DOUGHTY HANSON & Co

WORKING TOGETHER TO PROMOTE MORE SUSTAINABLE PRIVATE EQUITY INVESTING

WWF

Conservation | Climate change | Sustainability

Private equity and responsible investment: an opportunity for value creation

ABOUT WWF-UK

WWF is at the heart of global efforts to address the world's most important environmental challenges. We work with communities, businesses and governments in over 100 countries to help people and nature thrive. Together, we're safeguarding the natural world, tackling climate change and enabling people to use only their fair share of natural resources.

"This study captures the dawning of a new enlightenment on ESG – it is not just about risks but equally about opportunities – and the best Private equity managers have awoken to this."

Alan MacKay
Chief Executive
Hermes GPE LLP

WWF-UK believes that private equity can and will have an important role in achieving a more sustainable model for business. A responsible and active approach to the management of portfolio investments, including a focus on environmental and social initiatives, can and should be an important driver of value creation. It's an approach that's not only good for business but also creates additional social and environmental returns.

For further information on WWF's work within the finance sector please visit:
wwf.org.uk/financelab

WWF-UK provides business and industry with environmental insights, guidance on tackling climate change and engaging communications for customers, employees, investors and policy-makers. We work with HSBC, Marks & Spencer, Canon, Lafarge, MBNA and other leading businesses.

ABOUT DOUGHTY HANSON

Doughty Hanson is one of the longest established private equity groups in Europe. Since its inception in 1985 it has generated strong and consistent returns across its fund programmes in mid-market buyouts, opportunistic real estate and technology venture capital. With over 50 investment professionals, the group is headquartered in London and has offices in Frankfurt, Luxembourg, Madrid, Milan, Munich, Paris and Stockholm.

The buyout team focuses on majority ownership and control of businesses at the upper end of the European middle market with enterprise values between €250 million and €1 billion.

CONTENTS

pwc

We are grateful to PwC for providing technical advice and guidance to WWF during the preparation of this document.

EXECUTIVE SUMMARY

Private equity managers are particularly well-placed to promote sustainable business practices through active management of their portfolio companies and are increasingly being encouraged to do so by investors. Such an approach can create additional value for all stakeholders and reduces the financial and reputational risks to which they are exposed. This study explores the responsible investment agenda within private equity and concludes that:

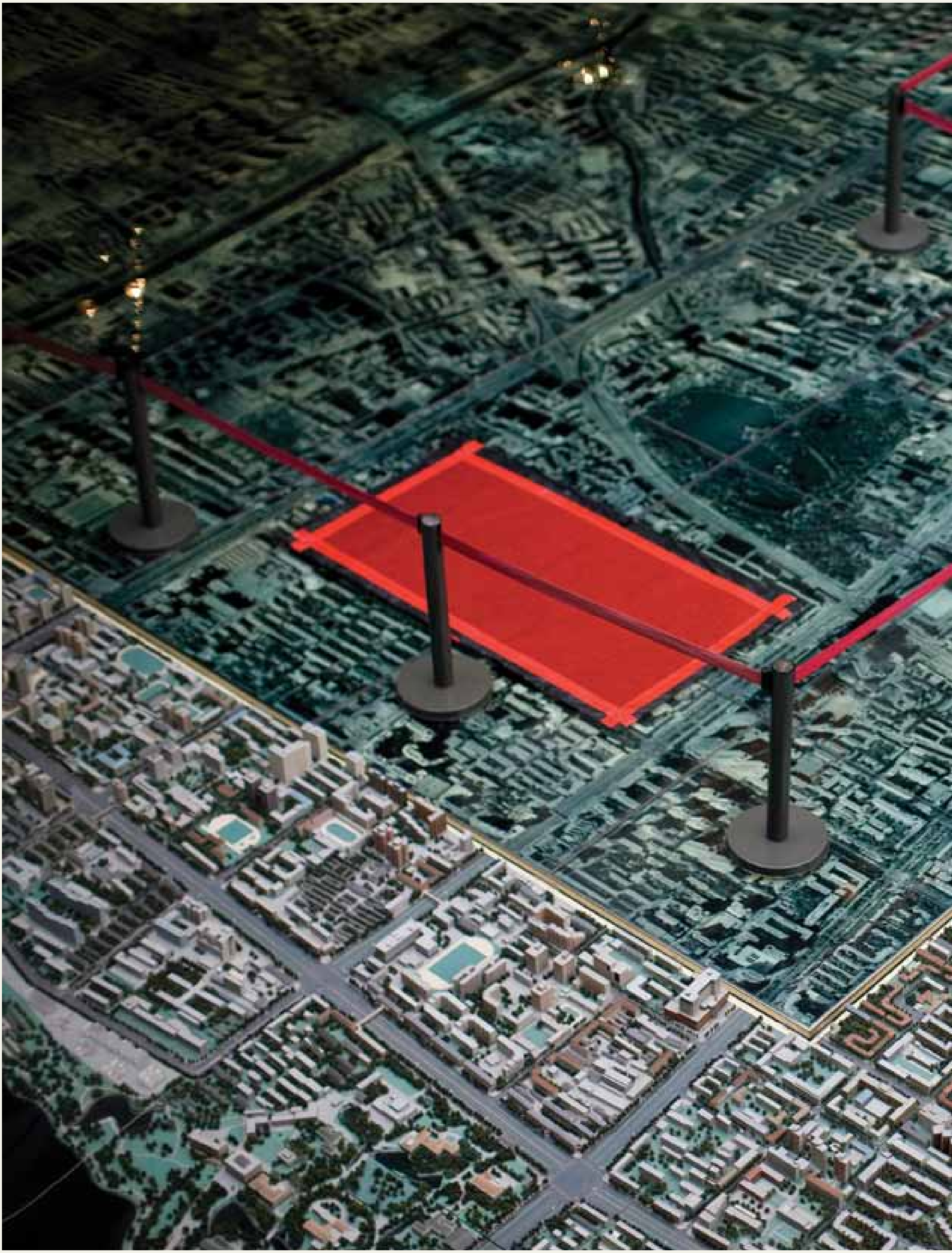
- Over the last 10 years, both the private equity industry and the sustainability agenda have grown in importance. As a result, at a sector level, sustainability represents an opportunity for private equity houses to boost future returns while simultaneously demonstrating 'responsible investment' credentials. This can be done by screening for environmental, social and governance (ESG) issues on acquisition; managing key ESG issues during their period of ownership; and through open reporting/disclosure of ESG issues management on exit. Certain private equity houses increasingly believe that proactive management of ESG issues is becoming a source of competitive advantage.

- Traditionally, to the extent that private equity houses have engaged with ESG issues at all, the focus has been on commissioning site-specific, environmental due diligence as part of risk management. Today, the scope of such 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 for leading houses.

- The private equity industry is showing increasing appetite to integrate consideration of ESG issues into mainstream investment decisions and to understand their impact on value. It is now possible to quantify the value derived from ESG issue management by using techniques outlined in this study, and as demonstrated in the associated case studies.
- The private equity business model is ideally suited to its traditional focus on identifying and generating operational improvements in portfolio companies. A small shift in approach – to focus specifically on eco-efficiencies – can now generate a double dividend: an improvement of financial returns while minimising environmental footprint.
- Private equity houses should recognise the trend among blue chip companies increasingly to report both ESG management programmes and results, and evaluate the potential for value creation through these means.
- Private equity houses should now be working with the management teams of their portfolio companies to promote how effective management of ESG issues can show tangible, valuable, results. The time is now right for private equity houses to proactively drive the sustainable development agenda through ownership of portfolio companies. This is not only the responsible thing to do, but it is also becoming increasingly clear that it makes excellent commercial sense too.

"Universities Superannuation Scheme General Partners (GPs) should be working with their portfolio companies, and Limited Partners (LPs) working with their GPs, encouraging the management of ESG issues to reduce risk and provide opportunities."

David Russell
Co-Head of Responsible Investment, University Superannuation Scheme



INTRODUCTION

The past decade has seen businesses giving greater prominence to sustainability, or environmental, social and corporate governance (ESG) issues. This is partly the result of emerging ESG 'megatrends' such as climate change, population growth and resource constraints, awareness of which has grown and which continue to pose daunting challenges for the future. Regulation has also played a part in this trend, coupled with wider interest in corporate practices from stakeholders including institutional investors, trade unions and the news media. Effective management of ESG concerns has become an item of genuine importance on the agenda of large corporations, not least because these factors are increasingly linked to corporate profitability and value.

How has this trend affected private equity houses? Such firms generally invest in portfolios of companies, where specific opportunities have been identified (before investing) to generate value for investors over the four-to-six years of their typical ownership period. This often highly-leveraged business model, with its focus on business efficiency and value creation, has not been seen to be naturally aligned with the need to take account of the long-term sustainability megatrends referenced above. Furthermore, during the 'noughties' in particular, the 'private' aspect of the sector, with its perceived lack of transparency and accountability, led to concern among stakeholders that investments were not being made and managed responsibly.

