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Private Equity News: Private equity looks to ESG offenders for higher returns

Private equity firms are finding new and creative ways to address environmental, social and governance criteria

By Selin Bucak

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Wanted: portfolio companies with a bad environmental track record. While asset managers and pension funds are rushing to find investments with good environmental,

social and governance (ESG) scores, more private equity firms are looking for bad apples.

That's because companies with a dreadful track record in addressing ESG issues are often cheap, and once improved, can be sold at a much higher price.

"It [ESG] has moved from being something only to keep the investors happy to become mainstream," said Will Jackson-Moore, head of PwC's global private equity and sovereign investment funds team.

But being mainstream is not enough. Buyout houses are increasingly finding new and creative ways to respond to investor demand around ESG to differentiate themselves in a crowded market.

Improve compliance

New York-based Blue Wolf Capital is among those investing in companies that have ESG problems.

"We utilise, among other things, an ESG lens to identify opportunities to improve environmental compliance and footprint, to improve productivity and growth through the better management of human capital and to manage the governance of a company throughout its life cycle," explained Adam Blumenthal, Blue Wolf's managing partner.

Blue Wolf, which has approximately $1.3bn in assets, acquired Suwannee Lumber Company, a family-owned business in Dixie County, Florida, in 2013. The business made lumber that was primarily used to make decks behind houses. Historically, the decks were sprayed with a preservative that later turned out to be carcinogenic.

Blumenthal said that although Suwannee had stopped using the preservative, it did not have a good record of cleaning it up. He said that Blue Wolf bought the company at a discounted price and made the environmental performance a central piece of its value creation plan. The firm worked together with regulators, engineers and state officials to roll out a five-year environmental mitigation plan. It also created a health and environmental programme and upgraded financial, reporting and planning systems. In addition, the firm made affordable health insurance available to all of Suwannee's employees among other benefits.

"We view [these] situations as opportunities," said Blumenthal.

"The way we use the ESG approach and lens is to say we think we are good at managing and remediating environmental problems; we are good at improving employee health and safety; we are good at implementing strict compliant governance systems.

"If bringing those skillsets to a company will let us buy it at a discounted value, execute our skillset and exit at a premium multiple, it's not a question of if we walk away, it is can we create value and is it an exciting opportunity."

Blue Wolf eventually sold Suwannee in 2018 to Canadian firm Conifex Timber for $258m, making a return of 3.5 times its investment, according to a person familiar with the matter.

The broad focus on ESG factors has grown significantly among PE firms in recent years. Major players such as Blackstone, KKR, Bridgepoint and Carlyle are among many firms that have hired heads of ESG or responsible investment specialists to address the growing demand from investors.

A survey by placement agency Rede Partners found 87% of limited partners expect to increase their allocations to sustainable strategies, while over 95% of LPs said they see sustainability and impact as increasingly important for them and their clients.

Almost all of the LPs surveyed by Rede said they require market-rate financial returns and 28% of LPs specifically cited poor track records as a risk to investing into the impact space.

Private equity firms that actively address ESG issues throughout an investment's life cycle argue that investors don't have to give up financial performance for non-financial impact.

A Boston Consulting Group report from 2017 found that non-financial performance was statistically significant in predicting the valuation that investors place on companies. The *Total Societal Impact* study found that investors rewarded top performers in specific ESG topics with valuation multiples that were 3% to 19% higher – all else being equal – than those of the median performers in those areas.

At CapMan, a Nordic investment company with €3bn in assets, one of its private equity funds focusing on Russia creates an ESG improvement plan for businesses that it invests in.

For potential investments that are categorised as medium risk according to the European Bank for Reconstruction and Development's ESG criteria, which focuses on identifying risk and measuring impact, CapMan hires an external consultant to map out issues and draft a post investment action plan.

Environmental policy

"Usually in Russia companies don't have environmental and social policies," said Natalia Boutina, investment manager at CapMan.

"It is our demand that a policy be drafted. They don't usually have ESG systems, they don't have responsible persons for environmental issues and social issues. We try to put that in order. Usually companies don't provide training to employees for fire protection, health and safety, so we urge them to organise that area."

UK mid-market firm Palatine Private Equity invests in companies with low ESG scores as long as it is not in a material part of the business, said partner Beth Houghton. An example is the firm's investment in The Alchemist, a cocktail bar and restaurant chain.

Under Palatine, Alchemist reduced staff absenteeism and churn, and cut costs by installing LED lights and smart meters and reducing water usage. The company also began recycling glass, cardboard and food, reduced plastic waste, and installed new kitchen segregation systems that enable organic waste to be used for energy generation instead of going to landfill.

At Carlyle, chief sustainability officer Jackie Roberts said the firm integrates ESG into its investment process at every step.

She said: "In the large Europe buyout fund, we go through developing the most material KPIs for those companies, we then monitor those annually. The goal of improving governance and transparency is very important to our investors, we want to make sure we are monitoring key risks."

Broader approach

In 2013 Carlyle bought DuPont's auto paint business for $4.9bn. When it exited the business in 2016, following a series of share sales, the private equity firm made a $4.5bn profit, *Bloomberg* reported at the time.

The firm, which was renamed Axalta, had a division that made paint for coating cars. Customers were asking for environmentally friendly products, so Carlyle had the firm reduce its use of solvents and switch to waterborne paint. The firm also developed a new, less carbon-intensive way of applying the paint.

The authors of the recent Rede survey said that private equity has moved from simply screening out investments because of their poor ESG score to a broader approach. They said that firms measure non-financial returns and compete for capital based on ESG outperformance.

"ESG must create value or it is wasting time and money," the report's authors noted. "At its best ESG helps enhance deal value via improved risk/return and franchise value via improved GP/LP relationships."

PwC's Jackson-Moore said he is having regular discussions with clients regarding the opportunity for buying companies with lower ESG scores. "I think part of the reason private equity is more focused on ESG is if [a business] has a poor ESG record, they end up having to sell it at a lower multiple… there is an opportunity for private equity to have a value creation plan around cleaning it up," he said.

But he has warned that this will not be for everyone. It will be a tough sell for some LPs who may need convincing that investing in a business with a bad track record in ESG is actually a good idea.

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