CAPSTONE PARTNERS

ESG as a Strategy for Private Equity Investing & Value Creation

Why it Matters and What to Consider

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Executive Summary

Capstone Partners explores how private equity firms can leverage Environmental, Social, and Governance (ESG) frameworks within their portfolio companies to enhance and create value from inception to exit. ESG initiatives in and of themselves do not make a poorly performing company profitable. However, when properly applied, ESG frameworks are a non-traditional financial analysis and engineering tool that can materially strengthen the fabric, flexibility, efficiency, and long-term growth potential of an organization and drive enhanced economic shareholder value.

Our featured contributors include the leaders of Boston-based private equity firm The Watermill Group, ESG and investor communications program provider Library Ave Consulting, and ESG and impact analytics software provider Tablecloth. Collectively, these individuals provide unique perspectives on strategies, tips, and tools for successful ESG integration.

Background

ESG's relevancy within private capital investing is clear, with ESG-focused assets under management (AUM) accounting for more than one-third (approximately $3.1 trillion) of committed capital in 2021, according to Prequin.[1] Of this, private equity accounted for the largest asset class, with $1.82 trillion invested in ESG funds. Investor demand was the primary reason that fund managers reported implementing ESG strategies, particularly amid mounting political pressures for private equity fund transparency and ESG reporting.

The COVID-19 pandemic has been a notable driver of ESG awareness in the U.S., as organizations were required to find an appropriate balance between employee health and safety and company productivity. Work from home and the Great Resignation also brought to the forefront a long-needed reset of the traditional business landscape and factors such as a corporation's social responsibility, its role in the community, impact on the environment, and adherence to recommended guidelines were more closely scrutinized. In a survey of its portfolio companies, TPG Capital noted that in addition to an increased focus on health and safety, social capital, and environmental initiatives, the uncertainty of COVID-19 also catalyzed enhanced risk management—yet another asset of a well-run ESG strategy.[2]

This paper explores the multifaceted definition of ESG, why the topic is relevant for every firm to consider, hurdles and upcoming changes the industry will likely face, and how to approach ESG integration. Despite its connotations, ESG is not a synonym for altruism, but rather, it is a strategy for optimizing a business and investor returns.

Taking Stock of Responsible Investing

ESG in the Culture Wars

My mother recently asked me if I was “doing ESG now.” She had heard the term from a talk radio host who conflated corporate ESG initiatives with progressive political activism. Her question was reflective of the general tendency to reduce the broad and nuanced range of ESG issues to two signature items: carbon emissions reduction and the concentration of people of color and women on corporate boards and in C-suites (d/b/a Diversity, Equity and Inclusion – DEI). These topics, while important, are only part of the complex and increasingly relevant ESG landscape.

To be clear, ESG advocacy is not the lunatic fringe of the woke left run amok in corporate board rooms. Rather, this arena has attracted a passionate group of practitioners, who have made it their mission to help investors and company managers employ frameworks to measure non-economic business impacts alongside more traditional financial underwriting and value creation techniques. My favorite exhibit in this piece follows on pages five and six. Flip ahead to see the myriad considerations business leaders face as they build organizations across 12 industries covered by our Investment Banking Team. The staggering range of issues understandably tempts a focus on a few flashpoint items like carbon reduction rather than embrace the other layers of sensible corporate governance.

Nuthin’ but a G Thang

With the breathless focus on emissions and workplace diversity, the “G” of ESG–corporate governance—often gets short shrift in the conversation. (Corporate governance includes, but is not limited to, organizational transparency, risk management, anti-corruption, executive compensation, board independence, and privacy issues). Sure, the editorial pages can spar over the emissions of an oil major or the racial/ethnic makeup of a Fortune 100 board, but for many of the family and entrepreneur-owned businesses that we represent at Capstone, having a board populated by non-family members and endowed with decision making power can be a novel concept. Proper board governance can shine a spotlight on existential issues that a business must face as it professionalizes and accepts outside capital. For instance, in the era of state-sponsored hacking and data theft, cyber security policies and user data protections play a crucial role in protecting a company from scandal. Firms that neglect to develop these policies have likely not contemplated

Taking Stock of Responsible Investing (Continued)

the true cost of an event and, knowingly or otherwise, invite risk on a not if, but when basis. An ESG tune-up prompted by an institutional investor can be the long-needed kick-in-the-pants that a business owner needs to get the governance house in order.

Mega Funds Lead the Way

Interestingly, the private equity mega funds have led the charge in ESG adoption and the middle market funds are falling in line behind them. As you'll see in the pages that follow, firms like Carlyle launched initiatives over a decade ago and now have mature ESG programs. They committed the capital and human resources even before the LPs made robust ESG programs a condition of continued funding. In the middle market, LPs haven't historically held GPs accountable to tangible ESG standards until recently. Now a tidal wave of ESG best practices adoption is underway in the middle market.

Harder, Better, Faster, Stronger

In our view, the adoption of ESG initiatives in the private equity industry is part of a larger trend: the only way managers generate outsize returns in the buyout business in 2022 is by making portfolio companies dramatically bigger and better. The era of financial engineering in private equity is dead and buried. Print the obituary. So, let's call ESG exactly what it is: a playbook that systematically makes a business better. A better employer. A better risk manager. A better custodian of customer and patient data. A better steward of our environment. A firm that is more rooted in its market and community by creating better economic opportunities for every stakeholder. Of course, there are skeptics. Some managers do not accept as gospel that ESG adoption produces superior financial returns. Many more simply acquiesce to the cynic's Golden Rule (whoever has the gold makes the rule) and accept that ESG reporting is the price of raising capital from an institutional investor. Time will tell whether GPs turn good ESG hygiene into cold hard cash and cement these principles into M&A diligence forever.

