The Road to Responsible Private Equity
A Responsible Investing Framework, Insights, and Cases Toward a Positive Pathway

By Umachander Balakumar and Tensie Whelan

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ABOUT NYU STERN CENTER FOR SUSTAINABLE BUSINESS
The NYU Stern Center for Sustainable Business (CSB) was founded on the principle that sustainable business is good business. We provide education, conduct research, and influence industry practice by proving the financial value of sustainability for business management and performance. At CSB, we aim to equip future and current corporate leaders with updated business frameworks that embrace proactive and innovative mainstreaming of sustainability, resulting in competitive advantage and resiliency for their companies as well as a positive impact for society.

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EXECUTIVE SUMMARY

Private equity (PE) as an asset class has unparalleled access to company governance structures, which allows PE firm leadership to have outsize influence on corporate purpose, strategy, and practice. In addition to bringing capital to its portfolio companies, private equity also brings management and operational expertise, board members, and fund-wide targets.

Academics, non-profits, and regulators continue to extensively study the positive and negative impacts of PE on portfolio companies and on society. NYU Stern Center for Sustainable Business reviewed a broad sampling of those studies and interviewed PE firms and key stakeholders to understand and categorize PE’s varied impacts. We found it useful to organize our research first through the lens of PE firm governance, strategy and practice, and then through its corresponding influence on portfolio companies.

Our goal was to develop a framework to assist private equity firms and their portfolios in being more responsible and sustainable, driving long-term value creation for people and the planet without sacrificing superior returns.

The responsible investing framework CSB has developed lays out the criteria that investors, civil society, regulators, and others can explore to better assess a PE firm’s performance through the lens of human capital management, financial engineering, strategy and innovation, and societal impact, amongst other categories. It provides a perspective on responsible versus extractive private equity practices.

This report explains the framework’s key findings and real-world applications and walks through each category with examples of problematic and positive PE practice, providing insights into pathways that provide positive results for shareholders, portfolio companies, and society. Too often PE focuses on short-term results that destroy value for stakeholders, illustrated in the case study we commissioned on a pulp and paper company in Wisconsin, as well as in the academic literature we reviewed. Positive outcomes are similarly showcased through actual PE firm and portfolio company examples.

This framework and report represent the first phase of NYU Stern Center for Sustainable Business research on private equity. In the second phase, we plan to supplement our research findings with tools and training for investors, PE firms, and communities, and continue being a trusted thought leader and repository of responsible and sustainable investment approaches.
INTRODUCTION

Business leaders and investors are moving to embed sustainability in business and embrace stakeholder capitalism, a system in which corporations aim to serve the interest of all stakeholders (customers, suppliers, employees, communities, and shareholders). Increasingly, this approach is seen to be more profitable as well as more resilient in the long-term.

These shifts come at a time when private equity, whose goals are generally focused exclusively on shareholder return, has become an investor in many companies globally. PE funds are majority owners of hospitals, newspapers, schools, real estate, industrial manufacturers, consumer brands and retail, among other sectors. Worldwide, approximately 10,000 PE firms enjoy ownership rights in 40,000 portfolio companies, which in turn manage 20 million employees.

At that scale, private equity has a significant influence on corporate behavior, especially when it has majority or controlling interests. The PE firm policies and approach can create value for all stakeholders, including the environment, or it can extract value to the detriment of other stakeholders. For example, as we will cite later in the paper, in the hospital sector, PE ownership has been correlated with higher prices, longer hospital stays, and higher death rates. In the newspaper sector, PE firms fire reporters and drop local reporting, leading to lower engagement in the community and lower voting in local elections. In the education sector, PE ownership has been associated with higher costs and higher student loans coupled with poorer outcomes for students (who are often from disadvantaged communities).

On the positive side of the ledger, there are an increasing number of PE firms focused on environmental, social and corporate governance (ESG) and long-term value creation, as we will see in this report. For example, private equity is a big investor in renewables and associated infrastructure, investing $52B in 2021, according to Bloomberg.

If the U.S. is to rebuild its economy, protect the environment, take care of key stakeholders such as workers and communities, and transform to stakeholder capitalism, private equity needs to be a proactive player, as indeed many of its members are.

NYU Stern Center for Sustainable Business (CSB) has embarked upon a research and outreach initiative to improve accountability and societal performance of the private equity sector. Our goal is to identify how PE can avoid doing harm, as well as provide a positive impact. We have undertaken a robust academic review of the state of private equity in terms of its contribution to creating or extracting value and developed an accountability framework that provides insights into the various categories of private equity impact, both positive and negative.

The responsible investing framework CSB has developed lays out the criteria that investors, civil society, regulators and others can explore to assess the PE firm’s performance and includes human capital management, financial engineering, strategy and innovation and societal impact, amongst other categories. It provides a perspective on what responsible versus extractive private equity should look like.

To develop this framework, we undertook an academic literature review of more than 70 papers on PE and desk research and interviews with select PE firms that focus on impact and ESG integration.

We also engaged with PE-focused groups such as UN Principles for Responsible Investment, Predistribution Initiative, PE Stakeholder Project, CERES, ESG Convergence Initiative, Institutional Limited Partners Association (ILPA), American Investment Council (AIC), and interviewed key private equity firms (mainstream players such as Carlyle, KKR, and Blackstone and impact players such as DWM, Summa Equity, and Closed Loop).

In addition, we commissioned an in-depth review of the Consolidated Papers/Verso Corp Wisconsin Rapids paper mill treatment through successive ownerships, including two ownerships and related bankruptcies led by PE owners. In this review, we identified a series of signals that point to problematic PE ownership approaches in terms of negative societal and financial impacts. These signals, which include excessive CEO turnover, disinvestment in R&D, over-leveraging, selling strategic assets for quick cash, laying off large numbers of workers, and withdrawing support from local communities, also have informed the responsible investing framework.

We hope the framework and report will provide needed insights for limited partners, general partners, corporates, civil society, and regulators concerning signals of value creation or value extraction strategies. The report also presents cases demonstrating negative and positive outcomes arising from PE firm strategies with a focus on demonstrating a sustainable path to profit.
SECTION 1: The Responsible Investing Framework Overview

In this section, we present our Accountability Framework, in which we differentiate between decisions at the PE firm and portfolio company level. Though the categorizations are distinct, they are not separate, and practices at the firm level do influence the practices of the portfolio companies.

- At the PE firm level, the framework focuses on PE firm governance, policies, and decision-making and its impact on portfolio companies as well as its own footprint.
- At the portfolio company level, the framework identifies impact categories where PE firm policies and subsequent portfolio firm management can drive negative and positive ESG and financial performance.

ACCOUNTABILITY FRAMEWORK: PRIVATE EQUITY FIRM

The following impact categorizations were derived through a rigorous academic literature review and expert interviews with PE firms and civil society groups.

1. Sustainable and Responsible Investment Policies
2. Management & Human Capital
3. Strategy & Innovation
4. Fund Management
5. Societal Impact

Specific impact sub-areas are then defined with sample data points to illustrate how users of the framework can measure accountability. The sample data points are to be used as a guide and are by no means an exhaustive list of metrics available. The data points can be negative or positive.
### Management & Human Capital

**Management approach is guided by a robust responsible investment strategy and diverse and ESG-credentialed senior leaders**

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| I. Board, CEO & employee credentials | • Diverse board and deal teams with ESG credentials  
• Regular ESG/RI performance tracking at leadership and board levels  
• Dedicated ESG/responsible investment (RI) committees  
• Employee sustainability and stakeholder engagement credentials |
| II. Firm diversity, culture, and incentives | • DEI of firm employees  
• DEI talent pipeline including recruiting, retention, and promotion  
• Pay equity  
• ESG-aligned incentives and/or upward earnings incentives |

### Strategy & Innovation

**Firm’s capabilities in meeting its sustainable investment policy throughout its pre- and post-investment processes**

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| I. Long-term horizon and investment sourcing alignment with ESG and/or UN SDGs | • Sourcing of investments in line with firm’s sustainable investment policy with respect to region, timeframe, UN SDG progress, sector/industry focus  
• Holding periods consistent with driving innovation and returns  
• Implementing and adhering to sector-specific sustainability guidelines  
• Duty of care toward public goods (even when privately owned) such as water and forests  
• Responsible exits |

### Sustainable and Responsible Investment Policies

**Defined by firm priorities and monitored implementation**

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
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</thead>
</table>
| I. A robust and credible sustainable investment policy | • A defined purpose and scope with mechanisms for measurement and revision within the policy  
• Ownership and accountability of policies taken by leadership, board and/or investment committees |
| II. Monitored implementation of the sustainable investment policy | • Key person or persons defined within the policy for educating and promoting the policy across the firm  
• Active ESG due diligence completed on deals |
<table>
<thead>
<tr>
<th>Fund Management</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| I. Reporting and transparency of financial performance | • Use of PME with consideration of market cap, industry/sector, and leverage size  
• Use of subscription credit lines |
| II. Fund additions and dilution | • Number of top-up, annex funds and multiple fund investments |
| III. Subscription credit line use | • Reporting and transparency of subscription credit line use |
| IV. Prudent handling of dry powder | • Dry powder management practices with respect to time horizons (investments in liquid cash & cash equivalents vs. less liquid holdings) |
| V. Fees | • Amount and types of fees charged by the PE firm to the portfolio company |
| VI. Tax structuring | • Domicile of master fund  
• Fee waivers |

<table>
<thead>
<tr>
<th>Societal Impact</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| I. Transparent ESG and impact reporting for PE firm and portfolio companies | • Adoption of credible ESG standards and frameworks  
• Annual reporting of firm and portfolio company impact in line with sustainable investment policy  
• Independent third party audit of ESG  
• Compliance with EU SFDR, SEC, and other regulatory ESG labeling requirements  
• Financed emissions (Scope 3) |
| II. Formal or informal commitments to decarbonization, DEI, living wage, and other impacts | • Net Zero Asset Managers, SBTI  
• Living wage assessments  
• DEI goals  
• B Corp |
| III. Embedded Sustainability | • ESG is embedded in the organization’s business strategy along with performance-based KPIs supported by an appropriate level of investment |
ACCOUNTABILITY FRAMEWORK: PORTFOLIO COMPANIES

The following impact categorizations were derived through a rigorous academic literature review and expert interviews with PE firms and civil society groups.

1. Management & Human Capital
2. Strategy & Innovation
3. Financial Engineering & Leverage
4. Reporting Transparency
5. Societal Impact

Specific impact sub-areas are then defined with sample data points to illustrate how users of the framework can measure accountability. The sample data points are to be used as a guide and are by no means an exhaustive list of metrics available. The data points can be negative or positive.

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| I. Board & C-Suite credentials and governance | • ESG credentials  
• DEI  
• Domain and industry expertise  
• CEO and senior management team turnover  
• CEO, executive suite, and board terms and incentives aligned with long-termism |
| II. Employee well-being & satisfaction       | • Employee satisfaction and voluntary turnover  
• Living wage and benefit structures  
• CEO vs. employee pay ratio  
• Health and safety  
• Employee incentives  
• Employee-owned (or partially-owned) business  
• Productivity |
| III. Job creation and loss                   | • Job training including transferable skills for long-term job market preparedness  
• Career development, internal promotions  
• Involuntary turnover, outsourcing, offshoring, and automation  
• Net job creation |
| IV. Multi-stakeholder approach and long-termism | • Robust engagement of community, employees, NGOs, and other stakeholders  
• Feedback mechanisms for collecting and addressing stakeholder concerns in a timely manner  
• Management and risk decision to promote long-term resiliency and profitability |
### Strategy & Innovation

**Operational management of portfolio companies through assessments of material issues including ESG, long-term sustainable capital initiatives, and appropriate due diligence of M&A transactions**

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
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<tbody>
<tr>
<td>I. Operational management</td>
<td>• Appropriate R&amp;D investments&lt;br&gt;• Novel and strategic intellectual property developed&lt;br&gt;• Assessing and mitigating material ESG issues&lt;br&gt;• Managing value chain risks and resiliency including climate and human capital risks</td>
</tr>
<tr>
<td>II. Sustainable capital investments</td>
<td>• Capital investments to improve company's sustainability performance and innovation (% of EBITDA)&lt;br&gt;• Materiality assessments</td>
</tr>
<tr>
<td>III. M&amp;A Management</td>
<td>• Inclusion of ESG factors in decision making&lt;br&gt;• Strategic positioning (market reach, brand management, product diversity, industry headwinds, etc.)&lt;br&gt;• Financial stability (debt capacity of acquiring companies)&lt;br&gt;• Poor management and aggregation of debt-loaded companies and exits</td>
</tr>
</tbody>
</table>

### Financial Engineering & Leverage

**Use of financial mechanisms to increase portfolio company profitability and distributions to investors**

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
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</thead>
<tbody>
<tr>
<td>I. Debt-loading</td>
<td>• Asset-stripping&lt;br&gt;• Creation of secondary debt obligations to pay shareholder distributions&lt;br&gt;• Dividend recaps</td>
</tr>
<tr>
<td>II. Use of Chapter 11 bankruptcy as a reorganization tool</td>
<td>• Appointment of bankruptcy experts to the board</td>
</tr>
<tr>
<td>III. Capital structures</td>
<td>• Enabling capital structures for positive impact (ESG-linked credit)&lt;br&gt;• EBITDA add backs and adjusted EBITDA</td>
</tr>
<tr>
<td>IV. Tax structuring and accounting</td>
<td>• Value of tax avoidance as a result of corporate tax maneuvering</td>
</tr>
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</table>
# Reporting Transparency

**credibility and transparency of material ESG and financial information from portfolio companies**

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. ESG reporting</td>
<td>• Audited financially material ESG metrics to internationally accredited standards</td>
</tr>
<tr>
<td></td>
<td>• Audited ESG performance trends</td>
</tr>
<tr>
<td></td>
<td>• Reporting financial impacts of ESG (ROSI)</td>
</tr>
<tr>
<td>II. Financial reporting</td>
<td>• Reporting multiple financial performance metrics (i.e. IRR, PME, DPI, RVPI, and TVPI)</td>
</tr>
</tbody>
</table>

# Societal Impact

**embedded sustainability driving well-documented, improved performance on ESG issues, stakeholders, and impact indicators such as the UN SDGs**

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>I. Societal impacts in line with company operations, products, and services measured by ESG and/or UN SDG progress</td>
<td>• Contribution toward positive or negative material ESG and stakeholder outcomes (e.g., emissions, employee turnover)</td>
</tr>
<tr>
<td></td>
<td>• Contribution toward the UN SDG targets</td>
</tr>
<tr>
<td>II. Engagement with local communities and/or social and environmental impacts</td>
<td>• Supporting the local community (philanthropy, volunteering) while avoiding greenwashing</td>
</tr>
<tr>
<td></td>
<td>• Lawsuits related to social and environmental issues</td>
</tr>
<tr>
<td></td>
<td>• News coverage related to social and environmental issues</td>
</tr>
<tr>
<td>III. Embedded sustainability</td>
<td>• ESG is embedded in the organization's business strategy along with performance-based KPIs and supported by an appropriate level of investment</td>
</tr>
</tbody>
</table>
SECTION 2: PE Drives Successive Bankruptcies: The Wisconsin Rapids Pulp and Paper Case
By Paul Fowler

INTRODUCTION
For the entire twentieth century, Consolidated Papers, headquartered in Wisconsin Rapids, Wisc. owned the Wisconsin Rapids pulp and paper mill. Co-founded by the Mead family in the late nineteenth century, the Meads retained a controlling interest first as owners, then as majority shareholders, in Consolidated Papers throughout that period. Both the Wisconsin Rapids mill and Consolidated Papers were world renowned in the industry for bringing new products to market and developing innovative processes. Employees nostalgically recalled the visibility of their founders on the mill floor and in offices. Consolidated Papers’ presence in Wisconsin Rapids endowed the city the prestige of being the smallest city in the United States to host a Fortune 500 company. For generations of Wisconsin Rapids’ families, employment at the mill meant the security of a comfortable lifestyle as well as a job for life.

The hundred-year period of relative stability began to unravel rapidly, beginning at the turn of the millennium as Consolidated Papers was positioned for sale. It was acquired by the Finnish conglomerate, Stora Enso, in 2000. The sale sent shockwaves through the Wisconsin Rapids community and commenced an era when the mill would change owners several more times to the present day, jobs would be lost, demand for product would decline, numerous CEOs would be appointed and resign, and the mill would ultimately be idled in July 2020. In our December 2021 case study, we set out the history of the Wisconsin Rapids mill and provide an analysis of a number of external and internal factors, several focused on the role of private equity, that led to the decision in July 2020 to stop production at the mill. In a postscript to our December 2021 case study, we note that the mill entered new ownership for the fifth time in 22 years, being acquired by Sweden’s BillerudKorsnäs in a sale completed on March 31, 2022. Aside from a converting operation, the mill remains idle at the time of writing.

The full case study is available in Appendix 3.

Untangling the impacts of changes in global demand from PE impacts on the fate of the mill
We make clear in our case study that the initial and subsequent ownership changes of the Wisconsin Rapids mill occurred at the same time as major global shifts were occurring in paper demand and consumption and which continue to this day.

While some pulp and paper companies began to position themselves to respond to those changing demands, others, and notably the owners of the Wisconsin Rapids mill, did not. It is instructive to note that to transition a paper mill from, for example, production of photocopy paper to the production of cardboard boxes may require an investment of several hundred million dollars. Our case study calls out examples of companies such as SAPPI (public) and Midwest Paper Group (private) that made the necessary capital investment to transition their businesses from making paper products that were losing markets to manufacturing products for which markets were growing.

In our analysis of the Wisconsin Rapids mill, we identified a confluence of factors over the last twenty years that we believe together served to signal that the economic fate of the mill was in jeopardy. While some were external, such as changing demand for paper, a strong US dollar, and increasing globalization, we noted internal factors evidently influenced and motivated by a PE business model that hampered the repositioning of the mill towards economic sustainability. These factors left management ill-equipped and incapable to redirect the mill's production to more in-demand paper grades and continuing to produce paper for declining markets. Analysis of those factors, which we discuss in summary below, leads us to conclude, in the case of the Wisconsin Rapids mill, that the private equity models in place there failed the mill, its employees, and the community. They were not structured to provide the long-term and significant capital investment needed for such a capital-intensive industry as paper-making to transition its products from those that were facing customer decline to those that were seeing increasing demand.