However, the picture is changing. Over the past few years, an increasing number of private equity houses – driven by regulation and investor concern – have begun to factor ESG considerations into their investment strategies. Private equity managers are not only concerned to ensure that their investors are protected from the ESG-related regulatory, financial and reputational risks which their portfolio companies might face, but are increasingly aware that they can use ESG levers to maximise value creation. An increasing number of influential investors are becoming more keen to see that their private equity managers are taking ESG issues into account in their investment analysis, ownership practices and long-term strategic thinking.

This paper considers… the challenge of valuation and reporting

This emphasis on value creation means that the focus of investors' concern is not limited to the stages of pre-investment screening or post-investment exit, but extends throughout the period of ownership. Value creation requires increasing the operational efficiency of portfolio company operations – not solely in traditional financial terms, but also in how they use natural and human capital. Investors have recognised that consideration of ESG issues is driving innovation in areas such as clean technology and therefore provides investment opportunities across the corporate range – from start-up companies to conglomerates eager to diversify and build on core strengths. In short, approaches and attitudes to ESG issues are evolving – marking a transition from a mindset dominated by compliance with regulations, risk mitigation and liability assessment, to an approach that seeks longer-term strategic advantage and sustainable value creation.

This paper considers the relationship between the economically influential private equity industry and long-term trends – past and future – in sustainability. It considers, in particular, one of the most difficult areas relating to ESG issue management, and a topic which is of fundamental importance to the private equity sector: the challenge of valuation and reporting.

1. THE PACE AND SCALE OF CHANGE

The rise in concern over environmental, social, and corporate governance (ESG) issues has been driven by legislation within a framework of evidence-based policy and increasing stakeholder pressure. It is increasingly considered a mainstream issue in both the public and private sectors.

The importance of ESG issues also derives from the growing recognition that resources previously taken for granted are likely to be seriously constrained in future. Against a background of an expected one-third increase in global population by 2050, the challenge of providing everyone on the planet with access to safe, clean and sustainable energy will be extreme.

Two out of three people will live in water-stressed conditions by 2025

Since 1950, global water use has more than tripled and the UN Environment Programme has warned that if present consumption patterns continue, two out of three people will live in water-stressed conditions by 2025. By the same date, the combined effects of population growth, rising per capita consumption and climate change are likely to make food scarcer and more expensive. And meanwhile, the rate and scale of biodiversity degradation is significantly weakening the ability of the natural world to deliver key services such as climate regulation, air and water purification, provision of medicines and protection from natural disasters. These alarming trends present formidable environmental, social and strategic challenges for all society – including business.

These are among the pressing reasons why WWF has taken an active, long-term interest in ESG issues. Indeed, the charity wrote its first ethical investment policy in 1991, and has been closely involved with responsible investment and related issues ever since.

Leading companies are now choosing to manage risks and resources globally

Good environmental and social governance was, until fairly recently, seen by many as a philanthropic response – an ethical or moral choice or a means of demonstrating a desire to be an engaged corporate citizen. More recently, however, companies have begun to realise that the sustainability megatrends referred to above present real and material ESG risk management issues that require strategic consideration and active management as an integral part of good business practice. In short, a new business model is required. While in the past, concern might have led to site-specific risk management activities with a focus on environmental contamination or health and safety, leading companies are now choosing to manage risks and resources globally and over the long term. This not only requires action on their own account, but also across their entire value chain, from the sourcing of raw materials to the disposal of end-of-life products. When looking across the value chain, more progressive organisations are identifying opportunities for value creation in areas such as access to new markets, product development and staff retention.

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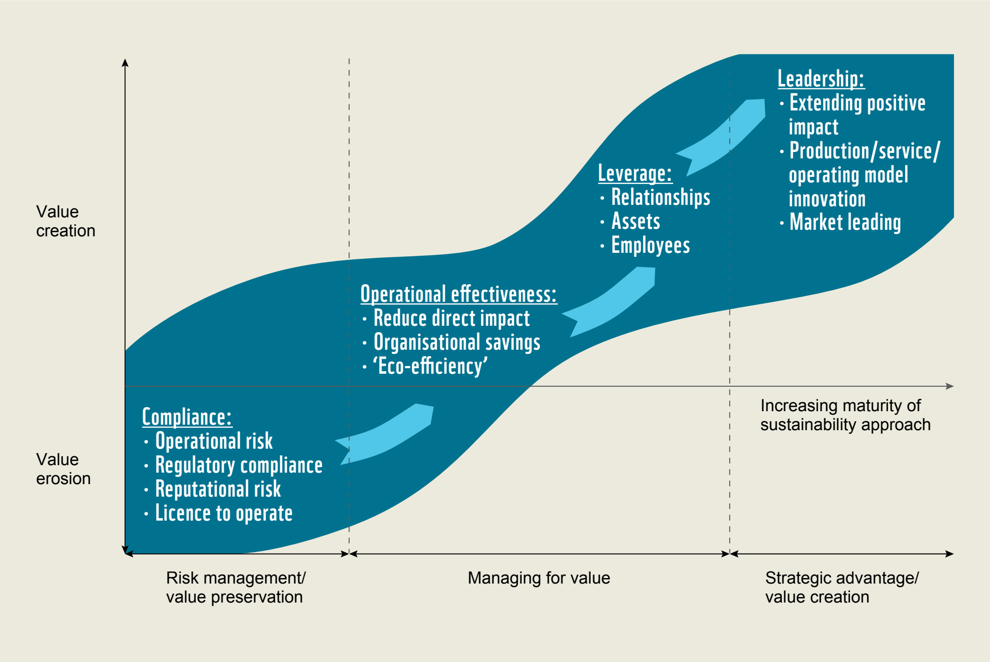


Figure 1: From risk management to business opportunity: much of the sustainability agenda remains voluntary, and companies have choices to make as to their strategic positioning – from 'compliance' to 'strategic advantage'.

This transformation is already evident in the private equity industry. ESG issues, or more particularly environmental concerns, have been considered by investors for some 10 to 15 years, though typically in the context of acquisition due diligence, with a focus on identifying and managing potential liabilities. But this pattern is changing. More focus is being given to business opportunity, not only by addressing a wider range of issues at the due diligence stage, but also by focusing on the management of sustainability issues and value creation during the hold period and through to exit.

The growing links between private equity and ESG

The intertwining of the private equity and ESG agendas in the past few years has been led by a number of drivers:

- Regulation: The UK CRC Energy Efficiency Scheme, the 2010 UK Bribery Act and the forthcoming Alternative Investment Fund Managers Directive are recent examples of measures that are driving the private equity industry to manage ESG issues as part of its core reputational and financial risk practice. A widely-held expectation is that a growing regulatory burden will play a part in driving private equity houses to address ESG issues.

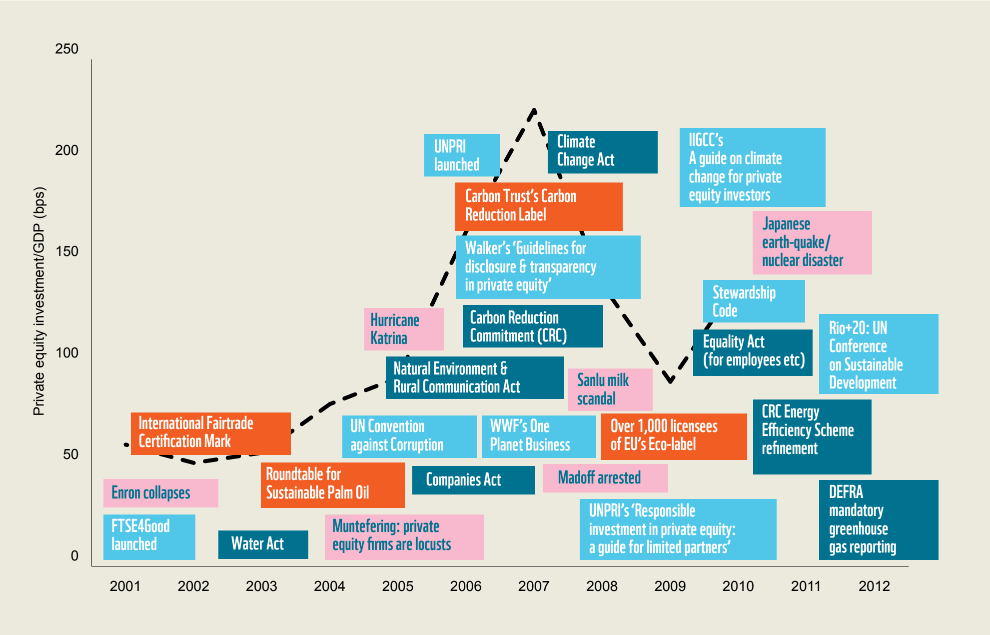
900

By September 2011, more than 900 investment institutions had become UNPRI signatories

- An increasing number of Limited Partners (LPs) are becoming signatories to the voluntary UN-backed Principles for Responsible Investment (UNPRI). The six principles provide a framework to help investors (and private equity houses) incorporate ESG issues into investment analysis and decision-making processes, so as to better manage risks and exploit opportunities. By September 2011, more than 900 investment institutions had become UNPRI signatories, with assets under management totalling approximately US$30 trillion. In 2008, the PRI formed a Private Equity Steering Committee to promote greater awareness of ESG issues in the asset class.
- Many firms are viewing the financial crisis as a suitable catalyst to fully integrate ESG activities into their strategies and business processes. As private equity firms tend to have relatively strong influence over governance issues by virtue of their position as owners, they are in an excellent position to drive positive change in ESG issue identification and management.
- The loss of public trust in the financial services sector, in the light of the recent economic crisis: private equity houses recognise that the necessary restoration of trust can be helped by an explicit commitment to ‘responsible investment’ via the ESG agenda.