Thank you for reading our report. We hope that the contents within provoke thoughtful discussions, and that you will pick up the phone and share your feedback with us.

Take care of yourself and take
care of someone else,

Brendan Burke
Managing Director,
Head of Sponsor Coverage

What is ESG?

While ESG is fairly nascent to the U.S. middle market, it has been prolific in Europe and Canada and has become an increasingly mainstream topic among large U.S. corporations. Within the private equity universe, ESG adoption has gradually increased, but has been stunted by the lack of uniform metrics, standard integration practices, and publicly available financial results. The official term "ESG" was coined in the 2004 United Nations (U.N.) paper "Who Cares Wins: Connecting Financial Markets to Changing the World," which gathered recommendations from analysts, financial institutions, companies, investors, pension fund trustees, consultants and advisors, regulators, stock exchanges, and non-government organizations (NGOs) to increase awareness of the topic's importance across all financial markets.[3] While ESG has frequently been sequestered to refer only to Environmental issues, the Social and Governance aspects of the acronym are far reaching and include everything from Diversity, Equity, and Inclusion (DEI) to workplace safety, and anti-corruption policies.

ESG measures are an effective prism through which every firm's management and investment strategy should be viewed to strengthen its competitive advantages, reduce regulatory and litigation risks, attract top talent, and increase operational efficiencies. Furthermore, by implementing ESG initiatives companies, whether public, private, or private-equity backed, can be better positioned to differentiate themselves to attract capital and maximize their value in a liquidity event. Buyers are becoming increasingly attuned to the importance of ESG as risk mitigation and as a tool for identifying areas of growth and innovation. Because of this, assessing a target's ESG-related value and risks is becoming standard in corporate and merger and acquisition (M&A) due diligence. In this light, by considering the full ecosystem that a company touches, there is collinearity in ESG and financial performance, where ESG integration helps to achieve long-term value creation.

ESG considerations will vary between industries and across sectors and may not always be presented specifically under the auspices of the multifaceted ESG terminology. Scrutinized topics falling under the ESG umbrella include employee retention and engagement; workforce diversity; geopolitical risks; ethical supply chains; workplace safety; and data privacy. When a holistic understanding of the term is embraced, it becomes clear that all aspects of having a favorable ESG profile are part and parcel with what it means to do good business.

ESG Overview by Key Criteria

ESG initiatives can support businesses' resilience from internal and external shocks, decreasing potential legal issues while increasing the attractiveness of the company to employees, investors, and shareholders.

Environmental

- Water use/Conservation
- Sustainable Natural Resources/Agriculture
- Waste Reduction
- Clean Technology
- Climate Change
- Carbon Emissions Reduction
- Green Building

Social

- Workplace Safety
- Labor Relations
- Workplace Benefits
- Diversity/Anti-Bias
- Community Development
- Avoidance of Tobacco/ Harmful Products
- Human Rights

Governance

- Corporate Political Contributions
- Executive Compensation
- Board Diversity
- Anti-Corruption Policies
- Board Independence
- Risk Management
- Transparency

Source: Capstone Partners

Sample of ESG Factors by Industry

ESG considerations are integral to the innovation and growth of companies across every industry. The table below showcases recurring ESG themes as noted by Capstone's Investment Banking Team.

Industry	Environmental	Social	Governance
AEROSPACE, DEFENSE, GOVERNMENT & SECURITY	• Alternatively-powered aircraft • Sustainable and ethical supply chain • Aircraft engine emissions regulation • Recycling of decommissioned assets	• Public safety • Talent diversity and aging workforce • Reputational risk of weapons manufacturing & complicity in the Military-Industrial Complex	• Privacy and security of personal & corporate information • Identity protection
BUILDING PRODUCTS & CONSTRUCTION SERVICES	• Energy efficient buildings • Water efficiency • Waste & hazardous material management	• Worker safety • Consumer demand for green products • Community awareness • Diversity, equity, inclusion-based recruitment	• Transparency and consistent disclosures • Sustainability focused leadership
BUSINESS SERVICES	• Energy prices for datacenter dependence • Travel efficiency for consulting services	• Unbiased human resource practices & recruitment • Advertising integrity	• Data privacy • Environmental consulting services
CONSUMER & RETAIL	• Ingredient sourcing • Recyclable packaging and materials & plastic reduction • Supply chain due diligence	• Humane & safe working conditions • Product labeling	• Consumer privacy • Product safety • Emissions standards
EDUCATION & TRAINING	• Online educational resources • Public school energy efficiency ratings	• Education quality & gainful employment • Marketing practices	• Diverse board of directors • Educational institutions' code of ethics
ENERGY & POWER	• Reducing greenhouse emissions • Toxic emissions & waste • Land and aquafer contamination • Investing in shift to green energy	• Health & safety of workers • Local politics & regulation and taxation • Increased energy demand for communities (affordability & reliability)	• Explicit emissions reduction targets • Climate risk awareness

Source: Capstone Partners and S&P Global

Sample of ESG Factors by Industry (Continued)

