noted that in an increasingly competitive fundraising environment, managing ESG risks and opportunities is a way for fund managers to differentiate themselves and maximise their access to investment capital (Source: ‘Responsible investment: creating value from environmental, social and governance issues. A survey of the private equity industry’, PWC, March 2012)

1.2 Linking ESG to fiduciary duty and investment returns

A substantial re-interpretation and broadening of the purview of legitimate fiduciary responsibility means that companies’ performance on ESG matters can and should be assessed extensively by fund managers.

Although fiduciary duty has different definitions and different legal interpretations in different countries, most share key principles. Fiduciary obligations exist to ensure that those who manage other people’s money act responsibly in the interests of savers (clients or beneficiaries), rather than serving their own interests. Fiduciary duties are generally seen as requiring a higher standard of performance than those generally imposed in contracts.

There is growing recognition that ESG performance is part of a fund manager’s fiduciary responsibility. The emerging view is that integrating ESG considerations into investment analysis so as to more reliably predict financial performance is permissible within fiduciary duty. This is codified in some countries. For example in South Africa, Regulation 28 of the Pension Funds Act sets out that responsible investment is not only consistent with fiduciary duty, but is actually a core element of good governance for retirement funds in South Africa.

2. VALUE DRIVERS FROM RISK TO REWARD

While the focus of this section is on the opportunities to drive value through enhanced ESG performance, it is important to emphasise that these efforts should be built on effective ESG risk management. Where ESG risk management is poor, an Action Plan should be developed and implemented in advance of or in conjunction with ESG value creation work.

Opportunities for ESG focused value creation are specific to each company and sector. The CDC Sector Profiles identify many sector-specific opportunities to help fund managers add value to companies. ESG factors which have proved to be closely correlated with value-creation include improvements in labour practices and efficient use of resources (especially energy and water use) and reducing the cost of doing business by eliminating bribes and facilitation payments.

The graphic on the following page provides a framework for identifying how good management of ESG aspects can result in greater total shareholder return, by improving margins and revenue growth, and increasing the valuation multiple both by growing profits and reducing the risk premium.

Each investment will have different ESG risks and opportunities and depending on its country, sector and specific characteristics. The sector briefing notes identify common/consistent ESG value drivers by industry sector. Unlocking opportunities does not have to be complicated but is not always self-evident. Fund managers may benefit form preparing a matrix (see example in Annex 1) to help them identify opportunities to add value to business from ESG improvements. The following section provides guidance to fund managers on frequently encountered value drivers and case studies.

2.1 Risk management - Improving environmental and social and business integrity management systems

In most companies, there will be opportunities to improve how they manage environmental and social risks. For example, introducing formal management systems or having management systems certified to best international standards. This may involve some investment but can add overall value to the business.

There will also be many opportunities to improve the way investee companies manage business integrity risks. Supporting the development of new or stronger anti-corruption and whistleblowing systems can help strengthen their internal controls and reduce the cost of doing business in the long run.

Case study: This case study demonstrates the value of investing in formal environmental and social management systems.

Middle East Food and Trade Co (MEF) was set up as the holding company of El-Rashidi El-Mizan Confectionary Company (REM), which is Egypt's leading producer of 'Halawa' and 'Tahina, two traditional staple food products made from sesame seed. Actis acquired 65% of the equity in MEF during 2002. During due diligence, Actis identified several ways in which the management of environmental and health and safety matters could be improved. This included the introduction of an ISO 14001 environmental management system and an OHSAS 18001 health and safety management system. A new hazard analysis and critical control points (HACCP) system was designed to align to the ISO requirements.

In addition to the new management systems, responsibility for ESG issues was clarified by the appointment of a staff member to ensure the implementation of the new ESG systems. Key ESG performance indicators were also introduced, monitored regularly and reported to the Board. After five years MEF became a market leader, exporting to 25 countries and saw both production capacity and its product portfolio double. The company also attained the highest level of accredited systems in the industry. The introduction of environmental and social management systems contributed significantly to the growth of the business.

Source: Responsible Investment in Private Equity: Case Studies: Edition 2, UNPRI, December 2009.