Good practice has been shared, with a cross-fertilisation of ideas and practices

- High-profile ESG successes within the industry, with some private equity houses reporting material value creation as a result of their ESG activities, or recognising the value created by ESG activities within their portfolio companies even if their role in creating that value has been peripheral. In some cases, good practice has been shared, with a cross-fertilisation of ideas and practices between portfolio companies. Some portfolio companies have found that they enjoy a symbiotic relationship with others, for example, where one company's waste materials have proved to be another company's raw materials. This is turn has led others within the industry to examine their portfolios to see where similar value can be created and subsequently realised upon exit.



Key

■	UK Legislation
■	Initiatives
■	Scandals/disasters
■	Production accreditation

Figure 2: The rise of ESG and the growth of private equity

The Growth of the ESG agenda has been concurrent with a growth in the relative importance of the private equity industry over the last 10 years. The increased influence of the industry in the UK and its active ownership model provides a unique opportunity for private equity to continue to drive the agenda as well as create material value from its outputs.

Responsible investing

Leading private equity houses recognise that investing LPs' funds responsibly starts with screening potential investments carefully. More firms are now defining sustainability, or ESG, policies which exclude investment in certain controversial sectors or activities (such as defence, gambling or tobacco), and/or which require a referral to a committee or designated individual for advice, before proceeding.

ESG

The aim of such diligence is no longer focused primarily on screening out unacceptable risks

Increasingly, such individuals are sustainability professionals, with 3i, Actis, Blackstone, Doughty Hanson (DH) and KKR among the growing list of firms with specialist in-house ESG capability. However, that said, only 5 to 10 firms have appointed dedicated sustainability professionals to date, against a British Private Equity and Venture Capital Association (BVCA) private equity house membership of 214 firms. There is therefore some way to go before this trend becomes mainstream. ESG investment procedures and 'tools' to guide investment professionals in effective ESG screening are also being introduced. External ESG due diligence is also now evolving from the traditional focus on site-specific risks (e.g. contamination, or health and safety liabilities) to embrace ESG opportunities as well as risks, and across the company's whole value chain.

The primary aim of ESG due diligence is now to identify material ESG issues which would benefit from active management during the period of ownership. (Examples might include opportunities for 'eco-efficiencies' – doing more with less – or for new product lines based on rising consumer demand for fair-trade, organic or responsibly sourced raw materials.) It is becoming clear that good practice is for such management to start from the date of acquisition, with ESG action plans or improvement programmes being integrated into the other work streams which comprise a typical 100 or 180 day plan. Otherwise, the risk is that ESG initiatives become sidelined (or are forgotten entirely) while organisational and efficiency changes, which are seen as more pressing, are implemented.

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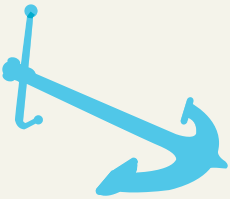


The economic reach of the private equity sector... gives it significant influence

Active ownership

The economic reach of the private equity sector – with some 2.1 million people[1] working for private equity-owned companies and fund portfolios covering companies of all sectors and sizes – gives it significant influence simply as a result of its scale. But it is not just this size which creates influence; it is also determined by the degree to which houses can exert control due to the extent of their share ownership.

Private equity houses are well-placed to be active owners and can be dynamic agents of change – for example, when the private equity house uses its own internal ESG expertise to support its portfolio companies. While approaches vary across the industry, private equity firms involved in buyout investment typically have control over that investment. Such control can be exercised in a variety of ways – not only from close engagement with the chief executive, and via representation on the board, but increasingly through a deeper level of engagement with operational management.

Building understanding of the business, its risks and ESG challenges and helping to develop bespoke initiatives can add real value, and can enable the best advice to be brought in from outside the company when necessary. An active ownership approach such as this can deliver more influence for the private equity investor than that held by disparate, individual shareholders in public companies or even public equity fund managers. With investment hold periods at present typically ranging from four to six years, private equity managers are also interested in medium-term value creation rather than short-term profit.

[1] BVCA.

Private equity houses are able to focus on more detailed reviews into operations, i.e. 'deep dives'

This hands-on approach allows private equity houses to work closely with portfolio companies. Together, they are able to focus not only on strategy, but also undertake more detailed reviews into operations i.e. 'deep dives', to establish whether high-level ESG policies and commitments are being implemented and are resulting in improved ESG performance.

Private equity house influence is felt within developed and developing markets, in part because many private equity investments in developed markets include facilities, operations or supply chains that are located in emerging territories. Indeed, the industry is targeting growing amounts of investment into emerging markets. The BVCA's Reports on Investment Activity show that average investment in locations outside the UK, the US and Europe has grown from 0.5% in the period 2001-03 to 5.9% from 2008-10[2], with this trend set to continue. However, both the ESG risks and the opportunities are more acute in emerging markets where national legislation is often less stringent, or less well enforced, than in more developed jurisdictions.

[2] BVCA Private Equity and Venture Capital Report on Investment Activity.

2. ESG TRENDS: SHAPING OPERATIONS AND VALUE

The business case for sustainability

Rising consumer awareness of ESG issues has meant that consumer-facing businesses are in the vanguard of companies seeking to reduce their sustainability impacts. Many are discovering the financial benefits this can bring. Marks & Spencer (M&S) was among the first to join the race to be the greenest retailer on the UK high street, launching its 100 'Plan A' commitments in 2007. This was supported by WWF, through its involvement in a number of environmental projects along the M&S supply chain, particularly those focusing on agricultural, marine, freshwater and carbon footprint issues. M&S expected to invest £200 million to achieve its goals but Plan A broke even early and added £50 million to the bottom line in 2009-10.[3]

£50M

Plan A broke even early and added £50 million to the bottom line in 2009-10

Many other household names, including General Electric, Walmart, Unilever, Coca-Cola and Tesco, have made ambitious public commitments and invested heavily in sustainability issue management. They are now reaping the benefits of revenue growth, cost savings and the more intangible reward of enhanced reputation.

Business leaders across many sectors are increasingly convinced of the need to integrate ESG issues into their core business. According to a 2010 UN Global Compact survey[4], 93% of large global company chief executive officers (CEOs) believe sustainability issues will be critical to the future success of their business, and all but a few are integrating consideration of these issues into their strategy, operations and supply chains.

[3] Marks & Spencer 2011 Annual Report.
[4] UN Global Compact CEO Survey, June 2010.

88%

of CEOs agree that sustainability should be embedded throughout their supply chain

However, performance and communication gaps remain between rhetoric and action:

- 88% of CEOs agree that sustainability should be embedded throughout their supply chain, but only 54% report their company is already doing so; and
- 72% of CEOs believe that companies should incorporate sustainability issues into discussions with financial analysts, but only 48% say that their company does so.[5]

Similarly, the private equity industry is starting to recognise the sustainability-related value creation opportunities that remain untapped within portfolio companies: 88% of GPs expect ESG issues to become more important in the next five years, but only 57% of LPs currently integrate ESG into investment decisions.[6]

These LPs were supported by a recent RCM report which stated "Investors could have added 1.6% a year over just less than five years to their investment returns by allocating to portfolios that invest in companies with above-average ESG ratings".[7]

Recognition of the ESG value creation opportunities is driving action: there are now 70 investment manager signatories to the UNPRI, and a growing number of private equity houses are publishing responsible investment policies and allocating dedicated professional resources to managing ESG issues.