**Summary of factors impacting the viability of the Wisconsin Rapids mill**

**Ownership factors**

*Repeated changes of ownership*

Between 2000 and 2022, the Wisconsin Rapids mill changed ownership five times. In 2000, Stora Enso over-paid⁴ to purchase Consolidated Papers to become at once a major player in the North American coated paper market and the world’s biggest coated paper manufacturer. In a fundamental misread of trends in commercial printing markets, it strengthened and increased its investments in coated paper production in North America at the same time as dramatically declining market conditions were exacerbated by events such as 9/11 and the ensuing prevalence of the internet and electronic devices.

NewPage acquired Stora Enso’s North American assets in a leveraged buy-out as the decline in demand for commercial printing papers continued at the onset of the Great Recession. Substantial debt and declining revenues left it struggling to make even interest payments let alone strategic investments. While it laid off workers, idled paper machines and closed mills, it failed to avoid bankruptcy proceedings. Upon emerging from bankruptcy it became a takeover target for Verso Corporation.

Verso Corporation's emergence in the pulp and paper industry mirrors that of NewPage as a product of a leveraged buyout in the mid 2000s. Like NewPage, it was burdened with substantial debt and suffered financially during the Great Recession. Unlike NewPage, Verso did become a publicly listed company but still adopted similar strategies to NewPage to meet its financial obligations with layoffs, mill divestments and paper machine idlings. Leadership talked of repositioning the company to respond to market opportunities but the capital investment levels that competitors were making was never achieved by Verso. The COVID-19 pandemic hit what remained of the commercial printing sector extremely hard and Verso responded by idling two more of its assets, including the mill at Wisconsin Rapids.

In the final years of Verso’s ownership tenure, it became clear that it was positioning itself for sale.

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⁴ In a press release disseminated by Stora Enso on February 22, 2000, describing the proposed acquisition, goodwill was estimated to aggregate approximately $2.7 billion. See full text of release.
BillerudKorsnäs purchased Verso Corporation, including the Wisconsin Rapids mill, for approximately $825 million on March 31, 2022. Aside from comments during a question and answer period at a press conference announcing the intended purchase in which BillerudKorsnäs's CEO Christoph Michalski noted it was currently contemplating to sell the Wisconsin Rapids mill, no subsequent announcements about its intentions have been made.

Proxy actions by activist shareholders
Verso experienced two proxy actions, once in 2017 and again in 2020. Proxy actions generally signal that a shareholder or group of shareholders are dissatisfied with a company's business decisions or its corporate governance and is seeking to exert control. Regardless of motivation, proxy actions distract the senior management team and disrupt the company's day-to-day operations.

Leadership factors
Frequent changes of leadership
Leadership turnover at NewPage and Verso Corporation occurred frequently, indicative of disagreement and in opinion of leadership, board members and shareholders. The CEO role at NewPage was filled seven times during its decade-long existence. One CEO, Mark Suwyn served as interim CEO twice, and as CEO (average tenure: 1.4 years). The CEO role at Verso was filled seven times during its fourteen-year existence, not including a period of time when an Office of the Chief Executive was formed until a CEO was appointed following the retirement of David Paterson (average tenure: 2.1 years). In contrast, the Chief Executive position at Consolidated Papers was filled only 6 times in its history (average tenure: 16 years).

Unconventional alignment of board member expertise with the company's core competencies
A significant number of board members at Verso Corporation had not had paper manufacturing company experience but rather came from private equity backgrounds. Post-bankruptcy, Verso's board comprised seven individuals. Of those, only two had had paper industry experience, one serving as the president of International Paper from 2003-2006, the other having spent 21 years at RockTenn (now Westrock), including ten years as Chief Operating Officer. The others were: a founder and Chief Executive Officer of a fiduciary services firm that supports the investment community in complex financial situations; a chairman and Chief Executive Officer of a private consulting firm specializing in turnaround management, merger and acquisition consulting, and strategic planning advisory services for public and private business entities; the Verso Chief Executive Officer with manufacturing experience in the aerospace, defense, energy and industrial markets; a former international tax planning specialist at Ernst and Young; and the founder and President of a consulting firm providing analyses, management, and business development services to companies across a broad range of industries.

Leadership compensation and performance benefits that incentivize short-term cash generation
Senior leadership employment contracts and other mandatory SEC filings provided insight into future direction at Verso. Notably, an interim CEO was appointed with the goal of selling either some of the assets or the company in its entirety. Such filings provide clear evidence of intent.

6. Christoph Mikalski and Ivar Vatne, “BillerudKorsnäs Conference Call,” Monday, December 20, 2021, 11:00 CET.
**Capital structure factors**

**Recapitalization actions to pay shareholder dividends**
Within months of its acquisition, Verso recapitalized the business to pay shareholder dividends of $250 million.

**High levels of indebtedness**
The private equity business models applied at NewPage and Verso Corporation placed little emphasis on strategic and capital investments. Rather the use of high levels of debt and dividend recapitalizations put pressure on leadership to cut costs by closing mills and reducing employee headcount.

**Use of Chapter 11 bankruptcy as a reorganization tool**
NewPage acquired the mill assets of Stora Enso shortly before the onset of the Great Recession. It became almost immediately over-burdened with debt as a result of the leveraged buy-out at the same time as printing and publication paper demand again declined. With no cash generation, and no capability or strategy to evolve paper grade production to other in-demand grades, NewPage entered bankruptcy to restructure its debt. Similarly, Verso Corporation acquired certain International Paper assets with high levels of debt, and dividends paid reduced cash on hand that might otherwise have been used to reposition mills or paper machines to manufacture other more in-demand products. Verso also struggled through the Great Recession and acquired NewPage following its emergence from bankruptcy. Verso, like NewPage, used Chapter 11 bankruptcy as a mechanism to refinance their self-imposed levels of debt.

**Business strategy factors**

**Pursuing a business strategy that significantly deviates from competitors and other companies in a peer group**
Throughout 2017–2018, Verso’s sales benefited from competitor companies exiting the declining printing and writing markets to focus on new opportunities, such as packaging. However, in exploiting the tight market conditions that ensued as competitors exited, Verso missed the opportunity to reposition itself away from those declining markets. During that period, Midwest Paper invested $30 million to convert its combined Locks, Wisc. facility from one that produced printing and writing grades of paper to one that produced brown paper for packaging. SAPPI completed a $200 million investment in September 2018 to rebuild a paper machine to add new paperboard packaging grades to its mill portfolio.

**Withdrawal of engagement with the community in which the entity operates**
The transition from proximate to remote ownership as Consolidated Papers was acquired by Stora Enso began the decline of company involvement and engagement in the community and an adaptation of company values away from stakeholders towards shareholders. Community engagement inverted following the sale of Consolidated Papers. Where once the company had been a foundational cornerstone of the community, after the sale certain community stakeholders realized the need to proactively engage at the corporate level to attempt to reignite and secure the company’s corporate citizenship in the community.
De-emphasizing the role of, and resources for, research and development activities
NewPage and, in particular, Verso Corporation de-emphasized the role of research and development in their businesses. Research and development headcount was reduced and the Research and Development Division founded by Consolidated Papers was relegated to a technical center by Verso Corporation, and then closed.

Making insufficient capital expenditures to adequately maintain and/or reposition key assets to align with trends in the marketplace
Capital-intensive manufacturing businesses require significant and regular capital investment to maintain and update production equipment. Monitoring capital investment over time provides insight into how robust and appropriate that investment is. During the period 2014–2017, Verso’s capital expenditures plummeted to Great Recession-era levels and investments on a per-machine basis were less than half of those at the time of emergence from the Great Recession in 2011.

Lack of long-term commitments necessary for the development of new products even without capital expenditure
The development of new products and applications requires adherence to a medium-term (2 to 3-year) plan to bring those products to customers. Without such commitment, new customers may not be acquired and existing customers lost. This was a concern at Verso.

SUMMARY
While we note in our case study that none of these factors in their own right necessarily imply that a significant business decision and its consequences are imminent, it is also evident that when elements are combined, the probability of a significant event is likely to occur.
SECTION 3: In-Depth Responsible Investing Framework

As shown in Section 1, we have structured the Responsible Investment Framework into two sections: one for the private equity firm itself and one for its portfolio companies. We then identified categories of impact, four for the PE firms and five for the portfolio companies. There are similar categories for each, but they manifest differently. We have included internal impacts (e.g., a PE firm’s practices vis-à-vis its own human capital and its practices toward its portfolio companies’ human capital), as well as external impacts (e.g. societal issues such as climate change). We have included environmental, social and governance (ESG) policies and performance but we have also included more conventional topics such as financial reporting and leverage as critical for responsible PE practices. This deep dive into the PE Responsible Investing Framework uses examples from our review of the academic literature, as well examples from PE firms themselves to help provide insights into a path for profit and stakeholder value creation.

PART I: Private Equity Firms

CATEGORY 1: SUSTAINABLE AND RESPONSIBLE INVESTMENT POLICIES
Crafting a responsible investment policy helps guide the operations and deal management of the firm with the goal of ensuring profitable returns based on stakeholder value creation, strategic management of material ESG issues, and positive societal impact. Firms must develop the policy’s purpose, scope, governance (how it will be managed), implementation, reporting, and revision. Poor definition and/or execution of such a policy may lead to allegations of greenwashing and reduced investor trust. Carefully defining each component while securing leadership buy-in, integration, and accountability is an important step to facilitate the long-term implementation of the policy.

Components of a Responsible Investment Policy
A firm-wide responsible investment policy includes purpose, scope, governance, implementation, reporting and revision and should inform and guide a culture of stakeholder value creation and transparency in activities, extending beyond traditional investment mandates to include non-financial key performance indicators (KPIs). The responsible investment policy should clarify if the company is pursuing an impact approach, e.g., investing in firms that have a positive societal impact such as inclusive finance or renewable energy, or a responsible investing approach which includes integration of ESG principles and practices into a standard portfolio of companies.

A responsible investment policy can be used to validate the deal sourcing, management, and exit of deals beyond simple check-box criteria. From strategies that focus on creating employee-owned stock ownership plans for portfolio companies to addressing thematic issues (recycling, clean energy, etc.), to prioritizing specific ESG metrics (CO2 emissions, diversity, etc.), there is a wide range of what can fall under such a policy. While motivation for developing a responsible investment policy can come from investor and regulatory pressure, it can also be a means of differentiation for the firm.

**Purpose**
The PE firm should define the purpose of its responsible investment policy. Potential elements could include goals such as:

a. Progress towards an environmental or social goal (which presents a business opportunity) through targeted sectors and deals;
b. Reducing risk associated with certain environmental or social factors by avoiding certain deals;
c. Addressing potential or current stakeholder issues through the selection of deals; and
d. Alignment with current or expected regulations.
e. Risk/return profile. Most PE firms investing in impact, for example, are looking for market rate returns, but some are willing to take concessionary rates.

The purpose of the policy should be clearly identifiable to internal and external stakeholders as well as to investors in order to avoid charges of greenwashing or reputational damage. A report by Bain & Company and ILPA found that “ESG-related risks and a lack of ESG performance improvement are the most dominant reasons LPs walk away from (PE) investments” with 67% of limited partners (LPs) saying they would walk away from an investment due to the potential risk of negative ESG headlines. Consider KKR’s responsible investment policy, shown in Figure 1.1.1, which clearly states its purpose.

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Scope
The responsible investment policy should define scope, e.g. the type of investments (primary, secondary and co-investments), and timing (current or future funds). General partners (GPs) should also specify the extent to which their policy applies in minority and/or non-control investments and global/regional business units with respect to their level of investment and influence. This may be a key point for GPs with diversified interests in different types of holdings. Not stating the scope related to minority-held investments may cause reputational damage if firms are not clear about their level of influence.  

There are also nuances amongst the types of investments and timing, which LPs might misunderstand if not given full information, especially when considering co-investment deals. Firms may apply sustainability mandates to specific funds but not firmwide due to large asset managers not being able to quickly adjust when taking advantage of market demand. However, doing so will create inconsistencies that draw scrutiny to the rest of the firm’s investments. Transparency on scope allows GPs to state the steps taken to address the application of the overall responsible investment policy on their deals and allows LPs to better conduct their own due diligence, understand the GPs’ processes and verify them. Based in Zug, Switzerland, Capital Dynamics defines its scope of investments in Figure 1.1.2 across primaries, secondaries, co-investments, and debt, while providing in-depth detail on how it approaches each of them from pre-investment to post-investment.

Figure 1.1.2. An excerpt from Capital Dynamic’s 2021 Responsible Investment Policy

**Measurement and Revision**

The policy should include a governance structure that ensures accountability, effective implementation and transparent reporting, and provisions for revisions of the policy. Detailed within the scope should be how the policy is being applied and measured. This includes the description of non-financial KPIs to be utilized pre-and post-investment, along with the specifics of how they will be implemented, reported, and revised. The specific KPIs may vary depending on the portfolio company and the sustainability strategy to be deployed.

This can fall under the purview of the Chief Compliance Officer or another senior role. Taking the size of the firm into consideration, the responsibilities may fall to cross-functional teams rather than a single individual, as we see in Figure 1.1.3 in an excerpt of Carlyle’s ESG policy.

Figure 1.1.3. Excerpt from Carlyle’s 2020 ESG Statement

Additionally, Carlyle portfolio companies benefit from our Global Investment Resources team, a dedicated group of Carlyle professionals deploying the firm’s global network, scale and resources to help drive revenue growth and operational improvements at portfolio companies, through, amongst other things, providing guidance to the portfolio companies on how they can make operations improvements, which frequently concern material ESG issues. This team includes a Chief Performance Officer, Chief Digital Officer, Chief Information Officer, Chief Procurement Officer, and Head of Government Affairs, as well as dedicated professionals providing guidance on healthcare and benefits, and real estate and energy usage, amongst other ESG areas of focus. In 2018, Carlyle also welcomed its first Chief Diversity and Inclusion Officer, who leads Carlyle’s in-house inclusion efforts and provides guidance to our portfolio companies, with a particular focus on their management teams and boards.

Regardless of where responsibility for the policy lies, firm leadership, board and investment committees need to have ownership. The policy must be accompanied by top-down organizational buy-in for effective implementation or risk being a simple due diligence questionnaire (DDQ) check-box item with no real firm value. This can be supported through regular board discussions of ESG/RI trends and tracking performance such as the deals declined due to ESG/RI policy considerations.

A responsible investment policy also includes guidance on implementation, reporting and revision, which will be covered in other sections of this white paper.

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CATEGORY 2: MANAGEMENT AND HUMAN CAPITAL

Crafting a responsible investment policy helps guide the operations and deal management of the firm with the goal of ensuring profitable returns based on stakeholder value creation, strategic management of material ESG issues, and positive societal impact. Firms must develop the policy’s purpose, scope, governance (how it will be managed), implementation, reporting, and revision. Poor definition and/or execution of such a policy may lead to allegations of greenwashing and reduced investor trust. Carefully defining each component while securing leadership buy-in, integration and accountability is an important step to facilitate the long-term implementation of the policy.

Human Capital

A purposeful approach to human capital management and a comprehensive sustainable investment policy creates the foundation for the successful application of different responsible investment practices. Beginning with human capital management, firms need to prioritize the recruitment and matching of relevant GP skills to deal types. Firms need to invest in junior-level talent pipelines or risk a talent vacuum in the future, especially for talented women and BIPOC individuals who have been underrepresented in the industry. Excellence in human capital management for a PE firm includes hiring and maintaining a diverse employee base with appropriate operational expertise and ESG credentials and supporting them through a positive, inclusive and equitable organizational culture. As limited partners add sustainability measures to their due diligence, data points including relevant backgrounds, skill sets and diversity are being examined to ensure competency and assess risk.

Industry & ESG Credentials

Some PE firms focus on hiring employees with financial engineering expertise whom they employ to cut costs at portfolio firms, sell real assets, and take on debt. This is a limited set of skills in today’s complex world, where LPs and portfolio companies are looking for PE firms with expertise that can help with improving operations and taking on a transformational pivot. In fact, one study found that the careful matching of GP skill sets with deal strategies (organic vs. inorganic*) can lead to better performance capture relative to peers, after removing the effects of leverage and observing increases in sales growth; earnings before interest, taxes, depreciation, and amortization (EBITDA); margins (EBITDA/sales) and multiples (enterprise value/EBITDA). In brief, GPs with operationally honed skill sets gained through industry experience or management consulting outperformed their peers with financial backgrounds in organic deals while those with non-operational backgrounds were better able to capture value in M&A deals.

Matching skills with needs is essential to capture value across various types of deals, but the practice is not being followed consistently across the industry. To address the issue, firms are targeting individuals with expertise in talent acquisition, capability assessments, and leadership. Coined as “leadership capital partners (LCP),” their responsibilities include the sourcing and support of appropriate partner skill sets to tackle deals. Though the title varies, firms are allocating resources to leadership to ensure they are staffing and incentivizing appropriately.

Sustainability credentials have growing importance due to the need to assess the materiality of ESG variables on portfolio company performance with respect to revenue, expenses, assets, liabilities, and costs of capital. Consider a firm evaluating the acquisition of a hotel chain with coastline properties.

* Organic deals focus on operational improvements while inorganic deals prioritize merger and acquisition (M&A) strategies.

Without proper industry experience or sustainability credentials, those evaluating the deal may overlook concerns such as the hotel chain being located in a high water-stressed region with poor energy infrastructure and its exposure to extreme weather events.  

Firms like KKR have recognized the importance of dedicated ESG teams and in 2021 tripled their personnel focusing on ESG compliance, integration, data science and impact measurement. Warburg Pincus similarly has created a dedicated ESG committee within its Investment Support Group; its members meet quarterly to discuss ESG activities and attend conferences for continued learning.

Industry backgrounds coupled with sustainability skill sets, especially for thematic GPs focused on impact, help firms identify unique investment opportunities. Closed Loop Partners, a firm that aims to accelerate the transition to a circular economy, sets an example with 80% of its partners experienced in recycling and sustainability. Ron Gonen, the firm’s CEO, has an extensive background in recycling including serving as Deputy Commissioner of Sanitation, Recycling, and Sustainability for New York City during the Bloomberg administration. Furthermore, he holds a number of patents in the recycling industry related to technology and business methods that have contributed to the sustainable business practices of his previous companies. With such a wealth of expertise to draw upon, Closed Loop is able to effectively implement targeted practices within its portfolio companies to drive not only financial value to its shareholders but societal value to its stakeholders.

