1. Objectives and overviews

Why ESG factors should be considered when planning for a successful exit

Fund managers and companies should understand ESG aspects that may be important at exit, in order to:

- Maximise the contribution that good ESG performance can make to return on investment (ROI).
- Potentially attract buyers for whom good ESG performance would be a priority and/or legal requirement.
- Prepare credible ESG materials for exit (e.g. for listing requirements or information that prospective buyers may wish to see).
- Help the company answer questions from prospective investors. For example, collate relevant ESG data which shows the extent to which business improvements have been achieved.
- Ensure the company's ESG management system is self-sustaining.
- Help mitigate post-exit reputational risks.

An overview of the exit stage is shown in the graphic below.

Click to view diagram

2. Activities

2.1 Plan the exit

It is likely that exit considerations will contribute significantly to strategic decisions on ESG matters throughout the investment's holding period. For example:

- Certain acquirers of the company may have minimum ESG requirements that must be in place prior to exit, so failure to meet these standards will reduce the universe of exit options.

- Improved ESG performance can enhance exit valuations.
- It may determine what evidence of ESG improvements should be collected during the life of the investment (e.g. KPIs tracking energy/resource efficiency, operating costs, savings linked to reduced occupational health and safety accidents).

- General considerations

  Nearing the end of the investment term, fund managers should review any material ESG issues to ensure there is sufficient time to address any potential problems. Holistic preparatory work, irrespective of the specific exit strategy, may help to maximise company value. This may be particularly valuable for investments held for a long time, where due diligence (DD) at acquisition is unlikely to have matched current best practice. In such circumstances, a detailed vendor-audit or review may be necessary. However, where adequate on-going portfolio engagement and ESG performance review has been encouraged, this may merely require collation of up-to-date information in an appropriate format.

  The original acquisition DD report can serve as a baseline against which improvements (or otherwise) in ESG performance can be effectively assessed. On exit, a high-level review may be pertinent to identify 'lessons learned', both positive and negative. This can help to inform a fund manager's wider ESG strategy, policies and procedures. Regular ESG reports prepared during the lifespan of the investment may also be a source of valuable information during the exit process.

  Fund managers should share relevant ESG information with potential bidders, and be prepared to address any questions in relation to the company's ESG performance.

  The strategy for dealing with ESG issues will be determined in part by the fund manager's chosen method of exit. For example, the level of data presented by the fund manager may vary if pursuing an initial public offering (IPO) or secondary exit.

- Private sell

Some buyers will not value ESG improvements unless the benefits are clearly laid out. It is important to show that ESG systems are in place as part of broader evidence of high-quality management. The company should not be afraid to discuss the areas it is still working on, as knowing where and what its challenges are can put it ahead of peers and be reassuring for new investors.

There are also buyers for whom good ESG management systems are a pre-requisite, or a stated wish, in order for them to invest in a company. These include the growing number of private equity funds with ESG policies, development finance institutions (DFIs), and multinational trade buyers with global standards (who are concerned about the amount of work that may be required to bring the business in line with their corporate policies and procedures). Acquirers may also be concerned about legal liabilities or reputational risks associated with investing in/buying companies in emerging markets that may have unresolved ESG issues (e.g. contaminated land or community unrest issues). Actively demonstrating that these risks are effectively managed should ensure that the maximum number of exit options are available to the fund manager. This might include:

- Preparing the offering document (private placement memorandum (PPM)) to include evidence of ESG improvements and how they have improved the company.
- Featuring ESG improvements in the road show presentations.
- Ensuring that prospective buyers cannot use ESG factors to negotiate a lower price by arguing for expensive warranties on potential ESG liabilities.
- Highlighting the operational value-add of ESG improvements in meetings with prospective buyers.
- Helping the company prepare for investor questions on ESG.
- Vendor DD documents featuring ESG DD by a consultant and an assessment of the business integrity (BI) management system. This can accelerate the investment process and make life easier for the company.
- Preparing a data room containing all documents that buyers, and their technical advisors, might want to see.

    - Consider pre-prepared answers to questions that might be asked.

- Public flotation (initial public offering)

  IPOs come with associated listing requirements, public scrutiny and reporting, stakeholder pressure and an increased need for transparency. Hence there are usually demands from ESG conscientious investors. As a result, fund managers should prepare detailed disclosures when considering an IPO, and should be ready to:

    - Include ESG in the offering memorandum, including any ESG risks. An increasing number of stock exchanges require such disclosure.
    - Consider answers to likely questions.
    - Include ESG in road show slides.
    - Consider how to maintain promises post-exit (especially if listing in the UK or US): it is important that ESG management does not fall apart when the fund is no longer there to support or oversee the company.

3. Outputs

Key outputs at this stage include:

Financial model

Typically, fund managers prepare a detailed financial model to arrive at a valuation when selling its portion of the company. The way ESG aspects were managed during the holding period will affect such a valuation. In many cases, focused management of ESG aspects will have enhanced the business and contributed to improved margins and reduced risks.

The following ESG documentation may be used to develop and justify the financial model:

- Monitoring reports that track the ESG performance of the company (e.g. an ESG action plan and KPIs). These are likely to have been prepared on a regular basis during ownership, and key issues should be summarised with important progress highlighted.
- Quarterly/annual reports prepared by the company for the fund manager, as well as public reports such as sustainability reports.
- Reports on serious accidents, incidents or fatalities over the life of the investment together with the remedial actions implemented.
- All relevant ESG permits, licences, accreditations or certifications, including any records of fines for non-compliances and associated remedial action.
- Evidence of an effective ESG management system, including minutes of company meetings at which ESG is addressed (board or management committee), policies and operational procedures.
- Any certifications to ESG standards, particularly internationally recognised industry benchmarks.

Information memorandum

Many fund managers have found that including tangible evidence of improved ESG performance in the information memorandum has better positioned the company to prospective buyers and enhanced its value. Tangible evidence may include access to new markets, growth in sales, or reduced operating expenditure due to waste or energy minimisation.

In many cases, the prospective buyer will require a warranty from the fund manager related to ESG claims. A good track record and market reputation by the company due to good ESG performance can bring comfort to prospective buyers that such claims are unlikely.