5 Accenture and UN Global Compact: New Era of Sustainability CEO Study 2010.

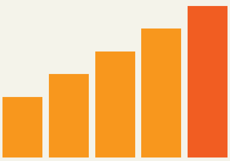
6 'EVCA: Responsible Investment in Private Equity' (presentation by Tom Rotherham, Director, Private Equity, Hermes Equity Ownership Services).

7 RCM Sustainability White Paper: Sustainability: opportunity or opportunity cost? 2011.

The challenge of valuation

Many businesses struggle to measure and track the impact of their sustainability activities on core business metrics such as revenue growth, cost reduction, risk management and reputation. As a result companies face challenges in:

- Selling the benefits of a sustainable business strategy to suppliers and subsidiaries; and
- Communicating the impact of their sustainability activity in terms that can be built into investors' valuation models and that can be ultimately rewarded by the market.



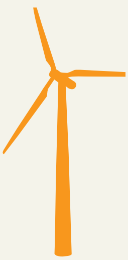
Companies committed to ESG performance… achieved above average performance in financial markets during the economic slowdown

On the one hand, companies lament that investors do not value their sustainability efforts, while on the other, investors complain that companies do not report sustainability initiatives in terms that they can value. Considerable research has been done into the business value of investment in sustainability projects, looking for linkages between sustainability issues and business performance. While many factors can blur the relationship between sustainability and share price, research into the link between them has yielded some interesting conclusions. Research by AT Kearney in 2009 showed that companies committed to 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 US$650 million in market capitalisation per company. Analysis such as this suggests that a focus on ESG issues is a proxy for a well-managed business with a greater focus on long-term risk mitigation.

In addition, increasing volumes of benchmark information are available to help investors make sustainability comparisons. For example, indices such as the DJSI and the Business in the Community Corporate Responsibility Index apply sustainability criteria to rank companies. Bloomberg is now posting ESG performance data on the terminals used by its 300,000 customers to make daily investment decisions.

Notwithstanding the available research evidence and the vast array of qualitative and quantitative information now available, there is no generally accepted methodology for quantifying the financial value of sustainability initiatives to companies and their shareholders. Below, we explore the link between sustainability factors and shareholder value and offer examples of how financial value can be and has been derived for sustainability factors. Private equity houses may wish to take note of these 'blue chip' company examples.

Understanding the link between sustainability and shareholder value



There are several challenges involved in quantifying the impact of a corporate sustainability programme or set of sustainability initiatives on shareholder value. Many different approaches have been tested but they generally resolve into one of two methodologies:

Metrics and indices

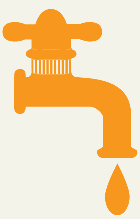
This approach involves identifying… a corporate sustainability metric or index… that is most closely correlated with shareholder value

This approach involves identifying (through econometric analysis) a corporate sustainability metric or index (weighted set of metrics) that is most closely correlated with shareholder value (or stock price performance) across a sample of companies through time. The measure is then used as a predictor of future financial performance.

A practical example might be using a company's safety statistics as an indicator of earnings potential. While health and safety breaches are not a forward looking indicator, a poor record of regulatory compliance over a period of years may suggest a problem with the organisation's safety culture. This could have damaging financial implications if a major incident occurred.

One difficulty for an investor lies in knowing which of the multiple sustainability metrics to track. For this reason, there are many attempts at constructing balanced scorecard approaches. For example, Innovest Strategic Value Advisors has constructed an environmental, health and safety (EH&S) management rating index, called EcoValue21, as an investment analysis tool and claims that it distinguishes companies with superior returns across a range of industries. Goldman Sachs has integrated ESG considerations into its investment analysis through its GS SUSTAIN approach. This identifies leaders in each industry based on financial performance (return on capital), industry positioning and management quality, as demonstrated by leadership on 20 to 25 ESG factors. They report a positive relationship between the effectiveness with which companies address the ESG issues facing their industry and their financial performance (return on capital) across most sectors.

Value drivers



These methods involve identifying the specific contribution that a sustainability initiative or programme might make

The second category of methods can be described as bottom-up or accounting based. Typically these methods involve identifying the specific contribution that a sustainability initiative or programme might make to the key financial metrics that drive corporate earnings or cash flow. In other words, they involve identifying corporate sustainability value drivers. For example, investing in an energy efficiency initiative may lead to cost savings by reducing energy bills and may add value to the company's reputation with employees, investors or customers. A company offering a new more environmentally friendly version of a product may be able to command a price premium or see increased sales volume growth leading to higher revenues. Figure 3 overleaf shows some examples of sustainability value drivers.

"It is management mantra that what gets measured gets done. It is LP mantra that what must be reported does not get ignored. Leading LPs expect better non-financial reporting, particularly of ESG impacts."

Alan MacKay
Chief Executive
Hermes GPE LLP

	VALUE DRIVER	DESCRIPTION
REVENUE ENHANCEMENT	Product differentiation/ brand enhancement	Command a price premium through sustainability labels or features
		Increase sales/market share through enhanced customer loyalty product service differentiation
	Product development/ innovation	Create a new product or service targeting unmet societal needs or finding alternative lower-impact ways to meet existing needs
		Develop new revenue streams through recycling waste, waste to energy and 'service-isation'
	Market access/ licence to operate	Enhance ability to operate/access new markets through improved reputation with regulators, suppliers, customers and employees
COST SAVINGS	Efficiency	Reduce operating costs through eco-efficiency (energy, water, resource use, packaging and waste reduction)
		Reduce operating costs through sustainability management systems and sustainable practices
	Security and quality of supply	Reduce procurement costs through secure sourcing of energy, water or raw materials
	Staff motivation and retention	Reduce staff costs/improve productivity through employee engagement training and development
RISK MANAGEMENT	Reduced reputation risk	Protect licence to operate, brand image and reputation by avoiding negative publicity, consumer boycotts, investor pressure and risk from regulatory changes
	Reduced cost of capital	Improve access to capital by achieving a lower risk rating in financial markets
	Reduced operational risks	Manage risks to operations from stakeholders action, regulatory intervention or physical impacts of climate change

Figure 3: Potential sources of business value from sustainability

The key challenges with this approach relate to understanding the linkages between sustainability initiatives and the bottom line and in finding data to support the quantification. While valuing specific stand-alone initiatives for their direct contribution to the bottom line is fairly straightforward, valuing an entire sustainability programme and capturing its long-term effects on earnings via brand, reputation and risk is a more complex undertaking.

PricewaterhouseCoopers (PwC)'s Sustainability and Climate Change consultancy practice used a bottom-up approach for it's sustainability valuation exercise. The firm uses a bottom-up approach for it's sustainability valuation exercises. Typically this involves identifying a set of key value drivers connected with a sustainability programme and drawing on an extensive toolkit of valuation techniques including methods for valuing intangible assets and methods for valuing risk. In order to meet the challenge of data availability, PwC typically uses data from a variety of publicly available and proprietary sources.

PwC's experience of working with companies suggests a model for understanding how sustainability drives business value. Companies react to external influences such as public policy, regulation and stakeholder concerns about climate change, pollution, biodiversity loss and poverty by implementing internal initiatives that aim to improve their sustainability performance. Corporate sustainability initiatives in fields such as energy efficiency, employee engagement or waste management can create value for companies directly by cutting costs or increasing revenue. They can also create value indirectly by improving reputation or credibility with customers, investors and other stakeholders. They can also help to preserve value by enabling companies to manage reputation risks, protect customer relationships and retain staff.

The creation of indirect value requires companies to understand the sustainability issues that stakeholders are concerned about and what value those stakeholders place on the companies addressing those issues. Indirect value creation also requires companies to communicate effectively with stakeholders.