**Diversity, Equity, and Inclusion (DEI)**

The attention on diversity in the workplace has increased significantly over the past few years and public markets have adapted by increasing the representation of marginalized groups across junior and senior levels. Evidence shows PE firms are catching up when it comes to diversity at junior levels, but are lagging in senior leadership representation. Targeted recruitment strategies and a focus on fostering professional development are ways firms have taken a hands-on approach to developing the next generation of talent from various backgrounds. Gender diversity at higher level positions is lacking at firms, especially for C-suite executives, where women only account for 15% of positions compared with nearly 25% in public corporations. People of color are also disproportionately underrepresented at senior levels, and more so in private equity than corporate America, as shown in Figure 1.2.1.

The lack of diversity can affect deal performance. Consider the 2020 study examining the effects of sociodemographic factors including gender, race and nationality, and occupational backgrounds of lead partners on deal performance. Firms with higher diversity in lead partners had higher growth rates (EV CAGR) and multiples (EV/EBITDA and EV/Sales) and performed better with complex deals and with deals that occurred in uncertain conditions.

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23. Complex deals represent deals following inorganic growth strategies, cross-border transactions, and company size.
24. Uncertain conditions represent the volatility/risk based on four drivers including the presence of a crisis period, economic policy uncertainty, industry volatility, and company age/maturity.
Figure 1.2.1. McKinsey Women in the Workplace Study 2021

Ethnic diversity in US PE\(^1\) vs corporate America, 2020, by role,\(^3\) % of ethnically diverse employees vs total workforce of the same gender

<table>
<thead>
<tr>
<th>Role</th>
<th>PE</th>
<th>Corporate America</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entry level/associate</td>
<td>39</td>
<td>37</td>
</tr>
<tr>
<td>Senior associate</td>
<td>37</td>
<td>30</td>
</tr>
<tr>
<td>Vice president</td>
<td>32</td>
<td>26</td>
</tr>
<tr>
<td>Principal/director</td>
<td>30</td>
<td>23</td>
</tr>
<tr>
<td>Managing director</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>C-suite</td>
<td>12</td>
<td>18</td>
</tr>
</tbody>
</table>

1. Private equity
2. Data are based on McKinsey's 2021 Women in the Workplace private equity industry data and corporate America pipeline roles in the following ways: entry level/associates are entry level; senior associates are managers; vice presidents (VPs) are senior managers/directors; principals/directors are VPs; and managing directors are senior VPs.

Figure 1.2.2. BCG Diversity and Innovation Survey 2017

EXHIBIT 1 | Companies with More Diverse Leadership Teams Report Higher Innovation Revenue

Companies with below-average diversity scores: 26% average innovation revenue reported by companies.

Companies with above-average diversity scores: 45% average innovation revenue reported by companies.

Source: BCG diversity and innovation survey, 2017 (n=1,683).
Note: Average diversity score calculated using the Blau index, a statistical means of combining individual indices into an overall aggregate index.

Figure 1.2.2 shows data on diverse leadership correlating with higher innovation revenue. Compared to occupation diversity, sociodemographic diversity was more significant in predicting outperformance and adds further evidence that it should be prioritized by firms. Unfortunately, socio-demographic diversity within deal teams is lacking, with only 1 to 2% identifying as Black or Latinx, compared to publicly traded companies where the breakdown is closer to 13%.

Figure 1.2.3 illustrates independent analysis of data compiled through Pitchbook, firm websites and impact reports of the top ten US private equity firms by assets under management (AUM), showing female representation in leadership positions ranging from 7% at Apollo to 40% at HarbourVest Partners.

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29. Based on Pitchbook ranking by AuM. Capital Constellation, The Blackstone Group, Bain Capital, TPG Capital, American Capital data from team page website only.
Firms are strengthening DEI through partnerships and dedicated internal working groups. Palladium Equity Partners prides itself on having a “majority of minority employees.” Seventy-two percent of its workforce identifies as minority and 64% identify as female. Palladium accomplished its high levels of diversity through developing a pipeline with partners such as the Association of Asian American Investment Managers, Sponsors for Educational Opportunity, and the “I Have a Dream” Foundation, among others. In addition, Palladium is working to increase diversity in its portfolio firms. As a member of the 30 Percent Coalition, Palladium Equity Partners set a goal for every portfolio board to be gender and ethnically diverse by 2021. In achieving its B Corp certification in March 2022, Palladium announced it had also made progress towards its 30 Percent Coalition goal, “out of 139 total members of its boards of directors, 28% are female, 29% identify as a member of an ethnic minority and 47% identify as a member of an ethnic minority or female.”

Other nongovernmental organizations (NGOs) partnering with PE firms on DEI include LGBT Great which has standardized the reporting for LGBT+ metrics to promote LGBT+ equity and inclusion. LGBT Great’s industry-focused benchmarking tool, iiBT, enables firms to see clearly how they score with respect to 10 different indicators including leadership & accountability and employees & engagement. Firms like BlackRock, who joined LGBT Great in December 2020, are positioning themselves to capture the next generation of talent by creating a more inclusive workplace.

Level 20 is another NGO that works to establish mentorship programs within private equity firms. Founded in 2008, Level 20 seeks to increase the representation of women in senior investment roles to at least 20% across the industry. A 2019 IFC report found in its review of over 700 funds that gender-balanced senior investment teams “generated 10 percent to 20 percent higher returns compared with funds that have a majority of male or female leaders with respect to IRR.” A similar initiative, ILPA Diversity in Action, brings together GPs and LPs with a common purpose of advancing DEI within the private equity industry. To date, the initiative has produced a set of diversity metrics for fund managers, their staff, and portfolio companies and has supplemented its standard ILPA DDQ with the same metrics.

30-40% of BIPOC employees at PE backed firms reported obstacles to gender diversity and inclusion in their companies related to recruitment, retention and advancement. 

Only four out of ten of the largest private equity firms report their senior leadership diversity metrics in their respective sustainability reports. Firms may expose themselves to litigation risk by not addressing DEI within their ranks and portfolio companies, especially as it becomes more scrutinized by market regulatory bodies and investors. A recent study by BCG found only 55% of PE firms have taken action to address DEI issues and that 13% more employees at PE-owned firms than at public companies say they have witnessed discrimination. Human capital scandals have plagued several initial public offerings (IPOs) from WeWork to Better.com, and the risks of lawsuits and negative press could negatively impact company performance and exit opportunities. Moreover, there is additional evidence from public markets to support the business case for increased financial performance from top quartile, gender diverse executive teams.

34. “Raising the Bar of LGBT+ Standards in Financial Services,” LGBT Great.
37. “Due Diligence Questionnaire and Diversity Metrics Template,” ILPA.
Firms like Summa Equity Partners are tackling the underrepresentation of women in finance by becoming signatories to the Women in Finance Charter to increase the overall proportion of women in leading positions at financial institutions. The charter promotes the recruitment, retention, and promotion of women, as well as inclusive culture and behavior through meaningful KPI goals. For example, the charter recommends that firms interview 50% women for roles at all levels and create processes for pay transparency and parity.  

A data-led approach such as that put forth by LGBT Great and Women in Finance Charter will allow firms to set year-over-year benchmarks, but also allow for comparison and the sharing of best practices across participating firms. Figure 1.2.4 shows Bain & Co.'s framework for turning benchmarks and commitments into actionable transformation. With a more value-driven millennial and Gen X workforce, firms will need to continue addressing DEI in order to attract and retain diverse talent among their peers.
Pay Inequity
Pay parity across gender and race is another material DEI topic. Women entering the industry are often underpaid compared with their counterparts. A woman would have to work an extra 42 days in 2020 to reach the same level of pay as their male counterparts, according to a 2020 Pew Research survey. With respect to median hourly earnings, that translates to women being paid 84% of what men make in the same position. In 2018, one of the largest PE firms reported through new government-mandated disclosure that they were underpaying their female employees by 30% while also paying men higher bonuses valued at 75.4% more than their female counterparts. This stark difference in compensation based on gender contributes to worker dissatisfaction, and ultimately women may choose to exit the industry altogether, creating a diversity talent vacuum in senior leadership roles.

None of the female GPs surveyed reported that they would be inclined to start their own practice in the event they decided to leave their current firm, as reported in the 2020 Investec’s General Partner Trends survey. The survey found that women were almost three times more dissatisfied with their roles in private equity compared to men, and 14.7% of the women surveyed would rather start a business outside the field of private equity. These disparities carry over to race and disproportionately affect women of color.

EY’s 2022 Global Private Equity survey reported 77% of firms with assets over $15 billion had elevated hiring and onboarding talent as one of their top three priorities. Beyond talent management, firms can also enact transparent pay disclosures to ensure no pay disparities exist between socio-demographic groups. Though disclosure may be difficult for firms just beginning the process, internal controls and tracking is necessary to identify potential issues within the firm. Not doing so puts firms at reputational and litigation risk and ill prepares them for a dynamic social landscape.

Company Culture
Company culture is defined by the values and purpose of the firm and expressed in the actions and practices of the firm. A positive culture and sense of purpose is becoming important to key stakeholders, from limited partners to employees.

To address the issue, in addition to a commitment to DEI and embedded sustainability, firms began providing access to better office amenities, relaxed office wear, remote work options, health and wellness reimbursement, career roads maps, and career coaching. Based on what was previously discussed, firms can build a strong firmwide culture beginning with:

When surveyed, 60% of PE firms reported having some difficulty recruiting millennial and Gen Z workers while 82% reported difficulty in retaining them.

1. Developing and implementing a clear statement of purpose and associated values.

2. Implementing the purpose and values through the firm’s responsible investment policy, ESG initiatives and aligned pay incentives.

3. Attracting and retaining a diverse workforce through targeted initiatives, commitments and partnerships with outside groups like LGBT Great.
   a. Hire a leadership capital partner whose role will be to help recruit diverse employees with critical operational and sustainability skill sets
   b. Ensure a diverse workforce pipeline for senior level positions
   c. Promote internally and provide career progression opportunities for junior level employees

4. Work towards internal pay transparency while correcting any pay inequality.

The very same metrics and policies focused firmwide ideally would be applied to portfolio companies, similar to how Towerbrook Partners seeks to have its portfolio companies attain B Corp status.45 This flow-thru effect from firms to portfolio companies allows PE firms to act as agents of change in reshaping corporate cultures across industries at a large scale.

**CATEGORY 3: STRATEGY & INNOVATION**

After laying the foundation for responsible human capital management practices and a responsible investment policy, firms should develop a strategy to implement these principles through the investment cycle. In order to ensure a responsible investing approach that creates value for all stakeholders, PE firms should take a long-term perspective (with associated capital investments), incorporate ESG considerations into deal sourcing, and consider the impact of the exit on the portfolio company’s stakeholders and performance. Research and case studies demonstrate better financial performance and improved societal outcomes for those PE firms and portfolio companies that take part in a more responsible approach to the investment cycle.

Beginning with deal sourcing, the process usually starts with due diligence, deal execution, implementation/value creation and ends at exit. From aligning and tracking ESG and UN Sustainable Development Goals (SDGs) metrics ad-hoc pre-and post-investment or through industry frameworks like the Operating Principles of Impact Management (OPIM), there are myriad ways to begin marrying a firm’s responsible investment policy to its investment decision-making process and strategy. A focus on creating long-term stakeholder value—worker well-being, customer satisfaction, and environmental protection—should be inherent in the strategy.

The typical PE investment process can be seen in OPIM’s guidance in Figure 1.3.1.

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Longtermism

Responsible investing requires a long-term vision of the investment cycle, even if the holding periods are relatively short. In other words, investing in sustainability transformation in a portfolio company as a way to position it for a successful exit (and a good valuation) means looking beyond the holding period. From 2010 to 2020, holding periods in private equity firms increased from an average of 3.8 years to 5.5 years, as per eFront. Other studies paint a similar picture, but highlight declines in recent years, especially with top-quartile holding periods falling from a peak of 9 years in 2016 to 7.1 years in 2019 as seen in Figure 1.3.2. The recent decline may be attributed to year-over-year increased fundraising cycles and merger and acquisition (M&A) activity which can shift the focus of firms towards quicker exits to take on new investment opportunities. On the other hand, European buyout firms may now expect a lengthened minimum 6-year holding period investments as the baseline; an increase from the typical 3 to 5-year holding period due to increased market competition.

48. Alex Lykken, “PE firms aren’t keeping portfolio companies as long as they used to,” PitchBook, January 24, 2020.
A long-term approach is critical to tackling important challenges for business and society. For example, private equity can be an effective leader in driving the carbon transition across multiple sectors. However, a short-term horizon will reduce investment needed to transition fossil fuel-reliant industries to meet emission reduction mandates as it is unlikely to pay off in a 3 to 5-year context, similar to how development banks are now forced to consider project investments beyond the short-term. In fact, as seen in Figure 1.3.3, PE has invested four times as much in fossil fuels over the last decade than in renewables.

50. Alex Lykken, “PE firms aren’t keeping portfolio companies as long as they used to,” PitchBook, January 24, 2020.
51. “Aligning Investments with the Paris Agreement Temperature Goal – Challenges and Opportunities for Multilateral Development Banks,” GermanWatch and NewClimate Institute, 2018, 122.
Perpetual Funds
A perpetual fund, also known as an evergreen fund, or open-ended fund, is one that allows investors to control their own investment level as each subscription goes into a fully funded portfolio. In addition, open-ended funds do not have a fixed term and will continue in perpetuity, hence their ‘evergreen’ designation. One study conducted by Partners Group demonstrated a $2.063 million difference in value creation between a traditional closed-end fund and an evergreen fund. The difference in value can be attributed to the structure of closed-ended funds which lose the benefit of compounded returns and face timing risk when distributions are paid out, which can then be potentially reinvested. Not all private equity funds can or want to mirror the indefinite holding period of evergreen funds, but they can plan to improve the industries they are in indefinitely by incorporating more responsible investment practices in line with ESG and UN SDG progress.

Figure 1.3.4. Evergreen Funds Outperform

Figure 1.3.4 shows how over 10 years, the typical $1 billion closed-end fund with the same return (IRR) as an evergreen strategy will lag that same evergreen strategy by $2 billion in value creation.

One example of a firm that has been managing its portfolio companies through an evergreen strategy is JAB Holdings with an investment policy geared towards long-term investments in consumer goods and services. JAB Holdings manages more than $50 billion in capital and has had a 20% compound annual growth rate (CAGR) since its inception in 2012, beating the private equity average return of 14.2%.

investment decision-making process as shown in Figure 1.3.5, making the case that value could be driven higher with attention paid to sustainability factors. Some of its holdings such as Green Mountain Coffee, Panera Bread, and Krispy Kreme are reporting on their sustainability initiatives.

Figure 1.3.5. JAB Holdings Investing Approach

Deal Sourcing

Deal sourcing is the pipeline of potential investments based on the firm’s criteria (strategy, risk-return expectations and impact objectives) and scope. Investments or deals are identified and considered through the firm’s expertise across market segments (lower middle, middle, upper-middle markets, etc.), sectors, themes (circular economy, climate tech, etc.), and other factors. Assessing and selecting investments typically includes a review of trends and characteristics in the target sector, identification of opportunities for growth and innovation and assessing management capabilities. Firms with a responsible investing lens should look for investments where they can deliver value to all stakeholders, including the company and the investors, in contrast to a strategy we have seen too often – purchasing a distressed company, selling its assets, firing most of its employees, loading it up with debt and letting it fall into bankruptcy. Firms with an impact lens would look for companies who contribute (or could contribute) to solving societal challenges, perhaps using the UN SDGs as a framework for identifying opportunities. Bamboo Capital Partners and LeapFrog Investments provide examples of firms prioritizing impact in their investment decision-making strategy.

Bamboo Capital’s investment strategy, which aligns with their OPIM pledge, states their strategic intent to target companies that improve the lives of underserved populations in developing countries. Bamboo tracks the performance of its portfolio companies through the UN SDG lens, including outcomes such as jobs supported, strengthened value chains, positive effects on customers, and reduced negative effects on the climate. For example, Bamboo’s investments drive SDG impact as follows:

**UN SDG #1 No Poverty** – Bamboo finances 33 microfinance institutions and seven fintech companies, providing 88 million people access to financial services.

**UN SDG #2 Zero Hunger** – Bamboo’s portfolio supports 62,000 smallholder farms through its agribusiness support and financing of three farmer organizations and three agribusinesses respectively.

**UN SDG #3 Good Health and Well-Being** – Bamboo provides services to 3.6 million patients through the financing of four healthcare access investee companies.

Bamboo’s theory of change can be seen in Figure 1.3.6 and further examples can be found in Bamboo’s annual impact report.57

LeapFrog also aligns its deal sourcing strategy with ESG goals and the UN SDGs. It seeks to invest in companies that increase access to financial services and healthcare for underserved populations. LeapFrog uses a proprietary framework FIIRM (Financial, Impact, Innovation, and Risk Management) as seen in Figure 1.3.7 to incorporate financial and operational key performance indicators as well as governance indices to drive and benchmark performance. LeapFrog also discloses how it accomplishes progress toward the UN SDGs in its impact report.58

**UN SDG #5 Gender Equality** – LeapFrog’s portfolio companies provided 41% of their services directly to more than 119 million women.

**UN SDG #8 Decent Work and Economic Growth** – LeapFrog supported more than 143,126 jobs.

**UN SDG #10 Reduce Inequality** – LeapFrog continues to address systemic inequality, targeting the catalytic areas of financial inclusion and healthcare, reaching 250 million emerging consumers.59

59. “Sustainable Development Goals,” Leapfrog Investments
Figure 1.3.6. Bamboo Capital Partners Theory of Change

Bamboo Capital and LeapFrog both apply their own proprietary frameworks for assessing the impact of potential deals. While mainstream PE firms may not want to use the SDGs as a framework, they can be guided by the Operating Principles for Impact Management, which requires firms to define their own strategic impact objectives and monitor impact before, during and after investment. Some 160 firms have signed on to the Principles, including companies such as the International Finance Corporation (IFC), Flatworld Partners, Credit Suisse AG, and others.