Industry	Environmental	Social	Governance
FINANCIAL SERVICES	• Digital solutions to reduce carbon footprint • Lending & investment to sustainable sectors • Increased frequency & severity of weather events (insurance)	• Democratization of lending • Socially inclusive financial ecosystem • Socially responsible investing • Serving unbanked regions	• Customer privacy • Transparency and ethical banking activity
HEALTHCARE	• Socially responsible supplier partnerships • Packaging material & waste • Energy intensity for BioPharma	• Equal access to healthcare • Product safety & recalls • Misleading marketing	• Patient privacy • Community health assessments • Value-based care • Accessible medical records • Selling practices
INDUSTRIAL	• Waste & hazardous material management • Recycling of input materials • Environmentally-friendly equipment and businesses practices	• Occupational health & safety • Supply chain transparency	• Improving quality standards • Increased safety of capital assets
INDUSTRIAL TECHNOLOGY	• Efficiency through artificial intelligence and big data • Renewable energy transition	• Improved job security • Capital maintenance education	• Cyber threat mitigation • Energy management analytics
TECHNOLOGY MEDIA & TELECOM	• Eco-conscious transportation • Data center operation • Manufacturing dependency on water usage and minerals	• Gender & ethnic diversity • Eliminating hiring & pay bias • Building AI without systematic biases • Funding for female & minority STEM programs • Social giving	• User privacy & data security • Antitrust disputes • Data security
TRANSPORTATION & LOGISTICS	• Reducing carbon emissions • Efficient uses of land for warehousing • Packaging material & waste	• Driver working conditions • Employee retention • Accident & safety management	• Transportation network regulation • Logistics audits

Source: Capstone Partners and S&P Global

ESG As Value Creation

Private equity firms have increasingly turned to the ESG playbook as a valuation creation lever and risk mitigant throughout the investment cycle.

Attracting Limited Partner (LP) funding today functionally requires an ESG program. Seventy percent of LPs surveyed reported that ESG considerations are included in their investment policy, according to Bain & Company's Global Private Equity Report 2022.[4] Furthermore, 93% of LPs noted that they would walk away from an investment with poor ESG metrics. In North America, the chief reason to avoid an investment in a company with ESG concerns was the risk of negative publicity (72%) while in Europe it was the lack of the target company's desire to improve its ESG performance (78%). Portfolio investments are increasingly being scrutinized by General Partners (GPs) in the due diligence phase for their ability to align with ESG-related investment criteria baselines, material risks, and value creation potential. Seventy-three percent of LPs noted that GPs' use of an ESG risk factor framework in acquisitions and the management of portfolio companies was moderately to extremely important when deciding whether to commit capital to a fund, according to a 2021 PitchBook survey.[5] The ultimate evidence for ESG initiatives are higher financial returns. There are clear instances of this, in which ESG efforts manifest themselves in operational improvements. In an anecdote that Lauren Winkler, Founder & Managing Partner of Library Ave Consulting, shared in an exclusive Capstone interview, a manufacturing company in South Dakota retrofit its facility to address pollutant and emission issues and buoyed the company's EBITDA by $3 million dollars annually through improved efficiency. By using an ESG lens to make operational improvements, forward-looking strategies to monitor, optimize, and innovate throughout an investment's holding time can further enhance shareholder value and drive a higher rate of return upon exit.

When analyzing more than 1,000 research papers on ESG and financial performance, NYU Stern found that the majority of ESG initiatives had a positive effect on operational metrics including return on equity (ROE), return on assets (ROA), and stock prices, according to the 2021 released study.[6] At the same time, the analysis concluded that there has been a lack of proper distinction between research on differing investment strategies and asset classes.

Six Themes on ESG & Financial Performance

1. Improved financial performance from ESG initiatives becomes stronger over longer periods of time.
2. ESG integration performs better than a negative ESG screening approach.
3. ESG investing can provide downside protection during market volatility.
4. Corporations drive improved financial performance from ESG adoption from risk management and innovation.
5. Managing for a low carbon future improves financial performance.
6. Mere ESG disclosure does not improve financial performance.

Source: New York University Stern

While empirical evidence is still being gathered to prove out the model for private equity ESG investing, several industry leaders have been trailblazers in its exploration. The Carlyle Group (Nasdaq:CG) was one of the earliest ESG adopters releasing its first annual ESG report in 2010. The firm tracks material performance indicators across its portfolio companies and hosts an annual Sustainability Workshop for the companies to guide in problem solving and information sharing. TZP Group launched its ESG 360° program in 2020 with a key objective being to lead other lower-middle market firms. TZP developed a playbook and has sought ESG integration from sourcing, to deal execution, to post-investment initiatives. These firms, among many others including those highlighted on the following pages, can serve as a guide for organizations that are exploring the value of ESG integration and are at the cusp of adoption.

Private Equity Firms Pioneering ESG Investing

Many leading private equity firms have adopted ESG programs and have raised and invested capital in impact funds. The examples below can provide insight into understanding and approaching ESG integration.

CARLYLE

AUM: $376.0 Billion
Dry Powder: $39.3 Billion
Active Portfolio: 307

Integration Highlights: In 2010, The Carlyle Group released its first annual ESG report, in 2020 it was one of the first firms to publish a Task Force on Climate-related Financial Disclosures (TCFD) report, and in 2022 it led the first PE partnership to standardize ESG reporting. The firm has more than $20 billion in ESG-related financings and regularly implements ESG strategies at its portfolio companies with key programs such as vision workshops, materiality assessments, and gap analyses.

ESG Investment Themes: Energy Transition and DEI

Portfolio Example: Carlyle acquired IRCA (Italian producer of specialty dessert ingredients) in June 2017 and completed a 12-week workshop with the company, ultimately establishing ESG goals for DEI, energy and carbon emission reduction, and waste management. IRCA sold in April 2022 for ~$1 billion, roughly twice the price Carlyle paid in 2017.