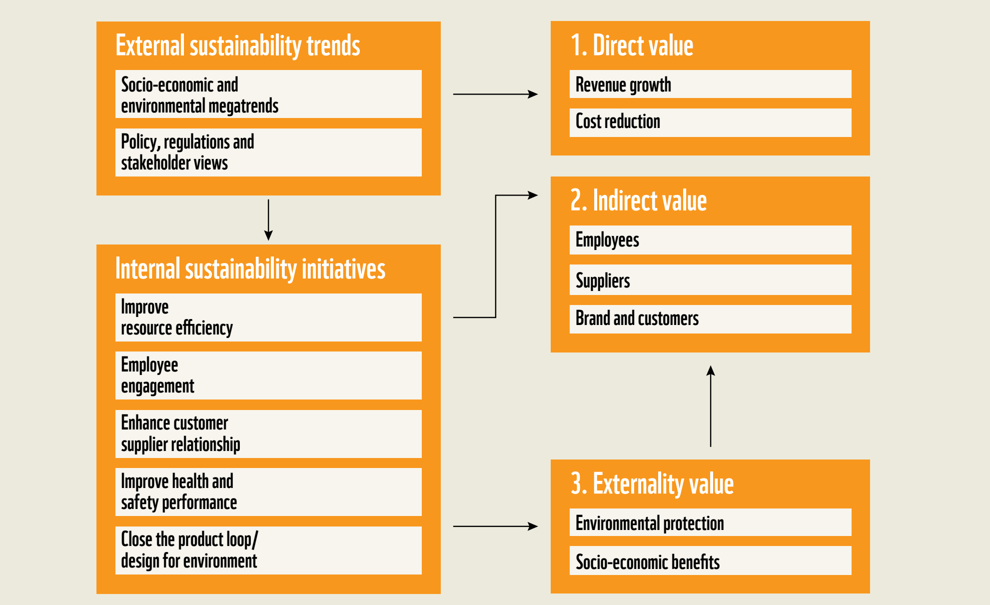


Figure 4: Modelling how sustainability drives business value

SOURCE: PWC SUSTAINABILITY VALUATIONS (2011)

Key drivers of value

Cost savings

£25M

United Biscuits… has saved approximately £25 million per year in the past five years through environmental initiatives

Cost savings are an obvious driver of value creation for many companies undertaking sustainability initiatives. Initiatives typically include investments in carbon reduction or resource efficiency (such as minimising energy or water use) within their operations and supply chain. Eco-efficiency savings of this nature can be substantial: United Biscuits, for example, has saved approximately £25 million per year in the past five years through environmental initiatives including a load-sharing system that pools transport arrangements with suppliers, customers and competitors, and an initiative to run its lorries on biodiesel made from the waste vegetable oil from its snacks factories.[8]

The UK brewer Adnams invested in a new eco-efficient distribution centre to reduce energy use and environmental impact. As a result, the centre uses 58% less gas and 67% less electricity per square metre compared with the old warehouse, and requires 3.2 pints of water to make a pint of beer compared with the industry average of eight. Energy efficiencies save Adnams an estimated £50,000 per year.[9]

£50,000

Energy efficiencies save Adnams an estimated £50,000 per year

Private equity houses are beginning to focus on what can be achieved through focusing on carbon reduction and energy efficiency initiatives with their portfolio companies. For example, KKR's Green Portfolio Program was developed in 2008, and now includes 16 portfolio companies. KKR and its NGO partner, the Environmental Defense Fund (EDF), says the programme has yielded US$160 million in savings within investee companies over two years, saving 345,000 metric tons of CO_2 emissions, 8,500 tons of paper, and 1.2 million tons of waste.[10]

[8] Business in the Community.
[9] Business in the Community.
[10] green.kkr.com.

The Carlyle Group, also in partnership with EDF, has sought to go beyond the traditional focus on risk mitigation during the due diligence process by identifying opportunities for operational enhancements that lead to better environmental and financial performance before investment. The process, using a tool called 'EcoValuScreen', involves Carlyle professionals evaluating the operations of a target company, identifying the most promising environmental management opportunities and incorporating them into post-investment management, governance and reporting plans. Its aim is to unlock opportunities for operational improvement and value creation through enhanced environmental management in potential investments.

2008

In 2008 Doughty Hanson appointed an in-house head of sustainability. This was the first placement of its type for the industry

These examples illustrate that each firm will need to adopt its own approach and tools, as all private equity houses are different – in size, operational geography, investment approach, and in how they engage and work with their portfolio companies. Some firms are able to be more hands-on than others and spend time within the operations working with other practitioners and, where appropriate, overseeing the work of external advisers. Some firms have made dedicated in-house postings to focus on the subject. Doughty Hanson's appointment of an in-house head of sustainability in 2008, for example, was the first placement of its type for the industry. By focusing on a range of sustainability issues within the firm's portfolio companies, Doughty Hanson has been able to support existing initiatives and also identify and implement new ESG programmes at companies where gaps existed before – in fields such as eco-efficiency, safety performance, supply chain management and product development.

Doughty Hanson's focus on ESG, in particular those initiatives relating to efficiency and revenue generation have they claim generated savings and additional income of €18 million and with a further €21 million per annum to go for. Some 200,000 tonnes of carbon dioxide, 150,000 tonnes of waste and 260,000 cubic meters of water have been saved from release, prevented from landfill, reused or recyled. In addition, they claim greater benefits have been gained by identifiying and addressing environmental and health and safety risks within portfolio company operations and supply chains.

SUSTAINABLE PRODUCTION

Sustainable production of goods can reduce waste resulting in cost savings and improved operational efficiency, safety and quality.


HT34-H3421

Cost savings through waste reduction

A Doughty Hanson portfolio company with wind turbine blade manufacturing operations in 15 locations across Europe, India, China and North America began tracking waste through its Health Safety and Environment (HSE) reporting system. The results showed that approximately 30% of all purchased materials ended up as waste each month. The annual cost in waste disposal of €250,000 per factory was notable – but minor when compared with the €40 million value of materials procured only to be thrown away. The leadership decided that this way of operating was unsustainable in both environmental and financial terms.

A pilot project began in 2009 at one site which identified quick win improvement initiatives using lean manufacturing (Kaizen*) techniques. The project was rolled out globally to all sites in 2010 to share existing quick wins and develop new ones. All quick wins are tracked and shared on a waste reduction web page. The global roll-out was launched first with factory directors who were shown the actual waste and cost from the manufacture of one set of blades – a real eye-opener which brought a step change in top-level awareness of waste and helped to ensure the global roll-out was a success.

Waste was reduced by 8% in 2010, saving the company €6.2 million – a benefit that required no capital expenditure and cost very little in terms of operational expenditure. The indirect benefits have not been quantified but it is likely that they are even more significant: the company found that the waste initiatives also improved operational efficiency, safety and quality – which has led to even greater cost savings.

* Kaizen means a constant perfecting. It engages workers into searching for small improvements at their workplaces which enable them to work in a better, cheaper and faster way. On the one hand it brings higher productivity, and on the other it helps to create a more congenial workplace, with easier tasks, less hurry, fewer defects and misunderstandings. Workers are involved in planning the arrangement of workplaces and tools, as well as analysing work processes. The Kaizen method is based on small, progressive changes and does not demand financial resources but rather systematic, consistent acts to improve technique, technology and methods of work.

The case study (see facing page) shows the cost savings that can be achieved by focusing on waste reduction. While efficiency initiatives of this type do not necessarily mean a company is environmentally benign, they often indicate the beginning of a corporate journey towards sustainable development which requires management of broader environmental and social issues, including supply chain management and product stewardship. The focus is not just from ‘cradle to grave’, but from ‘cradle to cradle’; a continuous cycle of sustainable improvement.

Revenue growth

With the arrival of business-focused corporate sustainability strategies… there are now sustainable products in almost every category

Direct revenue growth can be achieved by developing new products and services that feature sustainability attributes or are designed to meet previously unmet environmental or social needs. Historically, many of these offerings have been considered niche products. However, with the arrival of business-focused corporate sustainability strategies in some of the world’s largest companies, there are now sustainable products in almost every category such as Fairtrade coffee, low-carbon washing detergents, electric vehicles, consumer-oriented renewable technologies, and smart meters.

Clean technology is also becoming a clear business-to-business opportunity. Companies such as GE, Siemens and Phillips have invested in clean technology development (in renewables, energy efficiency, water and waste-related technologies) and are seeing significant business growth in these segments. Clean technology is also a hot area for private equity, with a host of small and medium-sized clean technology companies seeking capital to bring their ideas to market.

Others have seen opportunities to leverage their expertise in managing their own operational sustainability impacts to provide consulting services

Other businesses have focused on the concept of social sustainability and have realised the opportunity to design products and services aimed at the largest, but poorest socio-economic group – the 2.5 billion people who live on less than US$2.50 per day. Rather than treat these people as potential consumers, the most successful ventures are working to support the capacity of the poor to develop businesses themselves. Micro-credit or mobile telecom-enabled banking and information services for farmers are good examples of the types of initiatives being pursued (see for example Safaricom’s M-PESA service in Kenya (see: www.safaricom.co.ke/index.php?id=250).

While companies such as Cadbury, Unilever and Mars have focused in the past decade on acquiring green brands to take advantage of booming demand for Fairtrade, organic and low-carbon products, others have seen opportunities to leverage their expertise in managing their own operational sustainability impacts to provide consulting services. A decade ago, Du Pont began to capitalise on its long experience of managing safety within its own operations to provide safety consulting services and training programmes to companies and government agencies. Similarly, several energy companies have set up energy efficiency and carbon management consultancies.

These examples highlight how value-creating opportunities can arise from embedding sustainability into existing businesses. This can be achieved by enhancing the sustainability performance of the company's operations, products and services or of its supply chain.