When a firm focuses on strategic intent, defined by its overall responsible investment policy, it is better able to recognize and capture new opportunities and identify optimal exits. Though the OPIM does not provide specific tools and approaches beyond the framework, it requires signatories to provide an annual disclosure statement with an independent verification report. One such signatory is Developing World Markets (DWM), which provides a useful example of implementing and reporting on its OPIM usage.

DWM is an impact-focused private markets firm focused on private debt and private equity investments. Founded in 1994, the firm is consistently recognized as a leader in impact investing through groups like the UN PRI and ImpactAssets, and signed on to the OPIM in 2019. The firm aims to address social, environmental and economic inequalities and inefficiencies in emerging and frontier markets. It has launched multiple multi-sector funds that invest in financial inclusion, renewable energy, sustainable agriculture, water and sanitation, healthcare, and forcibly displaced communities.

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Beginning with strategic intent, DWM begins sourcing potential investments alongside a four-step process:

1. Screen Against an Exclusionary List: By recognizing that DWM’s investment mandate and ESG policy cannot be applied to every industry and sector, DWM screens potential deals with respect to labor practices, environmental concerns, local regulation and impacts on local culture, among other criteria.

2. Address Key ESG issues: After passing the initial exclusionary screen, deals are then vetted according to the quantity and magnitude of ESG risks which are further evaluated during due diligence.

3. Engage on Areas of Improvement: Before finalizing deals, DWM then engages potential investments to address areas of ESG improvement to bring them up to DWM’s best practice standard. In debt investments, this is applied through different negative and/or financial covenants, while in equity investments, DWM works with investees to identify and implement a strategic operational plan.

4. Report Regularly: Lastly, DWM reports its processes and ESG topics to investors, in line with its commitment to the OPIM.

With 160 signatories, the OPIM provides a robust framework for firms to apply their sustainable investment strategy within their investment decision-making process. More mainstream firms such as Apollo have also taken to adopting the principles and have begun targeting investments with respect to the UN SDGs. Managing impact and ESG is no longer solely the purview of impact-focused firms. Not having a framework or process in place exposes the firm to headline risk from their investments but also deters limited partner (LPs), who have begun adopting more ESG-focused mandates within their investments.

Innovative and profitable investment opportunities are also available to mainstream firms who prioritize impact or ESG goals within their investments. Summa Equity, a Nordic private equity firm, has managed to capitalize on its ESG approach to identify unique investment opportunities other firms may overlook. With an investment approach geared toward addressing natural resource efficiency, changing demographics and technology-enabled transformations, Summa Equity is investing in companies that solve global issues while generating competitive returns for its investors.

Summa accomplishes this by identifying investment opportunities based on the potential impact as measured by the UN SDGs. For example, Summa invested in Sortera, a Swedish recycling company, and identified SDGs #11 (sustainable cities and communities), #12 (responsible consumption and production), and #13 (climate action) as performance markers. Sortera improved the recycling process and opened an electric recycling facility, which enabled it to reduce its net emissions by 226,000 tons in one year. Furthermore, other initiatives like establishing speed caps on fleet trucks further reduced fuel consumption and costs by 10%. These types of investments led Sortera to quadruple its revenue in the 36 months following its acquisition. Summa’s strategy is paying off: its third fund closed in record time, and was oversubscribed with commitments of €2.3B in four months.

64. “Our Approach,” Summa Equity.
66. A fund is oversubscribed when investors commit more capital than initially asked for.
67. “Summa Equity raises the largest European impact fund to date – announcing final close of c. EUR 2.3 billion for third fund,” Summa Equity, January 20, 2022.
**Responsible Exits**

When the PE firm sells a portfolio at “exit,” it captures the final return on invested capital (ROIC) and demonstrates its ability to generate positive returns for investors. However, its exit strategy should include ensuring that the buyer will set up the acquired company for success, a step that is sometimes deprioritized in order to maximize returns. For example, a company may underinvest in Selling, General and Administrative Expenses (SG&A) in order to make margins appear higher to a potential buyer.

Exits can occur through different mechanisms: initial public offerings (IPOs), secondary buy-outs, trade sales, management buybacks, and liquidations. Of these, liquidations (bankruptcies) are viewed the least favorably due to their value destruction, and GPs only consider this a viable strategy when they fail to meet critical financial milestones to sustain the business. Between 2007 and 2018, secondary buyouts and trade sales (selling to a strategic buyer with an aligned business) were the predominant options employed by firms, a consequence of lengthened holding periods.

With lengthened holding periods, GPs must negotiate extensions or find additional liquidity for their investments due to increased fundraising amounts and LP demand for new opportunities. Secondary buyouts and trade deals provide this liquidity for GPs to exit and find opportunities during periods of increased competition, shrinking fundraising cycles, and increased dry powder (capital in search of a target). As firms feel these pressures, those without any defined procedures to assess business resilience and sustainability post-exit may see poorly executed exits that negatively affect the portfolio company.

<table>
<thead>
<tr>
<th>Exit Type</th>
<th>Buyer</th>
<th>Timing</th>
<th>Value Narrative</th>
<th>Business Resilience</th>
<th>ESG Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>IPO</td>
<td>Public market listing</td>
<td>Preparation begins 18-36 months before sale; pricing dependent on market sentiment and volatility</td>
<td>Brand; value proposition; competitive differentiators</td>
<td>Increased regulatory reporting including ESG; GPs hold onto a portion of control to show continued confidence in the company</td>
<td>Compare to industry peers evaluate potential and current ESG risks and opportunities; current level of disclosure</td>
</tr>
<tr>
<td>Trade deals</td>
<td>Strategic buyer usually with a complementary business line</td>
<td>Handover period of 12-24 months; dependent on sector/industry landscape and individual company factors</td>
<td>Business IP; existing relationships and client base; product consolidation</td>
<td>Dependent on buyer history, market behavior, and value narrative</td>
<td>Same as IPO + evaluate fit of acquiring company culture and ESG policies</td>
</tr>
</tbody>
</table>

68. A strategic acquisition by a company seeking a complimentary business line.  
69. Investees buy back shares and control from GPs.  
71. Market volatility is measured by investors using the Volatility Index (VIX).  
73. “Leading the Narrative for Your IPO,” LinkedIn.
The table above describes the characteristics of different exit strategies. When considering buyers, especially in trade deals and secondary buyouts, firms will need to assess the buying firm or company’s motivations for acquisition as well as its ESG history. An inadequate assessment of the goals of the buyer puts acquired companies at risk for mismanagement and eventual failure. In worst-case scenarios, this leads to bankruptcies of the exited companies, poor employee outcomes and negative stakeholder effects. The PE firm’s own mismanagement in the form of high leverage, poorly structured deal terms and faulty management can also drive the PE firm to a forced exit to recuperate liquidity, especially in buyouts. Historically not considered an important factor pending an exit, gauging business resilience post-sale needs to become more integral.

The pandemic shed light on the adverse effects of poorly executed buyouts in PE; as of April 2020, 27 of 38 consumer retailers owned by private equity firms were revealed to have the weakest credit profiles compared with the total pool. Thousands of employees went on unemployment while private equity firms filed for bankruptcy and continued to collect dividends.

Research indicates that private equity firms, particularly those specializing in leveraged buyouts, can increase the likelihood of bankruptcy in their portfolio companies. A study that tracked 484 public to private leveraged buyouts (LBOs) over 10 years found a bankruptcy rate of approximately 20%, versus the control group’s rate of 2%. This suggests that highly leveraged transactions in private equity are not prioritizing the long-term health of their portfolio companies, but rather their exit values.

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Michigan furniture store, Art Van, filed for bankruptcy three years after undergoing a buyout. When the firm filed for bankruptcy, employees were assured they would have 90 days of medical coverage, but layoffs cut the coverage by six weeks in the midst of the pandemic, putting employees at risk.

Art Van then set up a relief fund of $1 million which paid $300-400 per employee; not enough to cover three months of family health care coverage. Art Van’s bankruptcy can be traced back to the buyout wherein the $621.5 million price consisted of 11% equity and 89% debt, with only $2 million of that debt going to Art Van for operations.

Prior to the 2017 buyout, Art Van had operated for a decade without recording a loss, yet in the seven months after the deal, it posted a loss of $22.4 million. With its leveraged position, Art Van was expected to pay back more in sale-leasebacks than it generated in annual revenue.

This shows how improperly structured deals with high leverage can take cash-flow positive and growing companies to bankruptcy.

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80. The seller of the asset becomes the leasee of the asset and makes payments to the buyer.
Another example of a problematic approach is consolidating smaller healthcare providers into larger companies, loading them with debt, then exiting with high returns. This strategy leads to poorer quality of care for patients and labor shortages in the industry. In a working paper written in part by a Stern faculty member, researchers observed the effects of different ownership on 18,845 nursing homes between 2000 and 2017, of which 1,674 were acquired by PE firms across 128 different deals. As a consequence of PE ownership, the short-term mortality of Medicare patients increased by 10%, or 20,150 lives lost over the twelve-year study period.

A disciplined and planned exit strategy would allow the firm to aim for operational improvements and fewer bankruptcies post-exit. McKinsey interviewed more than 30 decision-makers and executives of PE funds to glean insights on their exit strategies and found that they consistently express a desire for more rigorous, methodical exit preparation processes. These strategies are usually planned at least 18 months before they wish to exit, which provides the firm more time to assess the intentions and capabilities of the buyer and ensure a responsible exit.

Industry groups like Global Impact Investing Network (GIIN) provide guidance on how responsible exits should be considered throughout the deal’s lifecycle, as shown in Figure 1.3.9.

Figure 1.3.9. GIIN summary of achieving responsible exits

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In addition to ensuring a responsible exit with the buyer, PE firms can work with the portfolio companies to more equitably share the exit’s financial returns. For example, HCAP Partners incorporates “carrot agreements” into its engagement with its portfolio companies upon acquisition, with the aim of incentivizing and rewarding companies that have made tangible improvements in job quality (a strategic priority for HCAP). The carrot agreement begins with HCAP setting aside a pool of capital upon exit if two conditions are met:

1. HCAP meets a certain return threshold, and
2. The portfolio company has made meaningful improvements on job quality standards during the tenure of HCAP’s investment.

If both conditions are met, the capital is disbursed to employees with a focus on those considered to be low- to medium-income (LMI) workers. HCAP successfully implemented two carrot agreements in 2020 with its investments in Mission Healthcare and Confirm Biosciences. Progress is measured by HCAPs impact framework metrics, which include average hourly wages and workforce breakdown by LMI workers. The metrics are measured throughout the investment life cycle. Another innovative strategy discussed in later sections includes employee ownership models, which align stakeholder interests with company operations and goals.

**CATEGORY 4: FUND MANAGEMENT**

Responsible investing includes responsible and transparent financial reporting. Private equity has experienced less regulatory scrutiny and regulation than public markets, sometimes resulting in lax or opaque fund management and financial reporting. From the use of PME and SLCs to inflate performance and excessive fees to generate additional revenue, GP activities are becoming subject to increasing scrutiny. In 2022, the SEC proposed new amendments under the 1940 Investment Act, seeking to increase “transparency, competition, and efficiency in the $18-trillion marketplace” from reporting to fees.

To ease investor worry and ensure continued success, GPs should proactively improve disclosures. Following the guidelines laid out by ILPA, GPs can include the additional line items on the use of subscription credit lines in their statements to LPs. Fees also affect the true value LPs receive when investments are sold and need to be defined clearly in management service agreements. Increased regulation may cause limited partners to shift their capital to more transparent general partners, allowing LPs to better manage investment risk. In fact, if GPs continue to manipulate fees to generate revenues beyond their carry and management fees, then the asset class as a whole loses investor confidence.

Our review of fund management practices by PE firms explores the transparency of financial reporting, with a focus on three areas that are most subject to abuse: the use of public market equivalence (PME) valuations, subscription credit lines, and fund fees.

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Public Market Equivalence (PME)

Private equity funds typically provide quarterly, unaudited reports and an audited annual report to investors. The quarterly reports provide snapshots of the firm’s operations, cash flows and investment performance, which LPs use to adjust their tactical asset allocation (TAA) and exposure to sector/industries and regions. Paying particular attention to financial performance reporting, this section will examine the discrepancies that can arise from non-contextual reporting in public market equivalence (PME) values and remedies GPs can adopt to fill the contextual gap. PME is considered a better measure than internal rate of return (IRR) and invested capital multiples (TVPI, RVPI, DPI, etc.) because it directly compares how capital might have performed if invested in the public markets using a public benchmark such as the S&P 500. This provides investors insight into how much value their private market investments generated relative to comparable public market investments. The use of PME can address the shortcomings of IRR by taking into account the length of the holding period, the timing of cash flows, and potential reinvestments, giving a more accurate measure of performance.

Unfortunately, a PME fails to account for many financially material factors such as market cap, leverage, sector/industry focus, foreign exchange effects and other characteristics of the fund. In fact, several studies have shown that the incorrect use of public benchmarks inflates returns, especially for buyout funds that invest in small-cap value companies. Adjusting for the size premium, the average buyout fund return was found to be similar to small-cap indices including the oldest small-cap passive mutual fund (“DFA micro-cap”). When the benchmark is levered up and changed to small and value indices, returns are lowered by -3.1% per annum. Additional studies have also considered the appropriate beta to use when PMEs are reported, with many drawing the conclusion that a beta between 1.2 and 1.5 is appropriate when comparing small- and large-cap indexes respectively. Overall when considering market cap, leverage and sector/industry, the current performance of private equity funds has been shown to be near the level of public markets when compared to PE performance two decades ago. This highlights a potential agency conflict when observing LPs’ willingness to accept poorly evaluated returns to justify their continued investments in PE.

87. An active portfolio management strategy based on current market factors derived from a firm’s Strategic Asset Allocation (SAA) which can be considered a firm’s long term asset allocation derived from their risk tolerance and return expectations.
Contextual information is necessary when reporting PME to LPs, especially in volatile markets. To provide greater clarity, GPs should work with LPs to select appropriate benchmarks, betas and leverage values that closely match the fund’s characteristics. Other factors such as market cap, region, sector, industry, and foreign exchange rates should also be taken into consideration when presenting LPs with a PME figure. Hedge funds are setting appropriate benchmarks together with LPs to manage LP return expectations and to provide more transparency. To continue building trust with LPs, GPs should be transparent in their financial performance reporting and include external factors that could potentially influence performance, such as the use of subscription credit facilities and the fees charged to LPs and portfolio companies.

**Subscription Credit Facilities**
While the aggregate volume of subscription lines of credit (SLCs) has increased exponentially since 2014, as seen in Figure 1.4.2, their use has advocates and critics. A limited partnership agreement (LPA) sets the total value an LP has pledged to invest in the GP’s fund or investment vehicle. This committed capital is then called in periodic intervals or when needed by GPs to make investments.

SLCs allow GPs to borrow money similar to a loan with the LPs uncommitted capital as collateral instead of calling capital directly from LPs. GPs use SLCs to deploy capital quickly, especially in rapid-paced buyouts. This allows GPs to call capital less frequently, lowering the administrative costs associated with processing capital calls and allowing LPs to maximize the time value of money (TVM) of their investments by placing them in more liquid investments prior to the call.\(^95\)

Though subscription credit line use may seem innocuous, it comes with risks that are heightened by a lightly regulated environment. As a consequence of using SLCs, GPs are able to inflate performance, specifically the internal rate of return (IRR) of investment vehicles. Consider the example in Figure 1.4.3 which compares a traditional capital call schedule with the use of a subscription credit line.

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Consider the example below in Figure 1.4.3 which compares a traditional capital call schedule with the use of a subscription credit line.

Figure 1.4.3. Subscription credit line call schedule examples

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<tbody>
<tr>
<td>GP cash flows 96</td>
<td>-$60m</td>
<td>0</td>
<td>0</td>
<td>$15m</td>
<td>0</td>
<td>$100m</td>
<td>14.83%</td>
</tr>
<tr>
<td>LP cash flows 97</td>
<td>-$60m</td>
<td>0</td>
<td>0</td>
<td>$15m</td>
<td>0</td>
<td>$100m</td>
<td></td>
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<tbody>
<tr>
<td>SLC</td>
<td>$60m</td>
<td>0</td>
<td>0</td>
<td>-$75m</td>
<td>0</td>
<td>0</td>
<td>29.10%</td>
</tr>
<tr>
<td>GP cash flows</td>
<td>-$60m</td>
<td>0</td>
<td>0</td>
<td>$15m</td>
<td>0</td>
<td>$100m</td>
<td></td>
</tr>
<tr>
<td>LP cash flows</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>-$60m</td>
<td>0</td>
<td>$100m</td>
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In the second scenario, GPs are able to report a higher IRR figure due to the SLC. This is largely due to the IRR methodology, which is highly sensitive to the timing and size of cash flows. The delay in calling capital in scenario 2 allowed IRR figures to be inflated to almost double the IRR in scenario 1 when no SLC was used. This performance inflation misleads investors and allows GPs to meet their hurdle rates artificially, giving them access to higher performance fees and share of the overall returns through their carry. Figure 1.4.4 outlines benefits and risks of SLCs for GPs and LPs more in detail.

96. Positive values represent net cash flows from portfolio companies to GPs while negative values indicate net cash flows from GPs to portfolio companies.
97. Positive values represent net cash flows from GPs to LPs while negative values indicate net cash flows from LPs to GPs.
Research has suggested that use of subscription lines of credit allows funds to delay capital calls from the beginning of the holding period to the middle of the holding period. This allows the fund to push negative cash flows further into the future, increasing overall IRR as distributions are paid out soon after. Similar to PME reporting, a principal-agent conflict also exists when LPs accept inflated IRR figures from GPs. With inflated returns, LPs are able to justify their investments in private equity and continue to seek new investments in the asset class, especially if their compensation is linked to their performance.

Advocates of SLCs have said sophisticated investors understand the use of SLCs and their effects on IRR and account for it in their due diligence. However, without understanding the total credit available and timeframe of credit drawdowns, it becomes difficult for even savvy investors to understand the level at which IRR has been influenced. Risks around subscription credit lines cannot be assessed without information on outstanding balances and the timeframe between drawdowns. Though many GPs currently report whether they are using SLCs or not, they do not provide specific financial details.

A recent study using Burgiss data of buyouts found that the annualized IRR for funds using subscription credit lines was increased by 2.6% and that low-performing funds used SLCs to increase the likelihood of meeting their set hurdle rate. Low-performing funds were also able to jump closer to their next performance quartile by using SLCs, thereby skewing the overall asset classes' performance. If this approach continues, defaults could occur during periods of high market stress with limited liquidity.