Standards & Tools: Task Force on Climate-related Financial Disclosures (TCFD); Sustainability Accounting Standards Board (SASB)

Reporting: 2022 Impact Review

Blackstone

AUM: $915.0 Billion
Dry Powder: $115.1 Billion
Active Portfolio: 457

Integration Highlights: The Blackstone Group (NYSE:BX) has more than a decade-long history of ESG integration and conducts an annual ESG survey and quarterly data collections from its portfolio companies. In 2021, Blackstone acquired ESG software and consulting service Sphera for $1.4 billion to further the firm's strategy.

ESG Investment Themes: Decarbonization, Good Governance, Diversity

Portfolio Example: Blackstone acquired dating platform Bumble (now Nasdaq:BMBL) in 2019 and helped achieve CEO Whitney Wolfe Herd's goal to build a women-led C-suite. In 2021, Herd became the youngest woman entrepreneur in the U.S. to take a company public at the age of 31 and became the world's youngest self-made female billionaire.

Standards & Tools: U.N. Principles for Responsible Investment (PRI); Task Force on Climate-related Financial Disclosures (TCFD); Taskforce on Nature-Related Financial Disclosures (TNFD); American Council on Renewable Energy (ACORE); ESG RepRisk

Reporting: 2021 ESG Update: An Integrated Approach to ESG

Source: PitchBook, Company websites, Capstone Partners

Private Equity Firms Pioneering ESG Investing (Continued)

KKR

AUM: $429.0 Billion
Dry Powder: $104.6 Billion
Active Portfolio: 424

Integration Highlights: Kohlberg Kravis Roberts (NYSE:KKR) launched its Global Impact Fund in 2018. The firm has made 15 ESG portfolio investments including six in 2020 and three in 2021.

ESG Investment Themes: Climate Action, Lifelong Learning, Sustainable Living, Inclusive Growth

Portfolio Example: KKR acquired majority stakes in Emsi and Burning Glass and merged the companies in June 2021 to create a leading labor market analytics company that promotes opportunity, mobility, and equity across the workforce.

Standards & Tools: U.N. Sustainable Development Goals (SDGs); Principles for Responsible Investment (PRI); Sustainability Accounting Standards Board (SASB); Task Force on Climate-related Financial Disclosures (TCFD)

Reporting: KKR Global Impact Fund Overview and Highlights from the 2020 Limited Partner Impact Report

TPG

AUM: $114.0 Billion
Dry Powder: $28.2 Billion
Active Portfolio: 253

Integration Highlights: TPG (Nasdaq:TPG) adopted an ESG policy in 2012 and raised $2.1 billion for its first impact investing platform, The Rise Fund, in 2017. TPG now has several investment platforms and has invested in 68 companies as of 2021. The firm launched Y Analytics in 2018, to study the net financial gain of social and environmental impact investing to inform its valuation methodologies and optimize outcomes.

ESG Investment Themes: Climate Change, Diversity, Equity, & Inclusion, Creating Innovative Investment Platforms

Portfolio Example: TPG acquired promotional products distributor HALO Branded Solutions in 2018. The company's policies ensure socially responsible supply chain management and sustainable sourcing.

Standards & Tools: U.N. Principles for Responsible Investment (PRI); Sustainability Accounting Standards Board (SASB); Taskforce for Climate-related Financial Disclosures (TCFD)

Reporting: 2020-2021 ESG Performance Report

Source: PitchBook, Company websites, Capstone Partners

Case Study: Q&A

Julia Karol
President & COO
Watermill Group

Anabelle Skalleberg
Principal
Watermill Group

The Watermill Group is very much a family legacy, can you share some of that history?

Karol: The firm started in 1978 with my father and my grandfather and they started doing what was called 'bootstrap acquisitions.' At that time private equity was really a new concept and investing in businesses and using leverage to buy the businesses and add value wasn't very common. One of my favorite anecdotes is that they put an advertisement in the paper that read: 'Do You Want to Sell Your Company?' And they got a number of responses. At the time, the businesses that were largely available and needed support were manufacturing businesses, so we developed an expertise in that.

The other thing that was happening around then were these new concepts of corporate strategy and business strategy. They were just starting to come out of Harvard and the consulting firms were just starting to grow and use them. So, we developed a strategy focused competency simultaneously because we needed the capability of supporting companies through strategic transformation. Today, we are still family led and we continue to focus on industrial businesses, although not exclusively.

Capstone is exploring ESG and how PE firms can integrate these measures into their investment thesis. You've done that in very real way. Can you tell us what led you to launch WMX?

Karol: The reason we started researching gender diverse companies came from the MeToo movement. When it started gaining traction, the venture capital world responded quickly and put

Watermill Group WMX Fund

As a woman-led firm, the Watermill Group has committed to using its seat at the table to make space for more companies with high growth potential, creating access to the capital and resources smart leaders need to thrive. With a commitment to help accelerate the demographic and cultural transformation underway around the world, the WMX initiative widens the path for these vital shifts to take hold in the Private Equity industry. Watermill is leading the change by making investments in great teams led by women with a vision to build enduring businesses. The group supports WMX-funded leaders with a vibrant circle of trusted funders, advisors, and partners wholly dedicated to the collective success of all stakeholders.

Investment Criteria:

Size
$20 million to $200 million in revenues.

Industries
While Watermill is backed by deep expertise in Industrial Manufacturing and Value-Added Distribution, the fund pursues investments across a range of industries.

Board
WMX seeks control investments in dynamic businesses that are owned or led by a woman, or have at least one woman in the c-suite. Watermill is flexible about percentage of ownership, making them an ideal partner for teams looking to retain a meaningful portion of their equity.