Private equity and responsible investment: an opportunity for value creation

A Doughty Hanson owned company involved in the manufacture and supply of pre-cast concrete ceilings and floors to the construction sector has recognised that environmental considerations are a key driver for business growth. The company has developed a range of thermally efficient products that have been designed to meet existing and anticipated stricter 'green' building codes. Viewing energy efficiency as an opportunity and differentiator the company's research into, and development of, more energy efficient building solutions (many of a proprietary nature) has been an important feature of the company's growth over recent years. The revenue generated directly from the sale of these products amounts to €1.5 million a year and the company estimate a saving of over 80,000 ton (metric) carbon dioxide a year through these solutions being installed into buildings.

Reputation and brand

75%

Some 75% of market value can now be derived from intangibles

A company's market capitalisation is built on its capacity to generate earnings from its physical and intangible assets. The value of companies has been shifting markedly away from the tangible 'bricks and mortar' that used to make up the greater part of their market value, to intangible assets such as intellectual capital. Some 75% of market value can now be derived from intangibles. In many sectors, intangible assets are a key differentiator and often a company's most valuable asset. From a brand in a consumer goods business to a spectrum licence in telecoms to patents in a pharmaceutical company, understanding the value of these assets is an important consideration in the context of transactions and strategic decision-making. However, while these invisible assets are significant drivers of shareholder value, accounting rules do not generally allow them to be recognised on the balance sheet unless they can be reliably measured.

Intangible assets are sometimes referred to as intellectual property or goodwill. These are umbrella terms used to describe assets such as brands, patents, licensing agreements, technology, customer relationships, employee know-how, community goodwill and reputation. Corporate sustainability programmes have the potential to touch all these areas and create value in myriad ways that would not generally appear on the balance sheet. For example, a market-leading sustainability programme adopted by a property developer may generate goodwill in the local community, allowing the developer to secure planning permission without opposition. Engaging employees in the corporate sustainability programme by encouraging volunteering in the local community can raise skill levels and employee loyalty to the company. Investing in sustainability and informing the public about it can increase customer loyalty or help maintain or achieve preferred supplier status or grow market share.

10%

89 listed European companies with higher levels of gender diversity outperformed their peers in terms of return on equity (by 10%)

Workforce diversity provides another example. The business case for employee diversity argues that organisations need to develop diverse workforces to ensure they can draw from the best talent available on the labour market. By doing so, they are able to build more dynamic and creative teams which will give them a competitive edge, by virtue of which they will be able to demonstrate relevance to wider customer bases, and thereby increase profits. A study by McKinsey into the value of gender diversity within organisations found that 89 listed European companies with higher levels of gender diversity (selected according to the number and proportion of women on the executive committee and their function) outperformed their peers in terms of return on equity (by 10%), stock price growth (by 1.7 times) and operating results (by 48%) in the period 2005-07.

Risk management

Corporate sustainability programmes not only have the potential to enhance brand and reputation, but also to protect companies from shareholder value erosion. Sustainability risks can arise through many routes and may affect companies' operations or supply chains. Risks may be legal, financial, reputational or physical.

One of the most obvious routes to value erosion for companies is via legal liability risk arising from their operations and products. For example the cost to BP of the 2010 Deepwater Horizon oil spill was an estimated US$90 billion loss in market capitalisation.[11] The long-term damage a company's reputation in cases of legal liability may be incalculable. Product sustainability risk is also potentially significant; product recalls for health and safety reasons are expensive and corporate reputations, once damaged, are expensive (and difficult) to rebuild.

[11] www.time.com.

Behavioural safety initiative

A leading manufacturer of floor coverings, this Doughty Hanson portfolio company had a relatively poor safety record compared with the sector average during the five years to 2005. Local management and the private equity owners decided a step change in the company's approach to the management of health and safety was required to address the issue and when both the frequency and severity of accidents rose sharply in 2007, a behavioural safety initiative was implemented to improve the safety culture within the organisation.

It was calculated that in addition to the human cost, each accident with absence was costing the company €20,000 and in 2007 the total cost of all accidents was over €3 million group-wide.

The main features of the Behavioural Based Safety methodology are the focus on employee behaviour and on involving employees in occupational safety and health issues. Starting with a comprehensive audit and gap analysis, the company also ran a number of projects to improve policy and procedures, communication, the working environment including signage and use of personal protective equipment and training.

The results over the past three years have been dramatic. The company now has accident frequency and severity rates that are better than the average for the sector. This has reduced the cost of accidents at group level by some €1.7 million and resulted in a €200,000 saving on insurance premiums. The initiative is ongoing and the goal is zero accidents.

One of the most important methods for protecting shareholder value is stakeholder engagement. For example, engaging with local communities can minimise planning objections in relation to new developments. Research by a partnership comprising IFC, Rio Tinto Alcan and Deloitte, looking at 83 mining projects across a range of companies, found 24 cases where delays and disruptions caused by sustainability factors had raised project costs. The study estimated that sustainability investments can add around US$200 million in value (net of all costs) in a US$2 billion capital expenditure project over the life of the mine.[12]

[12] www.fvtool.com.

US$500M

Sustainability investments can add US$500 million in value (net of all costs) in a US$2 billion capital expenditure project over the life of a mine

The external megatrends of resource scarcity, climate change, energy security and water stress are all sustainability-related factors that present production, supply chain and workforce risks. Global corporations are beginning to bring these issues into their mainstream strategic and operational risk assessments and private equity houses should consider encouraging their portfolio companies to do likewise. For example, academic research into its cocoa supplier base commissioned by Cadbury in 2007 highlighted low incomes, rural-to-urban migration of young people and poor productivity as risks not only to future supply, but also to Cadbury's reputation in key consumer markets. As a result, Cadbury is investing £45 million over 10 years to improve the livelihoods of cocoa farmers and secure a more sustainable supply.[13] The business benefits have been considerable: the company cites its improved reputation (as measured by surveys) and a significant increase in consumer intention to purchase the product (by 5 to 10%).

Suppliers must meet certain sustainability criteria as the norm, rather than as an extra

The adoption of sustainability principles and responsible procurement practices by public and private sector organisations means that increasingly, it is becoming the case that suppliers must meet certain sustainability criteria as the norm, rather than as an extra. For example, Walmart's 'Sustainability Index' requires its 100,000 suppliers to complete a survey of their sustainability practices which can be viewed online by Walmart's customers. Initiatives like this, driving transparency, are creating market access risks for companies that do not adopt best practice sustainability principles.

The case study (see facing page) demonstrates how smaller companies can also benefit from managing reputation risks arising from their global supply chains. Moreover, this demonstrates how private equity houses can instigate and provide support to their portfolio companies in addressing broader issues relating to sustainable development by moving beyond the eco-efficiency cost-saving approach to address the challenge of longer-term sustainability and reputation risk management. Benefits on exit may not only include improved brand value, but also increased saleability.

[13] www.cadbury.co.uk.

Reputational risk management

Tumi designs and retails high-quality luggage, handbags and travel goods. It contracts out the manufacture of these items to suppliers in the Far East including Thailand, China and Vietnam. Positioned at the luxury end of the market, Tumi's products are durable and have an average life of 5 to 10 years. In addition, Tumi's global repair service processes some 50,000 items per year, extending their useful life and reducing waste.

Working with Doughty Hanson, Tumi has undertaken a number of environmental and social initiatives focused on working with its suppliers in the Far East, including:

- Becoming a member of the Fair Labour Association and ensuring suppliers are subject to independent audits.
- Undertaking regular internal audits of key suppliers to monitor environmental and social performance.
- Providing training to all key suppliers to raise awareness of environmental and social issues and of Tumi's expectations in respect of environmental and social responsibility.
- Establishing where leather hides are sourced from for Tumi (in particular to determine whether leather hides were being sourced from areas subject to deforestation) and implementing a leather hide traceability programme.
- Becoming a member of the Leather Working Group.

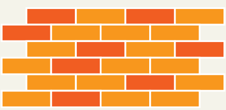
Doughty Hanson's focus has been on managing reputational risk, with a particular focus on the supply chain. By encouraging Tumi to go further in its approach than many luxury goods retailers, Doughty Hanson believes that it is adding value to its investment, which will be realised when it comes to exit.

The role of reporting in communicating value

Regulatory requirements in the UK Companies Act for corporate reporting on ESG issues by public companies are currently limited, but are likely to grow. The larger private equity-owned companies are subject to the voluntary Walker guidelines for Disclosure and Transparency in Private Equity.[14]

The benefits of good quality reporting

Maximising value from reporting requires organisations to go beyond minimal regulatory requirements. Sharing information, by disclosing which matters are important and why, and by explaining the organisation's strategic objectives and its performance in delivering against these objectives, enables value to be taken into account in valuation models. For investors to give credit for value created, they first need to know about it. Moreover, the familiar maxim of only being able to manage what you measure means that realising opportunities for value creation needs to include performance measurement and reporting, at least internally, but with the option to realise full value through external disclosure.