99. “Understanding the impact of subscription lines on private equity funds,” BlackRock.
102. The systemic implications of large subscription credit line defaults are difficult to predict.
Fees

The primary fee structure in private equity is straightforward; it includes management fees and carried interest traditionally represented by the 2 and 20 rule. The carried interest is 20% of the excess return earned by GPs after meeting a hurdle rate or preferred rate of return agreed upon by LPs. Carried interest is taxed as a capital gain to the general partner of the fund. The investment manager of the fund receives management fees in exchange for its investment advice typically in the amount of 2% of the LP’s invested assets under management (AUM). Investment managers use management fees to cover the cost of a fund’s annual operations.\(^\text{103}\) A visual breakdown of the typical organizational structure of private equity and associated fees can be seen in Figure 1.4.6.

\(^{103}\) “Enhancing Transparency Around Subscription Lines of Credit,” ILPA, 2020, 7.
The fees are usually listed in a “Management Service Agreement” for investors. However, when private equity firms fail to describe the scope or duration of services provided for the fee, firms can discover loopholes to avoid sharing profits from portfolio companies. One paper compiled by the Center for Economic and Policy Research discusses abusive fee allocation and expense practices including: double-dipping (charging limited partner investor funds for back-office expenses that should have been covered by the 2% management fee); failure to share monitoring fee income (the consulting and advisory fees paid to GPs by portfolio companies) and using consultants to avoid sharing fees (hiring outside of the PE firm and billing the services to the portfolio companies).\(^\text{106}\)

Excess fees lead to the misalignment of interests, especially in an increasingly saturated market, leading to adverse selection and moral hazard; in other words, information asymmetry enables the GPs to manipulate a better deal for themselves.\(^\text{107}\) GPs also charge and collect fees from their portfolio companies. Figure 1.4.7 describes some of the fees charged to limited partners and portfolio companies. The offsets column describes fees charged to portfolio companies that are offset by the management fee charged to LPs. This prevents GPs from generating revenue from simply performing expected fund management services, but these offsets have to be clarified in management service agreements with respect to the percentage offset and types of fees that can be offset. For example, if a GP manages to collect $1 million in fees from one of its funds with 60% offset, then only $600k would be deducted from the management fee paid to the GP.

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<table>
<thead>
<tr>
<th></th>
<th>Limited Partners</th>
<th>Offsets</th>
<th>Portfolio Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>One Time</strong></td>
<td>• Organizational expenses</td>
<td>• Transaction expenses</td>
<td>• Legal fees</td>
</tr>
<tr>
<td></td>
<td>• Broken deal expenses</td>
<td>• Exit fees</td>
<td>• Due diligence fees</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Breakup fees</td>
<td>• Consulting fees</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Financing fees</td>
</tr>
<tr>
<td><strong>Annual Fixed</strong></td>
<td>• Audit tax expenses</td>
<td>• Monitoring fees;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Fund administration expenses</td>
<td>• Accelerated monitoring fees</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Director fees</td>
<td></td>
</tr>
<tr>
<td><strong>Asset-Based</strong></td>
<td>• Management fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Performance</strong></td>
<td></td>
<td>• Carried interest</td>
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</tbody>
</table>

Portfolio company fees are usually one-time fees that GPs characterize as payments that companies would have to make regardless of their ownership status, ranging from legal to consulting fees. In addition to the fees listed above, GPs charge additional fees to portfolio companies including monitoring fees to provide oversight after acquisitions and transaction fees upon the completion of a deal. Both of these fees are dependent on the market cap and earnings before interest, taxes, depreciation, and amortization (EBITDA) of portfolio companies and do offer potential tax incentives for portfolio companies, but excess fees can potentially tilt a company into bankruptcy. The increased bankruptcy risk comes as a result of the value of fees which restrict a company’s ability to use the assets for other purposes. Over a 20-year time period from 1994 to 2014, 600 portfolio companies in a sample study were charged close to $10 billion in monitoring fees alone, plus another $10 billion in other fees. These fees are traditionally considered offsets, but without being defined as such in management service agreements, GPs do not have to report or include these expenses as part of their management fee.

Consider the Wisconsin Rapids mill case detailed in Section 2 of the paper. When the private equity owner took the company into bankruptcy, it charged additional consulting fees. The addition of these fees, compounded by the costs of undergoing bankruptcy, ended with the company restructuring its debt, yet GPs managed to walk away with more capital than before. These fees do not need to be reported to LPs if they are not specifically stipulated in LPAs. This level of opaqueness in fees allows too much leeway for firms to act in their own self-interest rather than carry out their fiduciary duty to investors. This has been empirically shown in accelerated monitoring fees charged to companies, and in lump-sum payments paid to GPs when companies are sold before their expected holding period. These payments have been described by the SEC as payments that “the investment adviser does not, or does not reasonably expect to, provide to the portfolio investment.”

109. Appelbaum and Batt, “Fees, Fees and more Fees.”
LPs are increasingly scrutinizing these fees and have begun asking GPs to include these costs under the umbrella of management fees or through better definition in agreements. The SEC has also begun to take action through new rule recommendations which would require firms to provide investors with quarterly statements on performance, expenses, and fees. In addition, the rules would prohibit GPs from collecting certain fees and expenses such as amounts for unperformed services, clarify which taxes can or cannot be included when GPs pay back carry fees, tackle portfolio company fees, and suggest limits on GP extensions of credit from LPs.

Fee waivers also exist in the purview of GPs, and allow them to waive management and related fees for a variety of benefits. In the first instance, GPs are able to use fee waivers to lower their taxable income rate by claiming their deferred share of future returns under the lens of long-term capital gains and not ordinary income. The reasoning being that since GPs are forgoing their management fee in the present for a share of future earnings, and since future earnings are subject to market conditions, GPs should be taxed at the long-term capital gains rate to account for market volatility of returns. Another use for fee waivers is GPs may reduce their own contributions relative to the amount of fees they waive, allowing them to minimize their own risk within the investments they manage. Issues arise surrounding fee waivers in the recognition of what should be considered ordinary taxable income vs. long term gains. Current regulatory guidance in the U.S. allows for firms to recognize the waiving of management fees bearing any significant entrepreneurial risk. Proposed regulations on fee waivers label the following as factors that decrease entrepreneurial risk:

1. the service provider holds, or is expected to hold, a transitory partnership interest or a partnership interest for only a short duration;
2. the service provider receives an allocation and distribution in a time frame comparable to the time frame that a non-partner service provider would typically receive payment;
3. the service provider became a partner primarily to obtain tax benefits that would not have been available if the services were rendered to the partnership in a third party capacity;
4. the value of the service provider’s interest in general and continuing partnership profits is small in relation to the allocation and distribution; and
5. the arrangement provides for different allocations or distributions with respect to different services received, the services are provided either by one person or by persons that are related under Sections 707(b) or 267(b) of the Internal Revenue Code, and the terms of the differing allocations or distributions are subject to levels of entrepreneurial risk that vary significantly.

The proposed regulations label the factors below as leading to entrepreneurial risk:

1. capped allocations of partnership income if the cap is reasonably expected to apply in most years;
2. an allocation for one or more years under which the service partner’s share of income is reasonably certain;
3. an allocation of gross income;
4. an allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service partner (e.g., if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or
5. an arrangement in which a service partner waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.

The miscategorization of fee waivers allows GPs to circumvent the underlying risk they are subject to with respect to their fund contributions but also allows them to realize greater profit when their returns are considered long-term gains.115

**CATEGORY 5 : SOCIETAL IMPACT**

Responsible investing frameworks should ensure that PE creates value for key stakeholders (including the portfolio firm, employees, communities, and investors). Research supports this outlook. For example, one study evaluated the performance of 16,802 companies that received PE financing and found that there was a positive and significant correlation between receiving private equity financing and annual employment and sales growth in the corresponding year.116 Another study examining whether 772 private equity firms contributed to the financial fragility of companies during the 2008 financial crisis showed that private equity-owned companies issued less debt and increased capital spending compared to their non-PE-owned peers. PE firms, as a result, increased the value of their investments by 6% relative to other companies in the post-crisis periods.117

However, some firms may go further and focus on making profits explicitly through creating positive societal impact, which is the subject of this category. Private equity is in a unique position, with its deep cross-sector engagement, to be a driving force behind a systems-thinking-led paradigm shift. Given global environmental and social challenges, PE firms that embed sustainability as core to their business strategy and report on robust social and environmental key performance indicators (KPIs) have the opportunity to create a competitive advantage.

Leading the transformation may allow first movers to capture high-value opportunities and attract more capital, with early firms adopting EU Sustainable Finance Disclosure Regulation (SFDR) expecting better fundraising periods.118 This will require firms to: address material ESG issues and impacts through their investment strategy; design and implement robust ESG/impact

implementation with their portfolio companies; make formal or informal commitments to address issues such as diversity, equity and inclusion (DEI) or climate change; track ESG-related KPIs; and report their progress in ESG/impact reports.¹¹⁹

It is important to note that ESG and impact are two different strategic approaches and both are valid. ESG aims to manage material ESG risk as well as explore ESG business opportunities. For example, a PE firm that aims to bring Employee Stock Ownership Plans to the employees of its portfolio companies is aiming to improve stakeholder benefits and performance through that strategy, but the companies that it works with may not have an impact focus. PE firms with an impact focus aim to solve societal problems through the purpose of those companies, investing in themes such as renewable energy or inclusive finance. In both cases, KPIs can be assessed and tracked qualitatively and quantitatively using ESG- or UN SDG-based metrics.

In order to provide a comprehensive overview of the potential societal value driven by PE firms, we will first examine how firms can drive societal impact by embedding sustainability within their firm processes and making formal and informal ESG commitments. Then we will address how firms can communicate their efforts through credible reporting and achieving a Benefit Corporation (B Corp) certification, amongst other strategies.

**Embedding Sustainability**

Sustainability is embedded when the proactive management of material ESG issues and a balanced approach to the needs of stakeholders (including shareholders) are completely and effectively integrated into the company’s business strategy with the goal of creating positive societal value which unlocks financial value for the company.

In the past, investors and corporate leaders would often dismiss the negative societal impacts of their businesses as externalities for which they were not responsible. Unfortunately, private equity ownership in industries such as healthcare, education and even newspapers can drive negative societal outcomes for which the PE firm is directly accountable. Academic research into private equity ownership of colleges, for example, found lower graduation and loan repayment rates, as well as lower earnings by graduates. The authors found evidence that these detrimental outcomes reflect lower educational inputs and increases in marketing spend due to firms prioritizing profitability through increased leverage. Students were burdened with rising tuition costs and more debt. In addition to the financial impacts felt by students, the quality and scope of degree programs decreased, leading to a decline in graduation rates by 13%.¹²⁰

With the consolidation of local newspapers and reporting outlets by PE (representing 13% of the market in 2019), another study found the focus on the bottom line led to reporters being laid off and local news coverage declining. The study also found that this led to local citizens being less likely to vote in local elections.¹²¹

This type of approach is short-sighted. Externalities are increasingly becoming internalized. Material ESG issues are now becoming part of everyday management concerns and require a systems-thinking lens. Climate change, for example, is affecting companies in many ways including energy

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¹¹⁹. SASB defines dynamic materiality as issues which are currently not financially material, becoming material in the future due to market sentiment and changing business conditions.


pricing volatility, distribution challenges, and operational risk in manufacturing and supply chains. Companies that do not manage that risk will ultimately experience its impact and underperform.

On the upside, a meta-analysis by NYU Stern CSB of over 1200 academic studies showcased a strong correlation between the performance of ESG factors and positive corporate (58%) and investor (33%) financial returns as seen in the figure below.

Figure 1.5.1. NYU Stern CSB ESG meta-analysis

Figure 1.5.2 illustrates findings from a study reviewing PE deals in the Asia-Pacific region with social or environmental considerations or in sectors related closely to ESG issues such as water, waste, education, etc. which were found to have higher return multiples than their non-ESG counterparts.

Figure 1.5.2. Distribution of multiples on invested capital for Asia-Pacific PE-led exits

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For the PE firm and its portfolio companies, ESG/sustainability has to be a part of corporate strategy, not a stand-alone strategy. That means approaching the sustainability landscape in the same way one tackles corporate planning: start with understanding the relevant ESG trends and associated risks and opportunities. Use the ESG lens to explore: what are the material ESG issues for the PE firm and its investment thesis? The investment strategy will dictate the material ESG factors; for example manufacturing will have different material ESG risks than technology. Other ESG materiality questions will include: how do we recruit and retain high-performing employees? Where is regulation going? What type of technologies might help? What is the competition doing? With whom might we collaborate to meet our goals? The Sustainability Accounting Standards Board (now part of ISSB, the International Sustainable Standards Board) provides a good guide to material ESG issues for both the PE firm and its portfolio companies.

After identifying the firm's material ESG issues, the firm should consult with stakeholders such as employees, regulators, NGOs and their own portfolio companies to determine what they consider to be the most material ESG issues for the firm. That mapping then can be used to develop a materiality matrix, which provides insight into the importance of various topics for the firm and the stakeholders, and become a core building block for the firm’s embedded sustainability strategy. This learning process will be helpful when working with portfolio companies to require them to develop their own ESG and stakeholder mapping and materiality matrices. A sample firm-wide materiality matrix by Neuberger Berman Private Equity Partners (NBPE) is shown in Figure 1.5.3, depicting key ESG factors across several industries. The proprietary framework helps guide NBPE’s due diligence and ESG integration across their direct investments. Though categorized differently, the same level of information is captured compared to traditionally formatted matrices, as seen in the example from Bank of America in Figure 1.5.4.

Figure 1.5.3. Neuberger Berman Private Equity Partners (NBPE) materiality matrix

<table>
<thead>
<tr>
<th>Environmental</th>
<th>Social</th>
<th>Workforce</th>
<th>Supply chain</th>
<th>Leadership &amp; governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emissions</td>
<td>Water management</td>
<td>Pricing transparency</td>
<td>Human capital development</td>
<td>Policy &amp; regulation risk</td>
</tr>
<tr>
<td>Consumer goods</td>
<td>Exterlics &amp; mineral processing</td>
<td>Food &amp; beverage</td>
<td>Healthcare</td>
<td>Infrastructure</td>
</tr>
<tr>
<td>Renewable resources</td>
<td>Resource transformation</td>
<td>Services</td>
<td>Technology &amp; communication</td>
<td>Transportation</td>
</tr>
</tbody>
</table>

The embedded sustainability strategy will inform all aspects of the PE firm’s approach, from its own human capital to its investment policy, deal-making, portfolio company engagement, fund management, and exit strategy. For example, consider EQT, a Swedish firm that in 2019 became the first private equity firm to include a statement of purpose, signed by their entire board, showcasing their commitment to the long-term viability or “future-proofing” of their portfolio companies. Their efforts fall in line with their active ownership and include commitments to support multiple stakeholders, diversity, and renewable energy within the scope of the UN SDGs. This has been good business for EQT; in a five-year post-exit study, 70% of their exited portfolio companies were shown to be still growing with an annual average sales and employment growth of 9% and 8% respectively. In aligning itself with its statement of purpose, EQT follows an embedded sustainability strategy beginning with a societal impact framework. The framework is similar in design to a materiality matrix focused more on the solutions and practices of a potential investment with respect to sustainability and the UN SDGs. Company operations, both direct and indirect, are analyzed through

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the environmental and social problems they solve (solutions) with respect to the efficacy and scope of the company’s impact (practices), as shown in Figure 1.5.5. This two-dimensional framework allows EQT a better in-depth review of their portfolio company’s contribution to UN SDG progress and a better understanding of the risks arising from sustainability factors.

Figure 1.5.5. Application of EQT Societal Impact Framework to WSAudiology

**WSAudiology**

*Global pure play producer of hearing aids and accessories with more than 100 years of experience and a proven track record as an industry innovator*

**Solutions:** Improving lives and reducing inequalities for people with hearing disabilities globally through continuous innovation in hearing aids and educational efforts

**Practices:** Pushing renewable energy and energy efficiency across operations for reduced negative climate and environmental impact – *Improved bottom line through increased operational efficiency – 32% reduction in electricity consumption between 2017–2018*

As discussed in the strategy and innovation section, regular updating of responsible or sustainable investment policies will be necessary, due to the dynamic nature of materiality. Firms that are sector-focused are especially vulnerable to disruptive technologies and social trends and need to be able to quickly change course and develop new metrics. Dynamic materiality can be addressed if firms include a scenario-based approach that considers potential sector-wide outcomes.

Identifying which products, technologies, or sector-specific practices are reducing ESG risk and driving ESG value can be evaluated by creating and tracking performance-based KPIs through proprietary or industry frameworks such as the Sustainability Accounting Standards Board, the ESG Data Convergence Initiative or the Operating Principles of Impact Management, which was covered in previous sections.

**Formal and Informal Firm ESG Commitments**

PE firms are increasingly making public commitments on material ESG issues such as climate and DEI, supported by industry-wide initiatives.

**Environmental commitments**

Formal commitments to groups such as the Net Zero Asset Managers Initiative enable firms to hold themselves accountable as agents of change. Net Zero Asset Managers encourages firms to report emissions, strategies and progress in reaching net zero emissions by 2050 or sooner.

Investindustrial, a European and B Corp PE firm, is a member of the Net Zero Asset Managers Initiative and pledged in late 2021 to achieve net zero across all its funds by setting science-based targets for its portfolio company emissions. Additionally, Investindustrial requires portfolio companies to publish their carbon emissions as well as their exposure to climate risks, and results have shown them mostly outperforming their public peers with respect to the MSCI Europe ESG Index. To continue their progress in keeping temperatures below or at 1.5°C by 2030,

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Investindustrial provided the following targets based on the Science Based Targets (SBT) initiative in its press release:\textsuperscript{132}

- Investindustrial’s direct and indirect emissions to be reduced by 68.5% on a headcount intensity basis and 46.2% in absolute, in accordance with 1.5° mitigation pathways;
- Investindustrial to achieve and maintain 100% renewable energy by 2030 and beyond;
- 100% of the Investindustrial portfolio companies in legacy and future funds will have their own SBTs validated by 2030 onwards;
- Residual emissions by Investindustrial and the portfolio companies to be neutralized by verified emissions removals from nature-based solutions.