Source: The Watermill Group

their money where their mouth was. Suddenly, you started seeing new early stage seed investors or VC [venture capital] funds founded immediately following the MeToo movement. It was exciting and it was important, not just for women but for people of color or members of the gay community. We were sort of waiting for that to happen in private equity, and it just didn't happen. That's where we realized that we could be the ones to pivot. That's when we started researching and we did a lot of qualitative and quantitative research.

What were some of your key research findings?

Karol: We found that a lot of women didn't even consider private equity to monetize their achievements because the industry has a reputation for being inaccessible to women. For those who did choose to explore it, they found that they weren't being heard by the investment banking community; they or their teams weren't being taken seriously. So that was the next hurdle, to go through an intermediary that sees the value of your company and is willing to communicate that to a market. Thankfully, I believe that's changed. And the final step in the sales process is talking to private equity firms and feeling like the people across the table understood your vision and your culture and the relevance that culture has on building your company. All those things must come together in a sales process if you are an entrepreneur, and we found that none of them were coming together at the time.

Traditionally, Watermill Group focuses on investment in Industrial Manufacturers. That's not a sector where you would expect many women-led diverse businesses. Did you experience pushback?

Skalleberg: While Watermill has historically invested in manufacturing and distribution businesses, we have expanded our industry focus for WMX deals. We made the choice to take a broader market perspective not necessarily because we got pushback from the industry, but because we analyzed the markets with more diverse management teams and identified those that were appropriate for this thesis and our skill set. We are very committed to this effort and in order to execute against it, we expanded to include other verticals and we've expanded also to include smaller opportunities.

How will you define the success of WMX? What key benchmarks or metrics are you tracking?

Karol: We want to see the typical benchmarks of corporate success like revenue growth and EBITDA margin improvement. We want to see each of our companies have a strategic plan and hit it. We want our companies to be an invaluable supplier to their customers. Those metrics don't change regardless of who's running the company. I think that's the most important thing. For every one of our companies, safety metrics are critical. So, we are always looking at that. We want see that every

By the Numbers: Why Invest in Diverse Management Teams

19% Higher Return on Equity

Companies that are run by female CEOs have, on average, a 19% higher Return on Equity (ROE) than their male peers, according to Credit Suisse.[7]

25% More Likely to Outperform

Companies in the top quartile for gender diversity had a 25% higher likelihood of financial outperformance than those in the bottom quartile, according to McKinsey & Company.[9]

1.4x More Revenue

Highly inclusive companies generated 1.4x more revenue and were 120% more likely to meet financial targets, according to Josh Bersin.[8]

19% Higher Revenue

Companies with highly diverse management teams reported 19% higher revenue than their non-diverse counterparts, according to BCG.[10]

culture is a good and healthy place to work; attention to employees is really important.

Skalleberg: It's having that annual meeting, or having our roster of CEOs, CFOs, and C-level executives, and seeing female names on it. Out of our five portfolio companies, we recently hired a CEO and it's a woman. WMX was an external effort to communicate our intention to focus on women in business. But we've already had practices in place, as Julia said, we had acquired a female led business. In our portfolio we are very, very intentional about having diversity in our boards and diversity in our C-level. When there's an opportunity or room to do that, we want to invest in and bring in companies that have female leaders, but we will also focus on our portfolio.

Karol: The more we went down the path of supporting WMX as a thesis, as an investment perspective, and because we really believe that diverse teams are more successful, we looked at the rest of our portfolios and thought, 'Wait a minute, we have to walk the walk.' So now every single one of our new hires has a mandate that we look at diverse candidates. We just hired a female CEO, every CFO, Director of HR, Director of IT, you name it, we're looking at a diverse candidate pool. Even prior to WMX we always made sure at least one woman was on each portfolio company's outside Board of Advisors (typically we have three to four external advisors). What's interesting is that our small size enables us to more fully pursue this strategy. Most of the large firms have an ESG fund or gender lens investing fund. But they can be specific and operate in a silo. We are working to live our values in every investment.

Anything to add?

Skalleberg: As I'm out and about talking to people about WMX, I recently came across a group that focuses on minority led businesses that is based in New York. They've had issues with minority owned businesses and special designations. Because when a financial buyer acquires them, the special designation is lost—and the valuation that company would have received if it didn't lose that designation would have been much higher, so they lose some of their value when they change ownership.

Karol: These are regulations that were created to catapult minority-owned, veteran-owned, and women-owned designated small businesses to the next level, by giving them access to government contracts. One of the sticking points, which we did a tremendous amount of research on, is that you lose your designation, not at the time that you exit, the minute the P&S [Purchase & Sales Agreement] has been signed. So if I were to put an offer in, and that business owner accepts that offer, they lose that designation. And therefore sometimes as much as 30% of their revenue is no longer eligible. So, your discouraging financial buyers from acquiring these types of businesses, and that needs to change. It's really an important point, because these business owners who have built something tremendous deserve to see the financial rewards of their hard work.

Julia Karol is President and COO of Watermill Group and the Founder of WMX. She is responsible for overall firm operations and helping Watermill portfolio companies develop and implement their strategies. She received a M.A. in Education Policy, Organization and Leadership from Stanford University, completed the Owners, Presidents, Managers program at Harvard Business School, and the Summer Institute for Entrepreneurship at the Stanford Graduate School of Business, and earned a B.A. from Tufts University.