Consistent external disclosure including sharing bad news, helps build trust

A commitment to open reporting demonstrates to stakeholders that nothing is being hidden. By contrast, a backdrop of secrecy along with selected disclosure of good news case studies risks companies being tarnished with accusations of 'greenwash'. Consistent external disclosure of material impacts and performance, including sharing bad news, helps build trust. This is particularly so where disclosures demonstrate that management not only understand the key ESG risks facing their business, but are also managing them.

14 'The Guidelines for Disclosure and Transparency in Private Equity' published in November 2007 following an independent review undertaken by Sir David Walker. See: www.walker-gmg.co.uk/?page=10551.

In some circumstances, high-quality reporting can also facilitate improved business understanding. In many instances, the desire to report externally has driven companies to consider their impacts on society and the environment more carefully. The increased breadth of reporting, influenced by guidelines such as the Global Reporting Initiative[15], has helped provide new insights into the range of issues on which a company has influence. In turn, the scope of information available has helped investors identify opportunities for 'shared value' – strategic benefits for society and the natural environment which also benefit the business. An example is provided by NIKE setting up local sports facilities for local children, who then take up sport and buy NIKE clothing and equipment. Taking such a broad perspective of sustainability is not necessarily the most efficient way of exploring new opportunities related to ESG issues, but businesses looking to address ESG risks for the first time can learn from this experience.

Unsurprisingly, the move to more transparent reporting occurred hand-in-hand with an increasing emphasis on stakeholder engagement. Many businesses recognised that developing a good understanding of stakeholder expectations lay at the heart of sustainable business management, helping to improve business awareness and risk mitigation and driving better-informed decision-making. This has particularly been the case in the internet age, when technology is providing stakeholders with real-time information. Failure to respond to the interests of stakeholders in a timely manner can have catastrophic effects – for example, in lost margin, sales or market share. Equally, some companies are now recognising the need to balance stakeholder expectations for increased disclosure, with the need to identify, manage and report on only those ESG issues that are genuinely material to its particular business.

[15] www.globalreporting.org.

The focus should not be on increased disclosure, but rather on better disclosure

Challenges

Despite the benefits of open reporting, experience shows a number of common pitfalls and challenges involved in getting ESG disclosures right. The focus should not be on increased disclosure, but rather on better disclosure – providing information and value drivers pertinent to the business. An investment made into reporting information that does not generate business value can be onerous and expensive.

Achieving the right balance between disclosing information of importance to the business and information that is desired by external stakeholders is a particular challenge. Leaning towards the former can alienate wider stakeholders; a tendency towards the latter can lead to a costly data gathering exercise and reporting that is not taken seriously internally because the value is not clear.

Balancing the desire for openness while protecting commercially sensitive information can also be problematic. Disclosing greenhouse gas emission intensity data, for example, can provide competitors with insights into types of technologies and processes employed – a risk that requires innovative approaches to disclosing information that is transparent but not commercially damaging.

Supply chain risk and opportunity: monetising environmental externalities

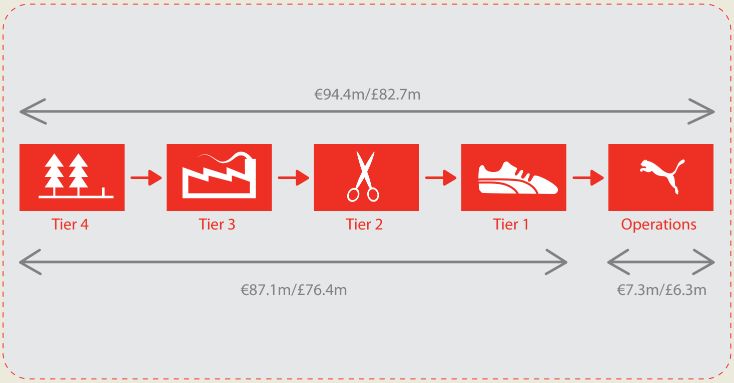
Sustainability megatrends such as climate change and water scarcity are impacting businesses in many ways. For example, apparel businesses have experienced cotton price increases of more than 300% over the last three years, caused by a combination of increased global demand, floods in Pakistan and crop failures in China.

PUMA, the sports lifestyle company, has a clear mission: not only to be the most desirable sports lifestyle brand in the world, but also the most sustainable. It recognises that such megatrends require a new business paradigm – one that works with rather than against nature, and that recognises that the cost and loss of value to nature must be accounted for when business is being conducted.

Adopting a new business model that works with nature has two major advantages. First, a more sustainable brand is more desirable to consumers. Second, megatrends such as climate change and water scarcity are already starting to be regulated and a business model that reduces exposure to these trends reduces its risk exposure.

PUMA is acutely aware that changing the business model requires a better understanding of the implications of decision-making on future business performance. As businesses are driven by the bottom line and rely on financials, one approach to internalising these environmental externalities is to attribute a monetary value.

To achieve this, PUMA created the 'Environmental P&L' – a means of placing a monetary value on the environmental impacts along the entire supply chain of a given business. The Environmental P&L account represents the company's first stage of measuring the full environmental, economic and social impacts on ecosystem services and below are the initial results for greenhouse gas emissions and water consumption, demonstrating the magnitude of the reliance on natural capital. This is helping better prepare the business for future regulation, such as disclosure requirements or taxation.



Extract from PUMA Environmental P&L Account: the figures represent the environmental/social cost of greenhouse gas emissions and water consumption in PUMA direct operations and supply chain.

Opportunities

The private equity sector has the opportunity to be at the forefront of future developments in corporate reporting on ESG issues. The concept of 'integrated reporting' has gathered momentum in recent years, driven by initiatives such as the Prince of Wales' Accounting for Sustainability project and more recently by the International Integrated Reporting Committee (IIRC).

The discipline of integrated reporting, linking strategy, governance, financial and non-financial performance, requires the embedding of ESG matters into the heart of business thinking by connecting non-financial matters with financial performance and ESG issues to achievement of the core business strategy. Adopting this style of reporting ensures a commercial focus to ESG management and a story that focuses on the return on investment, whether short, medium or long-term. In adopting an approach featuring genuine engagement with portfolio companies, private equity houses have the opportunity to contribute significantly to this emerging area.

Hammerson

Connected Reporting Framework

Our Connected Reporting Framework guides our approach to sustainability

RESOURCE USE

Objectives

01 To maximise the efficiency of our use of natural resources

02 To reduce waste and re-use where viable

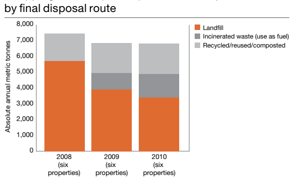
Action

- Waste audits commenced in France to establish recycling potential.
- Environmental co-ordinators employed at five UK managed assets.
- In 2010 we completed a sustainability implementation plan for France for our development projects.

Performance

Waste

Shopping Centres (France) Annual waste production by final disposal route



Waste financial indicators

	2008	2009	2010
Cost of waste			
UK	£1,719,476	£1,473,306	£1,667,517
France	Not recorded	£641,261	£533,094
Total	£1,719,476	£2,114,567	£2,200,611
Investment in waste management improvements			
UK		£6,000	£35,500
France		£9,126	£19,045
Total	£32,504	£15,126	£54,545
Estimated savings from landfill tax aversion			
UK	£254,364	£369,634	£557,761

Figure 5: Integrated reporting in action: Hammerson plc

In terms of their own disclosure, private equity houses should look to report on the value their investment in ESG issue management is delivering, and how it is contributing to their objectives. This requires a readiness to recognise challenges and be open about them.

To add credibility to reporting and clarity of return on investment, details on strategy, objectives, plans and progress against targets are required. This will help investors build ESG performance into their valuation models.

Private equity house reporting could benefit from learning about, and including commentary on, how this is being done in portfolio companies. Reporting should also show how the impacts of long-term ESG trends are being built into due diligence processes to ensure future business value is not at risk.