The Initiative Climat International (iCI) also aims to help PE firms accelerate the transition to net zero.\textsuperscript{133} As of May, 2022, 160 private equity firms representing more than $3 trillion assets under management (AUM) were signed up to iCI, which recently released a report on greenhouse gas (GHG) accounting and reporting for private equity firms.\textsuperscript{134} The report provides guidance and methodologies for firms to calculate portfolio company emissions based on the PE firm’s degree of operational and financial control over the portfolio company. Other aspects covered in the report include the calculation of direct and indirect emissions, financed and non-financed emissions, and reporting methodologies.\textsuperscript{135}

PE firms are also making individual climate commitments: Blackstone aims to reduce carbon emissions by 15% in aggregate over three years in new portfolio company investments where it controls the company’s energy usage. To support its efforts, Blackstone is developing a carbon accounting system that will allow it to measure, track, and report on the Scope 1 and Scope 2 emissions of its investments (the lack of Scope 3 tracking is an important omission, as most corporate emissions are Scope 3).

Despite these PE firm commitments, data from PitchBook shows that buyout groups spent $42.1 billion on oil and gas deals from 2020 until the end of September 2021, versus $36.8 billion in renewable energy investments.\textsuperscript{136} While private equity is a significant investor in renewable energy, it has also invested $1.1 trillion in fossil fuel assets since 2010 as seen in Figure 1.5.6, double the market value of Exxon, Shell and Royal Dutch Shell combined.\textsuperscript{137} The PE Stakeholder Project found that the top 10 PE firms by AUM owned more than 300 portfolio companies in the oil and gas sector, as seen in Figure 1.5.7.\textsuperscript{138} In those 300 portfolio companies, 80% of the assets under management are in fossil fuels. With the recent increase in regulation and public scrutiny on emissions, oil companies have taken to selling assets to private equity firms or going private to avoid disclosures.\textsuperscript{139} The war in Ukraine and its related increase in oil prices has also caused some private equity firms to invest more in fossil fuel assets.\textsuperscript{140}

\textsuperscript{133} “Nearly 90 Private Equity Firms Representing $700 Billion AUM Have Signed up to a Global Climate Initiative Ahead of COP26,” PRI, March 26, 2021.
\textsuperscript{134} “Initiative Climat International publishes new standard for GHG accounting and reporting in private equity,” PRI, May 9, 2022.
\textsuperscript{136} PE firms spend billions on fossil fuel assets despite ESG promises | Citywire (citywireusa.com)
\textsuperscript{139} Simon Jessop, “Investors call for private firms to disclose more environmental data,” Reuters, September 7, 2021.
DEI Commitments

Commitments to DEI, as discussed in the human capital section, should also be part of the firm’s focus on positive societal impact – for their own employees and portfolio company employees, but also in terms of vendors, customers, and communities. Groups and initiatives like LGBT Great which promotes LGBT+ equity and inclusion and the Women in Finance Charter, which seeks to increase the representation of women in the field, are examples of organizations firms can partner with to address DEI within their firm. Other groups like the Management Leadership for Tomorrow (MLT) have created specific certifications like the MLT Black Equity at Work Certification to encourage firms to, “pursue Black equity with the same effort as their pursuit of earnings and other key priorities.” Firms that have committed to earning the designation include Ares, Bain, BlackRock, and Wellington Management.

The process of earning the certification requires firms to show observable progress toward the following five key areas:

1. Increasing Black employee representation at every level of the organization, from the Board of Directors and senior leaders to middle management and professionals to the organization as a whole;

2. Ensuring pay equity between Black and White employees in similar roles and providing just compensation and equitable benefits for positions in which Black employees tend to be overrepresented;

3. Creating an anti-racist workplace where Black employees feel they belong, are valued and can advance;

4. Progressing toward proportionate vendor and supplier spending with Black-owned businesses and proactively utilizing organizational capabilities in support of Black equity; and

5. Providing annual contributions and/or in-kind services to non-profit organizations that increase Black equity and investing in Black equity-focused financial institutions and/or investment products.

A table of available DEI commitments PE firms can be involved in, including a list of participating firms, can be found in Appendix A.

Reporting

Top-of-the-line ESG reporting for both the PE firm and its portfolio companies is becoming increasingly important to ensure good management and to attract capital. The lack of a standardized definition of ESG coupled with a lack of audited ESG reporting has increased investor concerns about greenwashing. Public market funds have experienced challenges to their ESG labeling as seen in the 2022 raid of Deutsche Bank and SEC investigation of Goldman Sachs. While the crackdown has begun in public markets, PE firms have also begun increasing the transparency of their own ESG reporting. In fact, some private equity firms have demonstrated that transparent reporting of ESG leads to building investor confidence and reducing concerns of greenwashing by limited partners.

ESG reporting standards such as GRI and SASB have already gained a foothold in public markets and are increasingly being adopted to private markets. SASB’s reporting framework is illustrated in Figure 1.5.8. As occurred with accounting standards, many of the frameworks and standards for ESG are undergoing consolidation. The ESG Data Convergence Project, a consortium of LPs and general partners representing over $4 trillion of assets, is seeking to standardize ESG reporting for private equity. Membership is open to any interested LPs and GPs. A summary of the first set of draft ESG metrics is in Figure 1.5.9: ESG Data Convergence Project Figure.

142. “Racial Equity at Work,” MLT.
146. “SASB Standards & Other ESG Frameworks,” SASB.


<table>
<thead>
<tr>
<th>Table 1: Differentiating Organizations That Provide Voluntary Sustainability Disclosure Guidance to Reporting Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scope of Information</strong></td>
</tr>
<tr>
<td>--------------------------------</td>
</tr>
<tr>
<td><strong>Type of Guidance</strong></td>
</tr>
<tr>
<td><strong>Industry-Agnostic or Industry-Specific</strong></td>
</tr>
<tr>
<td><strong>Target Audience</strong></td>
</tr>
<tr>
<td><strong>Approach to Materiality</strong></td>
</tr>
<tr>
<td><strong>Time Horizon</strong></td>
</tr>
<tr>
<td><strong>Governance Model</strong></td>
</tr>
<tr>
<td><strong>Governance Documents</strong></td>
</tr>
<tr>
<td><strong>Public Meetings</strong></td>
</tr>
<tr>
<td><strong>Public Comment</strong></td>
</tr>
</tbody>
</table>
Whether or not firms decide to join the ESG Data Convergence Project or other initiatives, best practice requires third-party audited reporting and is increasingly demanded by LPs. According to McKinsey’s Sustainability Reporting Survey featured in Figure 1.5.10, of the 57 investors who responded, 67% said they would like sustainability reports to undergo the same level of scrutiny as financial reports. As calls for audits of non-financial information increase, firms need to verify not only their performance against different ESG KPIs but also their processes. Firms such as Bluemark, a Tideline company, provide audit services to verify the progress of non-financial KPIs and the processes which firms use to collect the data in accordance with the frameworks they have adopted. An example of a verification report for KKR with BlueMark is seen in Figure 1.5.11.

More investors believe that sustainability reports should be audited and that the audits should be full audits, similar to financial ones

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150. An impact-focused consultancy.
This differentiation between process and performance-based auditing is a double layer of assurance for investors in confirming the data quality of reported metrics. These non-financial audits help avoid potential headline and regulatory risks related to misleading investors and are essential to a firm’s review of its sustainable investment policy and KPIs.

The United Nations Development Programme (UNDP) has released guidance for private equity fund reporting and alignment towards the UN SDGs. To propel the achievement of the goals by 2030, the SDG Impact Standard for private equity funds details how firms need to align strategy, management approaches, transparency, and governance to SDG targets. Figure 1.5.12 details several organizations that provide voluntary sustainability reporting guidance.

Recognizing, building and monitoring a sustainability metric inventory is a prelude to meeting jurisdictional reporting requirements focused on material ESG and climate risk factors. In Europe, the Sustainable Financial Disclosure Regulation (SFDR) acts as a regulatory body to improve transparency in sustainable investment products especially in their claims to combat greenwashing. To accomplish this, SFDR published guidance under numerous articles dealing with different forms of disclosure as they relate to sustainable investment products:

For private equity and other firms, articles 4, 6, 8, and 9 are important in reporting disclosures related to funds with sustainability characteristics and their accompanying risks. To aid in the classification of funds, the European Supervisory Authority (ESA) published a set of metrics and technical guidance on identifying principal adverse impacts (PAIs) which influence different sustainability characteristics. Of the metrics proposed, 14 were deemed mandatory with the additional being considered opt-in (see table below).

The PAIs act as indicators for fund managers to provide contextual environmental and social information on the adverse effects inherent in their fund and holdings. This information will be provided in a PAI Statement disclosed separately per Article 4 requirements. Additional guidance is forthcoming on ESA on the technical applications of breadth of coverage for the PAIs, especially focused on emissions.

154. “SFDR,” SFDR.
### MANDATORY ADVERSE SUSTAINABILITY INDICATORS

<table>
<thead>
<tr>
<th>Climate and other environment indicators</th>
<th>Social and governance indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>• GHG Emissions (Scope 1, 2, 3 &amp; Total)</td>
<td>• Violations of UN Global Compact principles and OECD Guidelines</td>
</tr>
<tr>
<td>• Carbon Footprint</td>
<td>• Lack of processes and compliance mechanisms to monitor compliance with UN Global Compact principles and OECD Guidelines</td>
</tr>
<tr>
<td>• GHG Intensity</td>
<td>• Gender pay gap</td>
</tr>
<tr>
<td>• Fossil fuel sector</td>
<td>• Board gender diversity</td>
</tr>
<tr>
<td>• Non-renewable energy consumption and production</td>
<td>• Exposure to controversial weapons</td>
</tr>
<tr>
<td>• Energy consumption intensity per high impact climate sector</td>
<td></td>
</tr>
<tr>
<td>• Biodiversity sensitive areas</td>
<td></td>
</tr>
<tr>
<td>• Emissions to water</td>
<td></td>
</tr>
<tr>
<td>• Hazardous waste ratio</td>
<td></td>
</tr>
</tbody>
</table>

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**Figure 1.5.13. ESA metrics**

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**Figure 1.5.14. SFDR key dates for entity level requirements**

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**Financed Emissions Reporting**

With climate change driving increased extreme weather events, droughts, coastal erosion, and higher temperatures, market actors have begun to focus on their emissions. The Partnership for Carbon Accounting Financials (PCAF) helps financial services firms calculate, monitor and report their financed emissions from their investments. Financed emissions dealing with investments pertain to the GHG Protocol's Scope 3 Category 15 (investments) designation, and deal with a financial firm's attributable emissions from their underlying investments including loans. Though not directly responsible for these emissions, firms indirectly bear the burden of a portion of the emissions based on the size of their invested capital relative to the value of the asset or loan. PCAF's methodology applies across 6 asset classes, including listed equities and corporate bonds, business loans and unlisted equities, project finance, commercial real estate, mortgages, and motor vehicle loans.

Current guidance does not include private equity but firms can begin to take steps to prepare for data sourcing and collection. The step of data sourcing is the most difficult process and requires firms adhere to PCAF's data quality guidance in selecting sources:

![Figure 1.5.15. PCAF data quality guidance](image)

Firms should strive for data sources with a score of 2 or 1, but market limitations in emissions data quality may make it difficult to achieve that goal. To collect audited or unaudited emissions or other primary data, portfolio company investments need good systems. Technology providers like Persefoni and Green Project Technologies exist to facilitate and aggregate the process of carbon accounting portfolio-wide, but it will be PE firms who ultimately push the adoption of such processes within their portfolio companies.

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The PCAF calculation methodology differs slightly by asset class. The base methodology shown here could be applied to private equity with a few changes.

Beginning with the attribution factor, the formula could be adopted to show a fund’s percentage ownership in a portfolio company and its emissions which will then be aggregated on a portfolio basis:

\[
\text{Attribution factor (portfolio company level)} = \text{Value of Equity and/or Debt in Portfolio Company (Capital Contributed)} / \text{Value of Portfolio Company Equity + Debt}
\]

- Capital Contributed = Amount of equity and/or debt contributed or invested in a portfolio company
  - This is inclusive of GP and LP contributions
- Value of Portfolio Company Equity + Debt = Value of annual valuation
  - 409A valuations may act as proxies for market valuation of the portfolio company
  - Since the valuation is updated annually, firms will need to take into consideration the timing of their valuations (calendar-end, fiscal year-end) and ownership changes

Consider the example below:

<table>
<thead>
<tr>
<th>Reference Date</th>
<th>Total Annual Emissions</th>
<th>Total Capital Contributed (equity and/or debt)</th>
<th>Portfolio Company Equity + Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1 2020</td>
<td>10 tons CO₂ₑ</td>
<td>100,000</td>
<td>30,000,000</td>
</tr>
<tr>
<td>Q2 2020</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q3 2020</td>
<td></td>
<td>600,000</td>
<td></td>
</tr>
<tr>
<td>Q4 2020</td>
<td></td>
<td></td>
<td>36,000,000</td>
</tr>
<tr>
<td>Q1 2021</td>
<td>15 tons CO₂ₑ</td>
<td>1,500,000</td>
<td></td>
</tr>
<tr>
<td>Q2 2021</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Q3 2021</td>
<td></td>
<td>3,000,000</td>
<td>60,000,000</td>
</tr>
</tbody>
</table>

2020 Financed Emissions = \[\text{Attribution Factor,}_i \times \text{Total Annual Emissions,}_i\]  
I. = \[0.5 \times (100,000/30,000,000) + 0.5 \times (600,000/36,000,000)\] \times 10 tons CO₂ₑ  
II. = 0.1 ton CO₂ₑ or 224.6 lbs CO₂ₑ

Above, we observe valuations being updated Q3 of each year, therefore to calculate the year 2020’s financed emissions, the attribution factor will have to consider not only multiple valuations but also ownership based on the total capital contributed. In this example, the time period is split into quarters and we can thereby take the average of the first and second half of the year to arrive at the total amount of financed emissions the PE firms are responsible for. These emissions at the portfolio company level will then be aggregated to the fund level for reporting. LPs will be able to use the same formula to calculate their portion of fund emissions by modifying the attribution factor to take into account the amount of capital that’s been called, and by aggregating the total emissions to the fund level:

Attribution Factor: Capital Called
Fund NAV
- Capital Called: Amount of capital invested by LPs represented by the total amount of capital called by GPs
  - Does not take into consideration the value of the total commitment, only what’s been called by GPs
- Fund NAV: The fund’s latest net asset value (NAV)

Attributable emissions will then be a portion of the fund’s total emissions.
Benefit Corporation (B Corp) Certification

Some PE firms have pursued B Corp certification to demonstrate their commitment to positive societal impact. For private equity firms, the B Corp standard requires firms to provide transparency on their firm’s governance structure, worker impacts, community engagement, environmental impacts, and stakeholder impacts. These are measured through a set of metrics that firms are required to disclose and which are publicly available on B Lab’s website. The requirements are as follows:

1. Demonstrate high social and environmental performance by achieving a B Impact Assessment score of 80 or above and passing our risk review. Multinational corporations must also meet baseline requirement standards.

2. Make a legal commitment by changing their corporate governance structure to be accountable to all stakeholders, not just shareholders, and achieve Benefit Corporation status if available in their jurisdiction.

3. Exhibit transparency by allowing information about their performance measured against B Lab’s standards to be publicly available on their B Corp profile on B Lab’s website.

Dozens of private equity firms have achieved B Corp certification including Bridge Fund Management and Investindustrial, with ratings from B Corp of 145 and 116 respectively. These ratings represent a firm’s overall impact and allow it to be benchmarked with peer firms in the industry. Below in Figure 1.5.17 is an example of a private equity firm profile and its B Corp score for TowerBrook Capital on the B Lab website:

![Figure 1.5.17. TowerBrook B Impact Score](image)

With a B Corp Certification, TowerBrook has displayed its commitment to a high level of transparency and accountability to its stakeholders. TowerBrook also actively encourages its portfolio companies to get B Corp certified if possible, such as KeHE. Other B Corp firms like Investindustrial have had 30% of their portfolio companies undergo the same certification process in 2022. Certified companies are required to report on their sustainability metrics annually and the results are publicly available on B Lab’s website, like KeHE as seen in Figure 1.5.18.

161. “About B Corp Certification,” B Corp.
Overall B Impact Score

Based on the B Impact assessment, KeHE Distributors, LLC earned an overall score of 83.9. The median score for ordinary businesses who complete the assessment is currently 50.9.

Workers 48.0

Workers evaluates a company’s contributions to its employees’ financial security, health & safety, wellness, career development, and engagement & satisfaction. In addition, this section recognizes business models designed to benefit workers, such as companies that are at least 40% owned by non-executive employees and those that have workforce development programs to support individuals with barriers to employment.

What is this? A company with an Impact Business Model is intentionally designed to create a specific positive outcome for one of its stakeholders – such as workers, community, environment, or customers.
PART II: Portfolio Companies

CATEGORY 1: MANAGEMENT OF HUMAN CAPITAL

Management of human capital at the portfolio company (PC) level begins with a diverse and aligned board and C-suite. Relevant industry and ESG experience is critical to meet changing investor and industry needs, and has been shown to improve company performance and innovation. A lack of consideration for ESG credentials can lead to high turnover, poor strategy execution, and increased risk of bankruptcy. Firms should align the interests of management by introducing ESG-specific incentives to C-suite members. In addition, similarly to the PE firm-level section on human capital, we review diversity, equity and inclusion (DEI), culture, and employee relations. Firms should treat employees as critical stakeholders who can improve performance, rather than a cost to be reduced. Beginning with improved employee pay, firms can introduce shared ownership models to significantly improve employee relations within the workplace.

Board Credentials

Private equity has long been lauded for its focus on operational efficiency, such as reducing headcount, to improve bottom-line performance and consequently, the credentials of the people it places on its portfolio company boards are often overweighted in financial engineering expertise. However, best practice today requires that PC boards are diverse and have ESG and relevant domain expertise (beyond bankruptcy or investment credentials) in order to create value. Specific domain expertise such as financial and digital marketing expertise on boards has been linked to improved initial public offering (IPO) performance and reduced business risk respectively.