Anabelle Skalleberg is a Principal at Watermill Group responsible for business development efforts and executing transactions. Anabelle is a graduate of the Pontificia Universidad Catolica Madre y Maestra (BA) and the F.W. Olin Graduate School of Business at Babson College (MBA).

Find out more at www.watermill.com.

Regulatory Environment: Lack of Oversight Results in Complex, Inconsistent ESG Frameworks, Ratings

The lack of oversight in the U.S. has allowed for dozens of ESG frameworks and thousands of rating agencies, each with different methodologies. This fragmentation has made data disparate, definitions unclear, and has clouded reporting value for investors, companies, and the public.

While mandatory disclosure on ESG metrics have been widely implemented in Europe and the U.K., the U.S. lacks government-monitored standards, making implementing and tracking ESG performance complex and inconsistent. In addition, rating agencies measure ESG maturity rather than performance, which can be less relevant to investors seeking to assess the value creation opportunity of a potential investment.

The dearth of standardized definitions and guidance has allowed companies to self-label as ESG-friendly. The prevalence of greenwashing—or falsely identifying as ESG or sustainability-friendly to promote marketing, public relations, investor interest, etc.—has eroded public trust around the ESG moniker. An overwhelming 75% of executives surveyed in North America agreed that their company has engaged in greenwashing, according to a 2022 Harris Poll.[11] This could in part be due to a lack of understanding on how to properly track and measure the success of ESG initiatives. Only 36% of respondents reported having analytics tools in place to measure progress and just 17% said they actually utilized those tools to drive results. Within the private equity community, both LPs and GPs voted the number one challenge to socially responsible, ESG investing as it being "unclear how to define and measure impact outcomes," according to PitchBook. In fact, in another report, 81% of LPs surveyed in the U.S. agreed that private equity needed stricter oversight and regulations—the highest of any surveyed country—according to a 2021 Edelman report.[12]

In response to the need for unification and clarity, CEOs and private equity firms have begun creating their own coalitions. Notably, in 2022, The Carlyle Group announced the Private Equity industry's first partnership to standardize ESG reporting, and has more than 190 committed GPs and LPs, representing $22 trillion in assets and more than 1,800 portfolio companies.[13] Participants selected six common ESG metrics (greenhouse gas emissions, renewable energy, board diversity, work-related injuries, net new hires, and employee engagement) to track and share data on across their portfolios.

*"**ESG metrics are a disgustingly confusing array of acronyms.** They're all different and I don't recommend every firm do the same one. The best way to go is a proprietary mix of the frameworks that are out there to suit your firm. Many middle market GPs will turn to SASB's Materiality Map, but ultimately—whether using SASB, GRI, GRESB, or any other framework to determine your ESG KPIs—the key is to determine what is most material for your portfolio."*

Lauren Winkler
Founder & Managing Partner, Library Ave Consulting

The U.S. Securities and Exchange Commission (SEC) is shifting towards a more regulated ESG environment, as shown by its 2022 proposal to require public companies to report on climate-related disclosures as of fiscal year 2023. The "E" is a natural first step towards standardization and is a harbinger of further regulations. SEC Chairman Gary Gensler has suggested that new proposals are underway, noting in 2021 that: "Investors have said that they want to better understand one of the most critical assets of a company: its people. To that end, I've asked staff to propose recommendations for the Commission's consideration on human capital disclosure."[14] The SEC has also targeted more transparency in private capital reporting, with proposed updates to Form PF. The proposal would require private equity funds with more than $1.5 billion in AUM to provide investors with quarterly statements on performance, fees, and expenses and would trigger an SEC audit for specific financial events. Increased scrutiny over this asset class is already in motion, and as new disclosure requirements are implemented investors will look to benchmark fund results against public comparables.

Software Provider: Q&A

Elenore Garton, Ph.D.
Co-Founder & CEO

Tablecloth

Can you share the history of Tablecloth and what led to your co-founding the company?
My Ph.D. is in policy and management, and I've been evaluating organizations for their impact for 20 some years. Our story started five years ago. I was seeing the movement towards impact investing and a lot of discussion around ESG, and there was a dearth of good data behind it. However, there were a lot of folks putting labels on things, but not necessarily being able to back that up, especially from a social science perspective. A lot of things that folks were calling squishy, like the 'S' and the 'G,' are measurable. So, I wanted to bring that social science knowledge into the conversation.

Then I met my partner, Kelly, who is a serial entrepreneur, and he really brought the data science and the data architecture component to the conversation. At the time, it was a disorganized field with data living in Excel spreadsheets on different people's computers. So, we put together a platform that would help people do that in a much more automated and simplified way so that they could spend more time on understanding what the data meant as opposed to chasing around the data. We have been working exclusively in the Private Equity, Venture Capital space for the last three and a half years, really focused on building a platform that helps people to implement ESG across their portfolios in a streamlined way.

How has the COVID-19 pandemic highlighted the need for companies to embrace ESG? There was a convergence of a couple of different factors, the pandemic being one of them. Thinking about things like essential workers and frontline workers, their health and safety, that was a movement that was unexpected. People were looking more critically at the role of business in terms of the community, ESG in business and other social movements, including climate change, and racial equity. Those all converged together at a time where folks were sitting at home paying attention more to current events. This push around broader stakeholders and not just shareholders had been coming for a while, but it was accelerated because of the pandemic.

Can you share some examples of how analyzing ESG data can help mitigate investment risks?
ESG is both a risk mitigation strategy and a value creation strategy. The focus on risk mitigation to me, and from what I'm seeing from LPs these days, is essentially table stakes. If you're not paying attention to pay equity, safety, your carbon footprint, the way in which you deal with waste and water, and those sorts of things, you are not going to be a successful company. There's reputational risk, you're risking your employee base as well as your stature in communities.