2.2 Accessing new markets and buyers

To access new markets a company may need to adapt its products or services to satisfy regulations, standards and customer demands. Evidence of good ESG practices is becoming an important ticket to market (especially for agribusiness, textile and other industry sectors which rely on supply chains that are exposed to ESG risks such as child labour).

Establishment of a subsidiary in, or sourcing from, a new market requires a company to understand the local ESG context and standards. In some cases, this goes beyond compliance with local legislation if local standards fall short of those expected by the company or its investors. Local ESG efforts and community dialogue can help entry into new markets with lower risks of disrupted operations and lower security costs. Companies may also be able to identify opportunities by looking at new markets for example, marketing products or services to customers at the ‘bottom of the pyramid’.

Case study: See Vlisco.

2.3 Identifying cost savings

Substantial cost savings can be made through the adoption of resource use efficiency measures. The importance of using energy, water and other resources efficiently will continue to increase as climate change, environmental degradation and resource scarcity grow. This is particularly the case in energy and/or water-intensive activities. Efficient use of resources is becoming a clear competitive advantage in many sectors and regions.

Case study: This case study demonstrates how private equity fund managers can support their portfolio companies to make significant savings through better environmental management.

In 2008, KKR partnered with the Environmental Defense Fund (EDF) – a non-profit organisation - to develop KKR’s Green Portfolio Program (GPP). GPP is an operational improvement program that KKR runs at the portfolio level. Portfolio companies identify key environmental performance areas (KEPAs), establish metrics and baselines to monitor them, develop goals and Action Plans to improve them, and measure and report programme results. In many cases, participating companies already have environmental efforts underway and the GPP provides additional resources, visibility and tailored support for each company.
At the end of 2013 nineteen companies reported their results: cumulatively, the participants had achieved US$917 million in avoided costs and added revenues, while avoiding 1.8 million metric tons of greenhouse gases (GHGs), 19.5 million cubic meters of water use and 4.7 million tons of waste.

Source: ESG in Private Equity: A Fast-Evolving Standard, INSEAD/Global Private Equity Initiative, May 2014

Case study: See Grameenphone.

2.4 Looking for opportunities to innovate

Product design should evolve and adapt as consumer preferences change and new technologies emerge. Pressure on companies to produce environmentally friendly goods (e.g. that have lower energy requirements and that can be renovated, reused or recycled easily) is growing. There may be significant opportunities for companies to develop and deliver innovative products and services that address unmet environmental or social needs.

Case study: This case illustrates how a new technology can benefit companies, consumers and the environment.

The development of new automotive technologies, such as hybrid engines, has led to a significantly increased efficiency in transportation sector. Car manufacturers increased sales are partly due to this innovative approach which met consumers' demands.

2.5 Improving productivity

2.5.1 Improving productivity by making supply chains more efficient

Strong relationships with suppliers are often key to good corporate performance. Long-term relationships depend on mutual trust. Many companies have found that increased focus on supply chain management and providing support for small and medium-sized (SME) suppliers to enable them to grow with the company has improved product and input quality.

Case study: This case study demonstrates how good E&S supply chain management can reduce costs and improve productivity.

Vlisco Group designs, manufactures and distributes 70 million yards of branded fabrics annually through its operations and retail presence in Côte d'Ivoire, Ghana, Togo, Benin, Niger, Mali and the Democratic Republic of Congo. Vlisco directly employ 2,700 people, 1,700 of whom are based in West Africa. Vlisco has improved its operational efficiency and reduced costs by localising the supply chain. This has also had a positive effect on local communities as the company has provided employment opportunities to underprivileged women and delivered training to local communities. Refer to Case Studies.

2.5.1 Improving productivity by upholding good E&S standards

Introducing environmental management measures (e.g. energy and water efficiency measures) and/or simple well-established human resource management practices can lead to increased productivity and product/service quality and improve workers' morale which can reduce staff turnover and associated recruitment and training costs.

Case study: This case study demonstrates the value of investing in good working practices to the benefit of the workers, the company and its investors.

Specialist consultancy Impact Limited developed a training programme to help garment factories in Asia tackle industry-wide challenges. The focus of improvements included human resources, occupational health & safety (OHS), fire and building safety and staff engagement. In Bangladesh, the programme resulted in 52% reduced worker turnover, and reduced worker absenteeism by 34%. Efficiency improved 18% and the cut-to-ship ratio increased from 95.6% to 96.6%.