3. WHAT NOW? IMPLICATIONS FOR PRIVATE EQUITY HOUSES

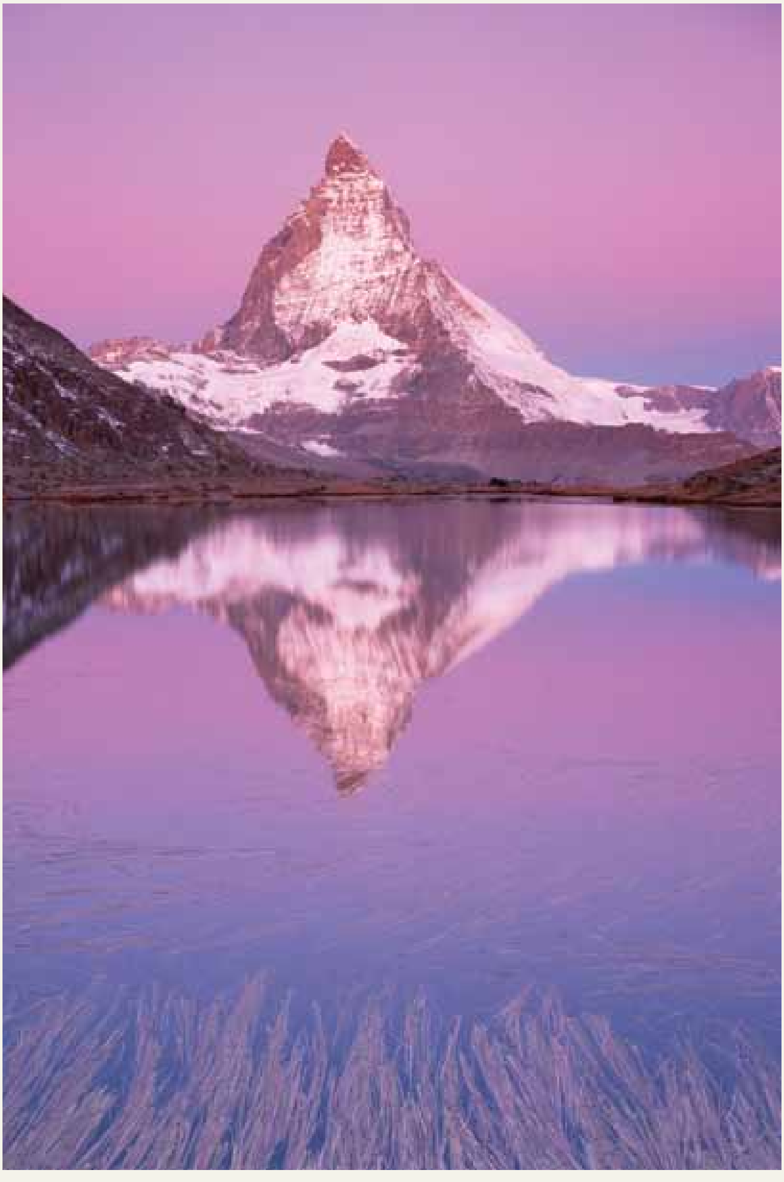
The private equity industry is skilled at building better businesses. This should mean that, in addition to being fitter businesses financially, private equity-owned companies are better businesses from the environmental, social and governance viewpoint too.

For private equity houses, it is essential that they are clear, internally and externally, about how they are supporting portfolio companies to realise value from ESG management. At present this is largely (and this is perhaps most important) about active engagement and taking credible action. In future, it will also increasingly be about reporting.

Reporting is likely to be of increasing significance in the future as the private equity industry as a whole starts to embed the concepts of sustainability and responsible investment into its business model. Demonstrating the value of active engagement, and highlighting the linkages between good environmental and social performance and good long-term financial performance, will be of particular importance.

Full engagement with the constantly evolving sustainability agenda provides private equity houses with the chance to identify and exploit opportunities. Throughout the investment cycle, from pre-investment screening through the 'hold' period to exit, integration of ESG issues into core processes allows for risk to be mitigated and value to be enhanced. Key points to bear in mind include:

- The likelihood that all private equity houses will continue to focus on the creation of value. Even though there is likely to be a wide variation in the approaches taken (reflecting the nature and scale of each firm and its management approach), there is also likely to be a common recognition that creating value is inextricably linked to supporting the sustainability performance of portfolio companies. As outlined in this document, trends suggest that maximising that value might involve active ownership and particularly hands-on engagement, exerting a more dynamic influence as agents of change.
- Having access to competent expertise, particularly where portfolio companies either lack the necessary skills or understanding to manage ESG/sustainability issues themselves. This is likely to involve the use of external advisers (possibly in formal partnerships with some of the larger private equity houses) or by appointing dedicated in-house specialists.
- Addressing a broader range of ESG issues rather than focusing only on issues of environmental efficiency. Other, non-environmental matters such as maximising value from the workforce in addition to natural and financial capital will become increasingly important. As noted, considering wider sustainability matters such as product stewardship and supply chain management will become the norm in future.
- Considering ESG issues throughout the lifecycle of a deal, rather than at particular stages only, such as pre-investment screening.
- Working in partnership, where appropriate, with respected external organisations such as WWF to address the more challenging issues relating to sustainable development.



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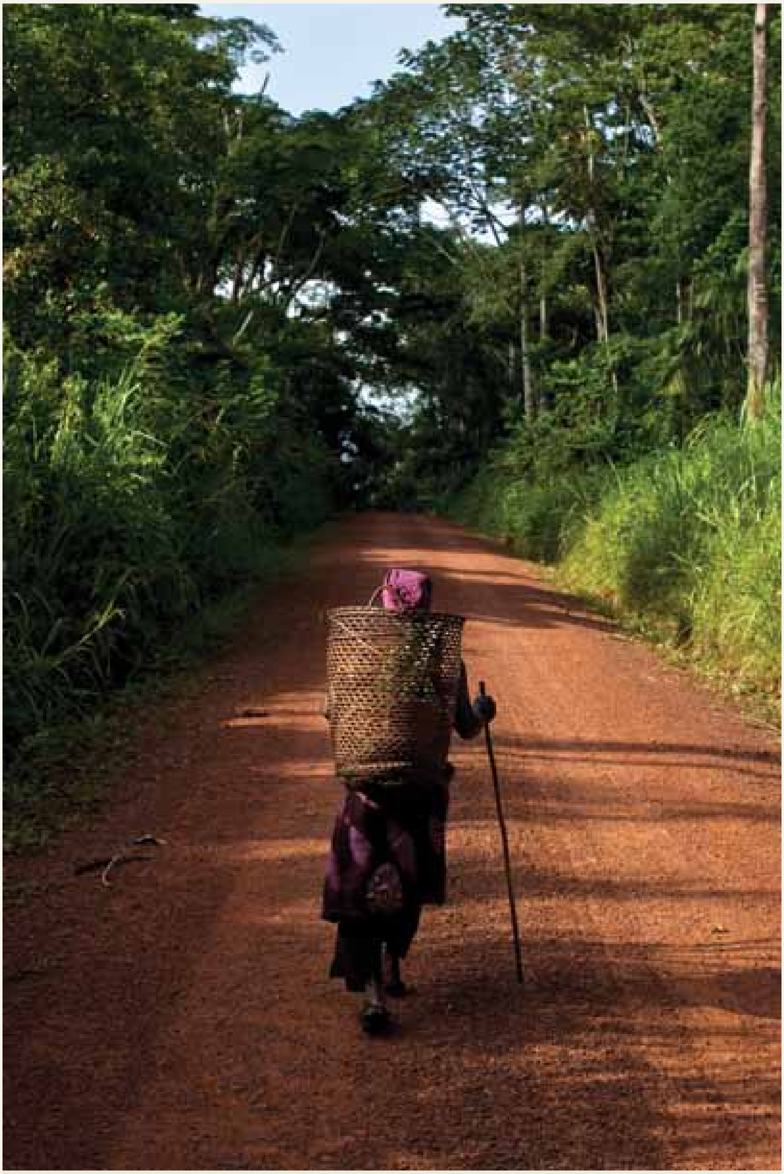
It should be recognised that 'engagement' by private equity houses is not always a prerequisite for progress on the sustainability agenda. Indeed, certain private equity-owned companies, working on their own initiative, are already taking a lead in this field and are publicising their achievements. To the extent that this provides an incentive, or an impetus, for private equity houses to absorb and apply sustainability lessons elsewhere across their portfolios, this has to be welcomed.

However, private equity houses should now be leading, not following, their portfolio companies in demonstrating how effective management and reporting of ESG issues can show tangible, valuable results. As the analysis in this paper has shown, the time is now right for private equity houses to drive the sustainable development agenda through active ownership of portfolio companies. This is not only the responsible thing to do, but it also provides private equity managers with an additional set of levers to generate enhanced returns for all of their stakeholders.

Private equity houses should now be leading, not following, their portfolio companies in demonstrating how effective management and reporting of ESG issues can show tangible, valuable results



Private equity and business in numbers

100% RECYCLED

C. US$ 30 TRILLION

The 900 investment institutions who are UNPRI signatories hold assets under management of c. US$ 30 trillion.

C. 2.1 MILLION

c. 2.1 million people work for private equity-owned companies.

93%

93% of large global company CEOs believe sustainability issues will be critical to the future success of their business.

88%

88% of GPs expect ESG issues to become more important in the next five years.

WWF

Why we are here

To stop the degradation of the planet's natural environment and to build a future in which humans live in harmony with nature.

wwf.org.uk

Panda House, Weyside Park, Godalming, Surrey GU7 1XR, T: +44 (0)1483 426444,
E: scharman@wwf.org.uk, **wwf.org.uk**