From a communications perspective, a lot of people focus on communicating about ESG because consumers value that and understand that you're paying attention to those things and trying to work towards that. In many ways, ESG has now become essentially what is good business and it has become kind of the standard that is almost synonymous with what is going to be a sustainable and successful company.

What does it really mean for a company to implement ESG? Hiring new people? Changing investment criteria? The first step is educating your board, leadership across the company, and employees. In many ways, folks are already doing a lot around ESG. They just haven't put the label to it. You have an environmental footprint; you have a social footprint; you have a governance footprint. It's a matter now of addressing those areas. It's about recognizing where you're already doing those things, and raising that up. Then, it is about looking at different policies and organizational practices. Organizations will often identify a committee across the organization to start addressing those things. Do you have an ESG policy? Do you have other whistleblower policies, cyber security, all those sorts of things. It's assessing where you're starting. Then, this is where the data needs to come into play. It's one thing to have a policy on fair hiring. It's another to see whether or not that is playing out. Look at a baseline of information, then prioritize what are the things you're going to work towards and how are those differentiated in your specific business? Once you see an area that you're not doing as well on, it becomes a maturation process of how to integrate ESG into your business practices. Every company needs to start with where they are and then continue to get better.

What should a fund expect when they start working with Tablecloth? What is the process?
I generally think about it in four phases. The first is a planning phase where we look at: What do you already have in place? What are your priorities? Where is that data kept? What is the quality of the data? Is it consistent, standardized?

Then we move into implementation. Once we've identified what we want to measure, we'll structure the data collection tools by developing surveys or data models. For example, when we're pulling from HR [human resource] systems, we have a particular data model, and we standardize that. Then we go to each of the portfolio companies and share with them the components of data that we're going to want to collect, and then engage them in that process. So, we're out doing the actual implementation of that data collection.

Then we move into an analysis phase, where we're taking that data after we've cleaned it, we pull in a lot of publicly-available data to be able to contextualize that information. For example, we're looking at, what is a living wage in your location, or what are the demographics in your location, and comparing you to the community demographics, not just where you're starting as a company in terms of your workforce.

Then, we visualize that data into dashboards. We bring dashboards back to both the GP and the company and ask, 'What do you see here?' Because often they know their data. They know, for example, when we're looking at things like pay equity and we see that white males are making significantly more than women or people of color, the company will often have an interpretation. For example, if we looked at tenure, if we cut that data and looked at people who've been there more than five years, maybe that changes because in the last five years they've been working on pay equity. The utilization of that data is really spending time with the portfolio companies to identify their goals as a result of what they see. There are lots of folks putting out long term goals, like going carbon neutral by 2030 or 2050. But what are you going to do this year? What are you going to do in the next three months? We help them walk back from those bigger goals based on the data. Then we rinse and repeat. We will look at the data again in six months or a year to see what has changed

Have you witnessed situations where there's a conflict between the portfolio executives and the GPs? None of our funds have been terribly dictatorial when those conflicts arise, and those conflicts have absolutely arisen. That is where the rubber meets the road. It used to be that you only looked at financial metrics, and now, having these other metrics that you can set side-by-side, means that you are going to have to make choices. Sometimes, our companies and the funds make choices that I would prefer they didn't, but they have to run those businesses and be successful.

If an owner has an EBITDA-based earnout, and the GP implements an ESG policy, isn't that a bit like changing the rules in the middle of the game? The GPs are very careful around this. It's also an area that we work with the GPs on to identify these priorities before the deal is done. At that point, they have a lot more sway over tying ESG metrics to the leadership compensation or putting it into the deal terms. We do have funds that bring us in earlier so that before they close the deal, they can start setting targets and goals.

Do you have a leading example of a company that you've worked with that saw a material change in their bottom line from ESG integration? One area very quickly that folks see value is reducing costs on recruitment and retaining employees. One fund we worked with that put a stake in the ground on $15 an hour, were very much looking at their bottom line. Their company got everybody above $15 an hour, they increased revenue by 15%, and EBITDA went up about 10% during that period. They were definitely concerned that it was going to decrease value and it did not. Value creation is something that our funds are tracking very closely, it's important in terms of getting buy-in as well. Our GPs are feeling more pressure, for a lot of companies this is new information. Demonstrating value quickly and helping the companies to see why this is important helps them to continue on that maturation process of integrating ESG into their practices more broadly. In the end, the holy grail in this space is really being able to tie those economics to the ESG and impact.

Do you see funds targeting companies where they can improve ESG measures to maximize value creation? Or are they more likely to target companies that have integrated ESG measures and fit into their investment thesis? I was just having a conversation right before this with one of our funds that is struggling exactly with that question: 'Should we be targeting companies that already are doing well or should we be looking for folks that are a two out of ten, where moving them to seven means that we've made a really big change?' That to me is more of their investment thesis and impact thesis. I don't necessarily dictate that, but I have funds on that spectrum at different places. Some believe if they're investing in companies that are not doing well in these areas and they can really focus on it, it builds a lot more value at exit.

Tablecloth specifically cites that it can help to raise capital faster and to speed up due diligence, how? We help our funds demonstrate the metrics that LPs are looking for. There's an incredible amount of pressure right now on funds to be able to articulate their ESG strategy. If you cannot speak to that then you are going to have a really hard time raising capital these days. We have funds that are out raising capital and if they get a question they can come to Tablecloth and within a minute get the answer to that question. We got a call last week from a Managing Partner at one of our funds saying: 'I'm giving a presentation in an hour. I need this number.' Tablecloth was able to go into the dashboards, get that number, and drop it into his PowerPoint within minutes. You can find that information on your phone at any point. For the people out raising the capital, when you get a question, you want to have the answers at your fingertips, and that's what we provide.