The ROI for participating factories was 21, with waste reduction savings of US$65,000 in six months. In addition, overall working hours were cut, and the proportion of workers working more than 60 hours a week was reduced by more than 44%, while at the same time take home pay increased. Results in India were similarly significant.

Source: Impact Limited

Case study: This case study demonstrates how an investment in irrigation systems can increase agricultural yields and conserve scarce water.

Permira identified an opportunity to address the global, long-term trend of increasing water scarcity in Netafim, an Israeli irrigation system manufacturer. Drip irrigation technology vastly improves water efficiency on farms. It helps to increase crop yields and allows water to be used for other purposes by local communities. Permira invested in Netafim in 2011 and worked with the company's founding Kibbutz organization to create a strong, independent Board and to expand global sales. The company currently provides drip irrigation systems to farmers in over 100 countries. Netafim's systems reduce irrigation water use by up to 40% and can increase agricultural yields by as much as 50%. Switching to Netafim's irrigation systems has also enabled farmers to reduce energy consumption, minimise weed growth and improve fertilizer efficiency.

Source: ESG in Private Equity: A Fast-Evolving Standard, INSEAD/Global Private Equity Initiative, May 2014

2.6 Enhancing the company's reputation and brand value

Many companies proactively and positively address the E&S impacts of their business. A reputation for sustainable business practices can help to build brands for which customers are willing to pay a premium. The same applies to companies with strong governance and business integrity practices. It can also foster brand loyalty, improve the company's reputation and generate goodwill among customers and stakeholders. Conversely, operating sustainably and with integrity can also help to avoid bad publicity and boycotts.

Case study: This case study demonstrates how investing in good ESG practices can restore a company's reputation, rebuild its brands and support future growth and a successful sale.

Over 2009 and 2010 Carlyle acquired a 29.2% stake in Guangdong Yashili Group Co. Ltd. (Yashili), one of China's largest infant formula companies. Like many infant formula companies in China, Yashili faced significant reputational challenges following a scandal in the sector during 2008. Some infant formula companies had substituted melamine (which is cheap but toxic) for milk powder in their products. As a result of the melamine substitution six babies died and 300,000 became ill. In the wake of the scandal sales of Chinese produced infant formula fell significantly and share prices in many firms fell between 30 – 40%. The first company implicated in the scandal, Sanlu, went bankrupt and two people were executed.

Carlyle saw an opportunity to use ESG to create value in a firm suffering from an industry discount, and worked closely with Yashili to rebuild its brand image. To address the melamine issue directly, Yashili made a major strategic decision to procure 100% imported raw milk powder from high-quality overseas dairy sources and established product testing collaborations with top-tier international laboratories to strengthen product quality and safety control. The Carlyle-Yashili partnership demonstrated to the industry how it could transform itself and meet international standards.

With Carlyle's assistance, Yashili established the first Food Quality and Safety Advisory Committee (FQSAC) in the Chinese dairy industry. With FQSAC's strategic guidance, Yashili further improved the safety and quality of its products, through the implementation of product quality control protocols and the introduction of enhanced internal control systems. Carlyle helped recruit a Chief Quality Advisor to oversee implementation of product quality control protocols and a Chief Research & Development Officer to lead new product development. The company achieved industry-recognised quality standards including ISO9001 and HACCP, as well as certifications by various national authorities.

Yashili is now committed to product quality and corporate integrity for sustainable growth and to building its capabilities in quality control and R&D. In August 2013, Carlyle sold Yashili to China Mengniu Dairy Company Limited, the No. 1 liquid milk manufacturer and the second largest dairy manufacturer in China.

Source: ESG in Private Equity: A Fast-Evolving Standard, INSEAD/Global Private Equity Initiative, May 2014; FT.com

2.7 Value at exit

With trade buyers and investors paying increased attention to ESG matters, sound ESG management can substantially improve a fund manager's chance of a successful exit. Increasingly, meeting ESG requirements/standards is required both by private buyers and for initial public offerings (IPOs) in emerging markets.

Case study: See Adenia Partners.