With increasing public market scrutiny of sustainability and diversity such as the SEC’s proposed climate disclosures and the Nasdaq Stock Market’s board diversity requirements, ESG and DEI credentials are being spotlighted. A 2018 analysis of 1,188 Fortune 100 board directors conducted by NYU Stern Center for Sustainable Business featured in Figure 2.1.1 found that “many companies with material ESG issues have very little relevant expertise on their boards.” Property and casualty insurance companies, which are already being directly affected by climate risk, for example, had no one with climate expertise on their boards. Non-diversified portfolio company boards risk poor IPO exits as well as increased business risk in not having the necessary acumen to navigate the industry.

In order to manage company growth and development, some PC board members should have domain expertise related to the portfolio company industry. That may seem obvious, but in fact, some PE firms underweight domain expertise on boards. For example, the PE ownership of the Wisconsin Rapids mill created a board where a significant number of board members at Verso Corporation did not have paper or manufacturing experience, but rather came from private equity backgrounds. As a result, the directors appeared to favor short-term cash generation strategies such as firing employees, selling off assets, and taking on debt paid out to the PE firm rather than investments in new technologies, to the detriment of the strategic pivot needed for the company to be successful.

168. The acquiring company owned by the second PE-owner.
Figure 2.11. U.S. Corporate Boards Suffer From Inadequate Expertise in Financially Material ESG Matters

<table>
<thead>
<tr>
<th>S Categories</th>
<th>% With Relevant Credentials</th>
<th>E Categories</th>
<th>% With Relevant Credentials</th>
<th>G Categories</th>
<th>% With Relevant credentials</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workplace Diversity</td>
<td>5.0% (60)</td>
<td>Energy</td>
<td>1.2% (14)</td>
<td>Accounting</td>
<td>2.6% (31)</td>
</tr>
<tr>
<td>Health Care</td>
<td>3.5% (41)</td>
<td>Conservation/Nature</td>
<td>1.2% (14)</td>
<td>Regulatory body (SEC, FCC)</td>
<td>1.0% (12)</td>
</tr>
<tr>
<td>Health challenges/advocacy</td>
<td>1.9% (22)</td>
<td>Sustainable Business</td>
<td>.8% (10)</td>
<td>Cyber/telecom risk</td>
<td>.6% (8)</td>
</tr>
<tr>
<td>CSR/ESG</td>
<td>1.5% (18)</td>
<td>Sustainable Development</td>
<td>.8% (10)</td>
<td>Risk</td>
<td>.4% (5)</td>
</tr>
<tr>
<td>Civil/human rights</td>
<td>1.5% (18)</td>
<td>Environmental law</td>
<td>.5% (6)</td>
<td>Ethics/corruption corporate responsibility</td>
<td>.3% (4)</td>
</tr>
<tr>
<td>Youth education, health, safety</td>
<td>1.2% (14)</td>
<td>Environmental protection</td>
<td>.5% (6)</td>
<td>Fiduciary/director responsibility</td>
<td>.3% (4)</td>
</tr>
<tr>
<td>Economic/community development</td>
<td>1.1% (13)</td>
<td>ESG investing</td>
<td>.3% (4)</td>
<td>Governance</td>
<td>.1% (2)</td>
</tr>
<tr>
<td>Human Resources</td>
<td>.8% (10)</td>
<td>Climate</td>
<td>.2% (3)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Adult education</td>
<td>.7% (9)</td>
<td>Water</td>
<td>.1% (2)</td>
<td></td>
<td></td>
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<tr>
<td>Nonprofit CEO</td>
<td>.7% (9)</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Philanthropy</td>
<td>.7% (9)</td>
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<tr>
<td>Sustainable development</td>
<td>.5% (6)</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Media/arts</td>
<td>.3% (4)</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Public policy</td>
<td>.3% (4)</td>
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<td></td>
<td></td>
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<tr>
<td>Affordable housing</td>
<td>.2% (3)</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Workplace benefits</td>
<td>.1% (2)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nutrition</td>
<td>.1% (2)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Workplace safety</td>
<td>.06% (1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ESG Investing</td>
<td>.06% (1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</table>

Diversity has been shown to be a driver in financial performance and innovation, yet a survey of 196 companies found only 45% of private equity-owned portfolio company boards valued DEI compared to 61% of family and venture-backed boards. A study on private equity placements or financing in China found that greater board diversity led to decreased costs for PE acquisitions and increased access to market proceeds. Studies in the public markets have also found that increased board diversity has positively affected the capacity for innovation, lowered volatility, and improved financial performance.

The Board Diversity Action Alliance, which seeks to improve board diversity in public and private corporations, released a report in September 2021 that tracked 873 companies going public since 2000, representing over 4,700 board seats – only 49 of those seats were filled by Black directors. Firms such as Warburg Pincus, Carlyle and Apollo have joined the Alliance and have pledged to:

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171. The cost associated with information asymmetry in private placements.
176. Belonging to the top 18 venture and PE firms.
1. increase the number of Black directors on its corporate board of directors to one or more;
2. disclose the self-identified race and ethnicity of directors on corporate boards; and
3. report on diversity, equity and inclusion measures on an annual basis.

One should note that while private companies are not required to report on DEI, it will become very helpful information during an IPO.

Apollo now has 30% board diversity across its controlled portfolio company investments and is seeking to apply the same principles to its management and employee base, while Carlyle launched ESG credit facilities in the U.S., Europe, and Asia totaling over $8 billion tied to achieving 30% portfolio company board diversity within two years of ownership.179

C-Suite Composition, Incentives, and Turnover

Composition

Private equity firm appointment of portfolio company C-suite leadership should consider DEI and ESG expertise, as well as incentives that align with longer-term strategic considerations and ESG metrics.

A study examining the diversity of Fortune 100 companies in early 2020 found women and racial minorities who reported directly to the CEO were more likely to be in positions with no pathways to a CEO or board role.180 Considered together with board diversity in the context of a “multi team” approach, another study found that diversity of boards and executives led to increased organizational innovation and better firm performance.181

Carlyle’s DEI Leadership Network initiative is an example of how PE can increase the diversity of portfolio company leadership. By bringing together 45 portfolio company CEOs around the globe representing over 140,000 employees and creating a peer group for knowledge transfer, Carlyle seeks to be at the forefront of driving leadership diversity through:

- Annual meetings with participating CEOs to hear experts, share successes and challenges, and engage with leaders spanning all sectors.
- Quarterly Expert DEI Speakers Series, which will be made available to participating portfolio companies’ employees. Topics will range from how to be an effective ally to habits of inclusive and high-performing teams.
- Dedicated communications channel to facilitate an open forum for leaders to have honest conversations and exchange ideas on pressing DEI issues.
- Access to resources and tools to support actionable DEI initiatives within companies. For instance, Carlyle’s training program on mitigating unconscious bias, Better Decisions, in which more than 80% of the firm’s employees have participated, will now be available to participating portfolio companies’ employees.

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With markets and regulatory bodies increasingly focused on sustainability, PE firms should help the executive leadership of their PCs to develop sustainability skills, not only hiring a Chief Sustainability Officer (CSO) that reports directly to the CEO, but also support training and learning opportunities related to ESG for the full C-suite. CEOs especially need to have some form of sustainability training not just to assess risks and opportunities but to also build a company-level culture of sustainability. In hiring the CSO, one should take into account the broad scope of responsibilities required, including the development of strategy, key performance indicators (KPIs), reporting and disclosure protocols, as well as recruiting engagement across business units.

**Incentives**

Aligned incentives for C-suite leaders have been a hot topic for years, as markets aim to align the interests of shareholders and management. In public markets, issues have arisen when CEOs (agents) purposefully drive up short-term profits to secure financial incentives tied to company share price. These decisions, which prioritize short-term returns, have encouraged boards to consider other forms of compensation such as restricted stocks and option plans. More recently, ESG KPIs have been included in CEO compensation packages, as seen in Figure 2.1.2.

A 2021 PwC Annual Corporate Directors Survey found 94% of directors supported the inclusion of ESG goals in CEO compensation packages. An analysis of 4,395 firms from 2011 to 2020 across 21 countries found that incorporating ESG factors into compensation resulted in lower carbon emissions and higher ESG ratings. These findings, though focused on public markets, reveal the benefits PE firms can capture in their own portfolio companies. With increasing regulatory pressure globally, firms should seriously consider adopting ESG-linked pay not only at the C-suite level but also the general partner (GP) level, as previously discussed. In addition to aligning management incentives, firms need to apply those same principles to their portfolio company workforce.

![Use of ESG metrics correlates to company size](image)

**Figure 2.1.2. CEO compensation packages**

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184. Adam Hirsh, "The evolution of ESG and the Chief Sustainability Officer," KPMG.
Turnover

C-suite turnover at portfolio companies is another challenge to be managed. For example, using the Wisconsin Rapids case study, leadership turnover at NewPage and Verso Corporation occurred frequently, as seen in Figures 2.1.3 and 2.1.4, indicative of differing opinions amongst leadership, board members and shareholders. The CEO role at NewPage was filled seven times during its decade-long existence, with an average tenure of just 1.4 years. The CEO role at Verso has been filled seven times during its fourteen-year existence, with an average tenure of 2.1 years (not including a period of time when an Office of the Chief Executive was formed until a CEO was appointed). By contrast, the Chief Executive position at Consolidated Papers (the original family-owned company) was filled only 6 times in its 96-year history, with an average tenure of 16 years. High CEO turnover affected the company’s commitment to a long-term strategy and may have led to decisions to idle or sell mills in order to recoup or limit losses. NewPage idled three mills and sold four, while Verso idled three and sold five, including the paper mill in Wisconsin Rapids. Bankruptcy ensued under both owners regardless. The sale and idling of mills might have been avoided if management and the board were more aligned and had the expertise to navigate a tumultuous market post-financial crisis.

<table>
<thead>
<tr>
<th>CEO</th>
<th>From</th>
<th>To</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peter H Vogel</td>
<td>May 2005</td>
<td>28 February 2006 (resigned)</td>
</tr>
<tr>
<td>Mark Suwyn (interim)</td>
<td>1 March 2006</td>
<td>16 April 2006</td>
</tr>
<tr>
<td>Mark Suwyn</td>
<td>16 April 2006</td>
<td>March 2009</td>
</tr>
<tr>
<td>Richard Willett</td>
<td>March 2009</td>
<td>18 January 2010 (resigned)</td>
</tr>
<tr>
<td>Mark Suwyn (interim)</td>
<td>18 January 2010</td>
<td>10 February 2010 (resigned)</td>
</tr>
<tr>
<td>Tom Curley</td>
<td>10 February 2010</td>
<td>15 June 2010 (resigned)</td>
</tr>
<tr>
<td>George Martin</td>
<td>August 2010</td>
<td>Till acquisition by Verso Corporation</td>
</tr>
</tbody>
</table>

Table 2.1.3. NewPage CEOs since the company’s formation till its acquisition by Verso Corporation. Entries highlighted in red are CEOs that were in place for less than one year.

<table>
<thead>
<tr>
<th>CEO</th>
<th>From</th>
<th>To</th>
</tr>
</thead>
<tbody>
<tr>
<td>LH Puckett</td>
<td>1 August 2006</td>
<td>28 November 2006 (retired)</td>
</tr>
<tr>
<td>Michael Jackson</td>
<td>28 November 2006</td>
<td>14 May 2012 (retired)</td>
</tr>
<tr>
<td>David Paterson</td>
<td>14 May 2012</td>
<td>31 August 2016 (retired)</td>
</tr>
<tr>
<td>Office of the Chief Executive</td>
<td>1 September 2016</td>
<td>31 January 2017</td>
</tr>
<tr>
<td>Christopher DiSantis</td>
<td>1 September 2016</td>
<td>5 April 2019 (resigned)</td>
</tr>
<tr>
<td>Leslie Lederer (interim)</td>
<td>5 April 2019</td>
<td>11 November 2019 (resigned)</td>
</tr>
<tr>
<td>Adam St. John</td>
<td>11 November 2019</td>
<td>30 September 2020</td>
</tr>
<tr>
<td>Randy Nebel</td>
<td>1 October 2020</td>
<td>31 March 2022</td>
</tr>
</tbody>
</table>

Table 2.1.4 Verso Corporation CEOs since the company’s formation till the present day. Entries highlighted in red are CEOs that were in place for two years or less.
Employee Relations

With private equity accounting for more than 11 million jobs in the US, it has significant influence on worker well-being, including job creation, pay and benefits, career advancement and other employee relations targets. Conversely, employee engagement and productivity, as well as low voluntary turnover, are essential to portfolio firm profitability. Unfortunately, PE-owned companies, in general, have opaque employee relations reporting, with only a few firms publicly disclosing employee-based metrics such as engagement and turnover. When PE owners focus on financial engineering to reduce costs without also investing to ensure growth, jobs and wages often suffer.

Employee-oriented efforts by PE firms include monitoring baseline DEI metrics and industry-specific worker metrics to improve worker well-being and reduce future reputational risk.

An analysis by the PE Stakeholder Project found that PE owns companies with millions of workers in low-wage industries such as food service, hospitality and retail, generally earning far less than $15 per hour. The report also found that one of the PE firms with the most low-wage employees was involved in successfully lobbying against the federal Raise the Wage Act, which would have increased the national minimum wage to $15 an hour. Another report by the US Government Accountability Office found that supply chain workers in portfolio companies belonging to PE owners were heavily reliant on food stamps.

Studies on PE’s impact on jobs have been mixed. A study looking at PE investments and their role in increasingly computerized fields found that without PE investment interventions, especially in IT development, employees would have been worse off with respect to long-term employability and earnings. On the other hand, leveraged buyouts (LBOs) in particular have been shown to contribute to job destruction at a rate 10% higher than their non-LBO equivalents. Employee data tracking, especially in LBOs, has been fraught with uncertainty. For example, involuntary employee turnover may be undercounted in LBOs due to: 1) failure to identify LBOs; databases incorrectly label LBOs without verifying capital structures 2) double-counting, including from secondary buyouts 3) including previously exited funds in studies, and 4) under-reporting jobs lost due to bankruptcies.

Some PE firms are aiming to create value for both PCs and employees through initiatives such as employee-owned stock ownership programs (ESOPs). This has been a focus at KKR, with one highly touted example – Ingersoll Rand. In 2020, KKR and the leadership of Ingersoll Rand introduced a $150 million equity grant that gifted its 16,000 employees 20% of their annual cash-based compensation in stock. Employee engagement prior to the grant was less than 20% but rose to 90% afterward. With the shared ownership model, an estimated $3 billion was created in value, based on training and alignment on operational goals (~$200M), reduced voluntary turnover (~$272M), the overall ownership culture (~$2.5B) and the resulting merger and acquisition competitive advantage ($100M - $200M). As a result, when KKR exited the firm in August 2021, it was able to collect close to a $4 billion return on its original $3.9B investment made in 2013.

KKR has since helped to set up Ownership Works, a for-impact organization founded in 2021, which aims to “work with corporations and investors to develop and implement innovative broad-based employee ownership programs that can unlock new levels of success for businesses and in turn create meaningful wealth-building opportunities for employees.” Ownership Works aims to accomplish this through its four organizational tenets of:

1. Structuring & implementing broad-based equity plans
2. Developing a culture of ownership: employee engagement & voice
3. Creating a financially inclusive & resilient workforce
4. Data & insight

The Gainful Jobs Approach framework developed by HCAP Partners is an operational impact framework for understanding job quality performance and driving meaningful impact at its portfolio companies including responsible exits. HCAP is able to quantitatively assess its progress toward creating high quality jobs in its portfolio companies with a focus on low- to moderate-income (LMI) earners through measuring and improving metrics such as employee advancement and wellness, as seen in Figure 2.1.5.

Figure 2.1.5. Gainful Jobs Approach framework

DEI for portfolio company employees has come under increased scrutiny from investors and regulators. To encourage their portfolio companies to adopt DEI measures, PE firms like Vistria Group have begun tying DEI goals to financial incentives for senior leadership. Vistria provides its portfolio companies guidance on hiring practices, recommending companies establish a racially diverse set of interviewees and interviewers. Furthermore, Vistria recommends portfolio companies evaluate vendors and contractors through the lens of minority ownership or operation and direct contracts appropriately.

Blackstone's Career Pathways program seeks to “drive economic mobility for diverse and historically underrepresented talent” through increasing access and enabling advancement, as they have done for more than 100,000 veterans and their spouses across their portfolio. KKR's Vets@Work program also targets increased employment opportunities for veterans, hiring more than 96,000 veterans and military spouses within its portfolio companies since the program's inception in 2011. Supporting the hiring portfolio companies through semi-annual events and third-party experts to share best practices, KKR strives to support veteran career development and retention across its own portfolio and firm.

**CATEGORY 2: STRATEGY & INNOVATION**

A private equity firm influences portfolio company strategy and innovation through its guidance on operational and merger and acquisition (M&A) management, including research and development (R&D) expenditures and intellectual property (IP) development. PE firms can build value through helping portfolio companies identify and mitigate material ESG risks as well as transition to more sustainable business models, practices or technologies. As firms seek to grow the value proposition of their portfolio companies through mergers and acquisitions, the inclusion of ESG factors should be considered to mitigate the effects of potential issues post-merger. Aligning the target company's sustainability and compliance policies with the acquiring portfolio company may reduce costs and risks associated with integration and should be considered throughout the process.

**Operational Management**

PE firms may seek value creation through operational improvements and innovation targeted at reducing costs, improving talent, increasing competitive pricing, varying product and customer mix, and other practices. PE firms may also seek to create value through financial engineering that increases debt and reduces headcount, but which may not support long-term health and competitiveness of the company (see financial engineering section). More recently, some PE firms are also encouraging portfolio companies to address material ESG issues that affect operations (e.g., climate risk, consumer demand for sustainable products) as part of business strategy.

A myriad of studies have examined the relationship between ESG and a company's financial performance. Institutional Shareholder Services, for example, measured the correlation between a company's overall ESG rating broken down by quintiles and its profitability measured by its enterprise value add (EVA) and volatility of EVA. EVA is measured in this study as the excess of capital a firm is able to generate beyond its return on invested capital (ROIC) minus the cost of capital (WACC) as seen in Figure 2.2.1 below. Similarly, EVA margin and spread are defined by EVA in dollars divided by sales, and EVA in dollars divided by capital respectively, which showcase how well companies are able to utilize their assets to generate sales. The results indicate that higher rated ESG companies are able to generate higher value while minimizing their volatility, meaning lower rated ESG companies are not able to efficiently use their assets to generate value, as seen in Figure 2.2.2. This efficiency is especially important in PE-owned leveraged companies, where efficient use of leveraged capital drives more financial returns.