Will the SEC's proposed rules to increase PE fund transparency impact ESG reporting? What the SEC recently came out with certainly has folks paying a lot more attention. There's no question that there's going to be some level of requirement this year. The Europeans had SFDR, the Sustainable Finance Disclosure Regulation, come into play last year around this time, but they are still trying to figure out how to standardize data collection around that. So, while the SEC has some rules that they're going to be putting out, I think there's still a fair amount of clarity needed in terms of standards in exactly what we're reporting on and measuring.

The data convergence project that's coming out of the LP community will also allow for some level of standardization. But, once you standardize, (and you saw this in the public markets in terms of ESG) folks learn how to teach to that test. Public companies learned the couple of things that they needed to pay attention to in order to get their rating up. I'm a firm believer that each company has complexity and has differences in what they need depending on the businesses or sectors that they're in. I still think there's going to be a level of customization needed for companies to be able to figure out what they need to focus on.

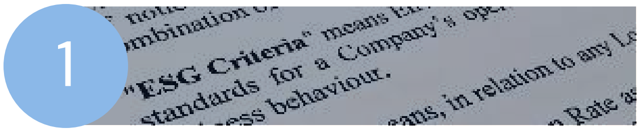
For companies that don't have ESG metrics or standards, what should be their first steps? There's often a little bit more education needed before moving towards policies and framework development. After the education stage, you must identify what it is you specifically want to be measuring, before moving to that first measurement, and seeing what you get from it. And it needs to match your investment thesis. I would say especially when folks are moving towards fundraising, having a thesis in place, even if you haven't done any measurement yet, but knowing what you're planning on doing, is really helpful. That's often when we see funds coming to us, kind of hair on fire, because they've had their first couple of conversations with LPs and maybe they haven't raised a new fund in a couple of years and the environment now is really different.

Nelli Garton, Ph.D. is the Co-Founder and CEO of Tablecloth Inc., a technology company that provides a software platform and services to help investors understand their impact on people, communities, and the planet. The through-line of her career has been to strengthen the organizations and ensure that resources flow to what works. Dr. Garton holds a Ph.D. and MA in Social Policy from the Heller School at Brandeis University, an MPA from Cornell University and a BA in Sociology from Colorado College. Dr. Garton is passionate about helping entities measure what matters and ensuring that when we know better, we can do better.

Find out more at: www.tablecloth.io

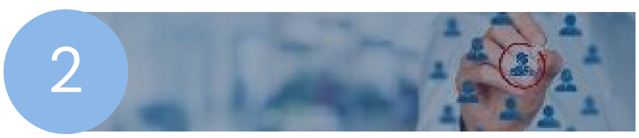
Launching an ESG Integration Program

LPs and GPs ranked creating a firmwide strategy, setting goals, and measuring success as the most important practices when developing sustainable investment/ESG programs, according to a 2021 PitchBook survey.



Start with Education

A recurring theme during discussions with private equity professionals, ESG software providers, and consultants was the need for education. Companies and firms should start by collecting quantitative and qualitative data on ESG frameworks, case studies, and annual reports to build a deeper understanding of the term and assess the strengths and weaknesses of ESG in their specific industry.



Assess Current Operations

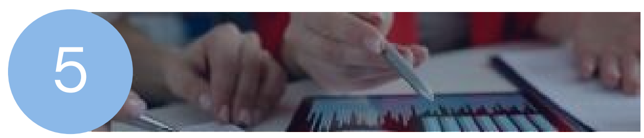
Review your company's core competencies and align ESG opportunities with your long-term mission and values. Assess where ESG may have the largest impact on performance and fund return, this may be company/industry specific or portfolio wide. How can you maximize your key offerings? Writing a purpose statement may further solidify your organization's focus and goals.

Set Performance Metrics

Once you have developed focus areas based on your company's core competencies, select key performance indicators (KPIs). This might include reviewing and selecting a reporting framework, or an amalgamation of frameworks, to help identify the most important KPIs for your industry. The metrics should be specific, measurable, and time sensitive.

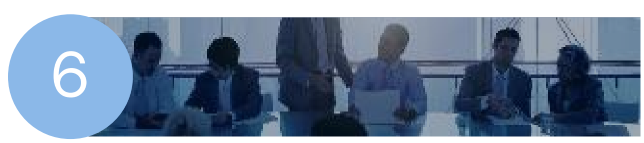
Update Firmwide Investment Criteria

ESG considerations should be woven into your investment criteria and shared internally and externally. This includes making ESG a standard part of due diligence screening, investment committee discussions, and private placement memorandums (PPMs). Creating templates and checklists which align with KPIs and goals can serve to create cohesion and align individuals with the firm's ESG objectives.



Implement a Tracking Method

Measuring progress is essential to drive change and communicate success. Start with a simple Excel spreadsheet that is updated quarterly based on pre-selected KPIs. As the data becomes more robust and complex, move towards a more sophisticated tool that can leverage the power of automation and ensure more streamlined and accurate data analysis.



Analyze and Report Results

Systematic reviews and recurring updates on the progress of strategic ESG initiatives is key to create accountability at the board level. Developments, both successes and failures, should be tracked and analyzed at a pre-determined frequency at the portfolio level and LPs should receive standardized ESG reporting updates.

Endnotes

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