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203. “Vets@Work,” KKR.
There are significant efficiencies to be gained from addressing ESG issues such as reducing natural resource use and waste as well as improving employee productivity. For example, 3M’s 3P program, an employee-based initiative targeted at reducing waste generated through better manufacturing processes and product design, has generated more than $2.34 billion in savings since 1975, while avoiding 2.85 million tons of pollutants. FedEx, facing stiff competition in a crowded marketplace, seeks to reduce fossil fuel costs by electrifying its fleet by 2040. FedEx has converted 20% of its fleet, resulting in the reduction of 50 million gallons of fuel. Pepsi utilizes a large amount of water in the production of its products, especially beverages. The company reduced its water usage by 26% over a 10-year period resulting in cost savings upward of $80 million.

Helping other companies uncover operational efficiency through sustainability is also a business opportunity for portfolio companies. In our global value chain, for example, transportation accounts for 27% of US greenhouse gas emissions. With 26% of those emissions being attributed to medium- and heavy-duty trucks, there is an opportunity to introduce new innovations to monetize the reduction in emissions. One such example is Convoy, a Generation Investments-owned portfolio

company, which acts as a digital freight network connecting shippers and carriers. By ensuring trucks are carrying close to 100% of their capacity and running more efficient routes, Convoy creates a higher trucker utilization rate to capture value for its carriers and ultimately investors. As a result, in 2020 Convoy was able to avoid 470,000 empty truck miles and save over 270,000 liters of fuel.

Jeanologia, a Carlyle portfolio company, which designs and produces sustainable textile solutions is also tackling water intensity. The textile industry contributes about 20% towards total industrial water pollution with 2,700 liters of water required to produce one cotton shirt. Jeanologia’s technologies are used to create ~15% of the 6 billion jeans produced each year, which resulted in savings of roughly 10.7 million cubic centimeters of water in 2019.

**Sustainable Capital Investments**

**Materiality Assessment**

PE firms should require portfolio companies to perform ESG materiality assessments to help prioritize material ESG risks and opportunities identified by internal and external stakeholders. The Sustainable Accounting and Standards Board (SASB) provides guidance on material ESG issues at a sector/industry level. SASB also suggests the identification of additional factors through its five factor test excerpted below:

I. Direct Finance Impacts and Risks  
   a. Is the impact captured by the company's financial statement line items?

II. Legal, Regulator, and Policy Drivers  
   a. Does the company operate in a heavily regulated industry?  
   b. Is the industry the company operating in expected to be subject to new or emerging regulation?

III. Industry Norms, Best Practices, and Competitive Drivers  
   a. What are common sustainability issues in the industry that are under-regulated and/or lack regulation?  
   b. What sustainability issues do companies in the industry commonly report?

IV. Stakeholder Concerns and Social Trends  
   a. What, if any, social trends are shifting consumer perceptions and demand?  
   b. Are there any identifiable company practices which can cause harm to employees or customers?

V. Opportunities for Innovation  
   a. Are there emerging or best-in-class technologies or business practices that would allow a company to improve performance on a topic by minimizing or capturing value?

Similarly, KPMG lays out a seven-phase process for building a materiality assessment seen in Figure 2.2.3.

After identifying material ESG factors with respect to stakeholders and management, a materiality matrix can then be built with the resulting information. The importance of different issues to management is on the x-axis and the importance to stakeholders on the y-axis; the grid-matrix then maps the prioritization of ESG issues as seen in an example from CISCO in Figure 2.2.4.

Figure 2.2.3. KPMG International Sustainable Insight: The essentials of materiality assessment

PHASE 1: Define purpose and scope
Define what materiality means for your organization and be clear about your objectives and audience

PHASE 2: Identify potential topics
Create a long-list of potential material topics

PHASE 3: Categorize
Refine the long-list of potential material topics by clustering them into categories

PHASE 4: Gather information about the impact and importance of topics
Explore each material topic in detail to understand its relevance to the business and stakeholders

PHASE 5: Prioritize
Prioritize material topics based on the strategic importance to the business, importance to stakeholders and the social, economic and environmental impact of each topic in the value chain

PHASE 6: Engage management
Test the results of your materiality assessment with key internal audiences to validate the outcome

PHASE 7: Seek stakeholder feedback
Follow up with stakeholders to get feedback on the material topics reported


The materiality matrix allows companies to evaluate ESG issues based on their potential or actualized impacts on stakeholders and business functions. Material issues should also be evaluated on their likelihood and magnitude of impacts on different financial channels such as revenue, expenses, assets, liabilities, and cost of capital. Categorizing by these two factors helps to highlight potential risks and value creation opportunities:

- Low-likelihood impacts are those that are material but less likely to occur or occur at a low frequency in current or future stages of funding. Their impacts can range from low to high magnitude on a company’s financial position and operations as a result of fees, litigation expenses, lost revenue, and reputational damage. For example, a workforce scandal, like the mass firing of workers through a publicized video call, is an isolated event but has a high impact on a company’s reputation. These and other potential low-likelihood events are less likely to be predicted.
- High-likelihood impacts are those that are material and likely to occur or occur at a high frequency based on historical precedence in current or future stages of funding. Their impacts also range from low to high magnitude on a company’s financial position and operations as a

result of fees, litigation, expenses, lost revenue, and reputational damage. For example, an electronic manufacturing company relies on large volumes of water in the manufacturing of its components and has begun moving the location of its factories to low water-stressed regions resulting in fewer expenses, increased revenues, and a higher future valuation. Potential high-likelihood events can be predicted based on historical trends and handling of company governance issues, operations, and the operating environment.

- Low-magnitude impacts are those that are material and have a low impact on a company's financial channels and reputation in current or future stages of funding. For example, consider an internet media and services company that incurs a more frequent number of data breaches but with fewer customers affected compared to the industry average. The company's data breaches represent a high-frequency event but the magnitude of the impact is low with respect to the number of customers affected. Low-magnitude events may accrue and pose potential high-magnitude consequences in future stages of funding. In this example, with continued data breaches, the company's reputation may be harmed which could result in higher costs of capital and loss of revenue.

- High-magnitude impacts are those that are material and have a high impact on a company's financial channels and reputation in current or future stages of funding. For example, the physical effects of climate change could lead to supply chain disruptions and negative financial channel impacts and would have a high magnitude impact on a company's bottom line and operations. Such high-magnitude events may even affect the company over several years following an event.

Applying the concepts of magnitude and likelihood of impacts allows PE firms to better grasp the impact and timing of various material ESG factors and equips them with insight on how and when to tackle certain issues. Firms such as KKR and Carlyle use materiality assessments to gauge the scope of ESG opportunities and risks and determine a strategy for management of portfolio companies. AEA Investors' materiality assessment of EVOQUA Water Technologies encouraged it to target water stewardship opportunities, as seen in Figure 2.2.5. As a result, EVOQUA reduced its water usage by 36% and delivered an 18% reduction in energy usage across its five largest manufacturing facilities since 2017.

Figure 2.2.5. EVOQUA Sustainability Report 2020

Mergers and Acquisitions

With private equity responsible for 30% of M&A activity, firms may be disadvantaged if they do not actively consider the ESG risks and opportunities associated with the acquisition target. In Bain & Company’s recent survey of 281 M&A executives, only 11% responded that they extensively assess ESG factors during the deal-making process. The Bain report recommends acquirers evaluate ESG in M&A on the basis of strategy, diligence and integration to evaluate potential risks and advance company ESG agendas.

Strategy as discussed previously includes the identification of material ESG factors and resulting action plans to capture opportunities or mitigate risk. In its application to M&A, strategy should be considered through existing sustainability policies at the portfolio company level and the PE firm level. In evaluating potential targets, guidance by industry groups like BSR recommend acquirers assess the company’s future fit in the sector/industry and overall global economy. Firms should explore whether the target company’s products or services are both complementary to the acquiring portfolio company and future-proof with respect to the dynamic materiality of ESG issues.

From analyzing supply chain risks to management of human capital, a variety of issues need to be considered, inclusive of the firm’s and acquiring portfolio company’s sustainability policy.

Not including a careful review of ESG factors in due diligence may create legal and reputational risk. In addition, acquirers may better negotiate deal values and transaction covenants if the opportunity costs of ESG factors are identified during diligence. Similar to the materiality assessment, these factors may then be grouped by their magnitude or likelihood of impact post-acquisition.

With respect to integration, firms should consider how their portfolio company’s and their own sustainability policies can be implemented by the target company. Are the two companies able to be well integrated because they face similar ESG challenges and opportunities or do they face challenges to integration arising from differences in culture and other factors? The evaluation of potential synergy and conflicts should be evaluated during the deal process and include steps to address material ESG risks, while ensuring any ESG compliance policies or issues are handled in the manner of the acquirer’s policies.

CATEGORY 3: FINANCIAL ENGINEERING & LEVERAGE

Private equity firms and operators often employ financial engineering mechanisms to increase company profitability and returns to investors such as debt loading, asset stripping and dividend recapitalizations. Used properly, these mechanisms can be used to improve returns, but improper use can result in irreversible, deleterious effects on the portfolio company. Starting with the use of leverage, PCs need to be mindful of the loss of resiliency and bankruptcy risk they may be courting.

224. OpEd: ESG in Due Diligence Is Not Just Another Box to Check - The Deal
Debt Loading

The use of leverage to generate higher financial returns is ubiquitous in PE because the cost of debt is significantly lower than the cost of equity. This is due to lower risk, as debt holders will be paid first in the event of bankruptcy. PE firms, especially for leveraged buyouts (LBOs), will raise large amounts of debt capital against a portfolio company’s assets to fund acquisitions or buyouts. Firms can increase their performance with respect to the internal rate of return (IRR) by increasing the amount of leverage, but also face the downside risk of bankruptcy if portfolio company performance is worse than anticipated.

Leverage is a key factor in helping general partners (GPs) show improved performance with respect to IRR, as per the example in Figure 2.3.1 from the Corporate Financial Institute.

![Figure 2.3.1. Corporate Financial Institute](image)

Notice as leverage increases, the value of cash flows and IRR increases as well, inclusive of debt payments. Especially in periods of low interest rates, PE firms are incentivized to use debt financing for portfolio companies (PCs) and increase the amount of leverage in their acquisitions to generate higher returns. This is not necessarily a positive; a recent study found that higher deal leverage is in fact associated with higher transaction prices and lower buyout fund returns, suggesting that firms are overpaying when access to credit is easier in low interest rate environments.

This dynamic relationship between interest rates and the use of leverage also intersects with how firms manage their relationship with banks, who have traditionally been one of the main sources of financing for firms. In a study involving a sample of 1,590 loans financing private equity-sponsored

227. “Leveraged Finance,” CFI.
leveraged buyouts between 1993 and 2005, firm relationships with banks were found to reduce information inefficiencies from repeated interactions while banks were able to price loans to cross-sell other businesses. 229

In some cases, PE firms have loaded PCs with as much debt as possible and used company revenue to meet debt payments with little or no operational improvements, then sell the company at a discount while still generating a high level of return. 230 A high level of return is possible because these deals were originally financed with little or no equity, allowing firms to force other debtors to agree to restructure on their terms to ensure a profitable exit. Other methods used by firms involved using portfolio companies to acquire additional amounts of debt to pay off shareholders.

Excessive leverage can create real challenges for PC viability as well as negative outcomes for its customers. This occurs when the leverage is not directly used to benefit the portfolio company and is instead used by firms for purposes such as dividend recapitalizations. When this happens, the portfolio company, though not a beneficiary to the added debt, is still responsible for the interest payments, forcing management to facilitate cost cutting at the expense of employee retention and quality of products or services rendered. One study that reviewed the performance of highly levered healthcare facilities in the UK found their death rates reach twice the levels of their unlevered counterparts. 231 The effect was only observed during the first wave of COVID and not any subsequent waves due to government financial intervention in healthcare facilities, suggesting PE-owned leveraged facilities did not have the financial and human resources to deliver adequate care. This was not true for PE non-leveraged facilities, which were able to more quickly mobilize and deliver a higher quality of care during the same period.

The use of excessive leverage may also contribute to the increased bankruptcy risk of portfolio companies. Recalling the previously examined Wisconsin Rapids paper mill case study, the first and second PE owners acquired the pulp and paper company through the use of debt financing. Cerberus acquired NewPage in a $2.3 billion leveraged buyout with Cerberus investing around $200 million with the rest of the deal financed by approximately $1.8 billion in high yield bonds and $300 million of equity. NewPage's inability to pay its outstanding bond payments in 2012 (worth around $1 billion in face value) led to a failed restructuring and ultimate bankruptcy. Keeping in mind that NewPage had already filed for bankruptcy before being acquired, Verso undertook significant amounts of debt financing to merge with NewPage. Verso already had a standalone debt of $1.2 billion before it merged with NewPage. Post-merger would see the value skyrocket to $2.6 billion with potential sales of $4.5 billion annually. By January 2016, Verso had sold some of its facilities for $62 million to meet its interest payments which had grown to $270 million annually. As a result of directing a majority of its revenue to meet debt payments, net income and the financial bottom line of the company fell. But Verso was successful in lowering its debt and became debt-free by the end of 2018, resulting in a Total Debt/EBITDA ratio of zero which stayed close to that value in 2019 (0.04) and 2020 (0.11). This was not seen in the calculated Altman Z-score of Verso's bankruptcy risk (.405) falling within the region of expected bankruptcy, highlighted by the second PE owner's poor use of

232. Altman Z-Score = 1.2*(working capital / total assets) + 1.4*(retained earnings / total assets) + 3.3*(earnings before interest and tax / total assets) + 0.6*(market value of equity / total liabilities) + 1.0*(sales / total assets). Z-scores below 1.81 indicate a distressed company, scores at or between 1.81 and 2.99 indicate a gray zone of bankruptcy risk, and scores above 2.99 indicate a no-default zone.
leverage in merging with NewPage because of other poorly managed operational factors including asset efficiency and profitability. Verso’s Altman Z-Score tracked over time can be seen in Figure 2.3.2.

Figure 2.3.2. Verso’s Altman Z-score

Other research has demonstrated that PE firms will purposefully load up companies with debt and sell off saleable assets, only to exert undue market pressure or exit with returns as the companies enter initial public offerings (IPOs) to raise money to pay off debtors. Take, for example, the long-term care hospital chain New LifeCare Hospitals, which operates 17 facilities in nine states, and filed for bankruptcy protection on May 6, 2019. Owned by a syndicate or group of PE investors, the chain had engaged in heavy cost-cutting initiatives leading to the shuttering of several hospitals, but still fell into bankruptcy.  

Looking again at the healthcare industry, a study found that in multiple healthcare segments, private equity firms have consolidated small providers into national chains while loading them with debt, and rolling them up into large market players capable of negatively influencing market pricing of services. In one such example of a PE-owned physician staffing firm that was consolidated into a large corporation, rates were almost doubled for services previously rendered.

**Asset-Stripping**

Another form of financial engineering used by PE firms is asset stripping, wherein profitable companies are broken up into profitable business units that are then individually sold. This can increase dividends to shareholders but with potential negative effects on future profitability and PC
viability. PE firms can also create secondary debt obligations through the leasing of portfolio company assets to other debtors. In the previously mentioned study of nursing home facilities, PE firms were found to have sold the rights to the underlying land on which the nursing home was located to debtors, creating new lease payments for nursing homes they were responsible for. Though shareholders were able to immediately benefit from the sale, the nursing home was placed in a precarious financial situation, responsible not only for the debt in the buyout deal but also for land lease payments. Regulations in European Union (EU) markets have been adopted to dissuade such practices and even impose time frames where firms must wait two years before engaging in such activities with assets in which they have a controlling interest (>50%).

**Dividend Recapitalizations & EBITDA Addbacks**

PE firms will use dividend recapitalizations (recaps) through having portfolio companies acquire new debt to pay a one-time distribution to their investors, which ultimately increases the level of debt the portfolio company has to pay, illustrated in Figure 2.3.3.

![Figure 2.3.3. Corporate Finance Institute](image)

Firms may also use dividend recaps to fund new projects and acquisitions related to the company or utilize the new financing to repay old debts, thereby reducing their interest payments. As discussed previously, higher leverage leads to higher risks of bankruptcy and the use of dividend recaps by firms may have grave consequences for portfolio companies, especially with the occurrence of any tail risk events where they might need access to additional liquidity. Dividend recaps may also be used as exit vehicles in management buy-outs with ownership of the company transferring from the PE firm to the company’s management team. Similarly, dividend recaps can be used by firms to repay themselves the value of their initial investment without losing their ownership stake. Dividend recaps should be used judiciously, especially in volatile environments due to their ability to increase bankruptcy risk.

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**EBITDA Addbacks**

EBITDA addbacks or an adjusted EBITDA may be used to artificially raise the valuation of a company. As EBITDA measures earnings before interest, taxes, depreciation and expenses with respect to the current owner, practitioners argue those expenses should be adjusted to take into account new acquisitions and/or owners. This resulted in a variety of expenses being added back to EBITDA and subsequent raised valuations which were deemed to be more accurate. A variety of line items qualify to be added back including those seen in Figure 2.3.5.

These expense addbacks based on operating assumptions have found themselves increasingly scrutinized due to widespread use and the large amounts being added back. As borrowers of capital, private equity firms are able to use this adjusted EBITDA value to their favor with lending agents like banks. Without comprehensive covenants in contracts, banks face unrecognized tail risk events in loans with inflated EBITDA values due to addbacks. This increased risk occurs because banks may unwillingly overlook higher adjusted EBITDA values as reasons to lower their monitoring of the loan and subsequently increase their risk of not being able to take timely corrective action. The inflated EBITDA values also do not take into account the amount of leverage GPs are using within their deals and in cases where leverage is measured against EBITDA, a higher adjusted EBITDA allows GPs to hide their true leverage. Though regulation around addbacks are scarce, lending institutions and investors should scrutinize all underlying assumptions for each addback line item to validate and mitigate any potential risks from misrepresentation.

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Figure 2.3.5. Types of EBITDA

<table>
<thead>
<tr>
<th>Type of EBITDA Addback</th>
<th>Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP adjustments</td>
<td>• Interim period vs. year-end adjustments</td>
</tr>
<tr>
<td>Owner expenses</td>
<td>• Owner’s compensation, benefits and discretionary spending</td>
</tr>
<tr>
<td>Facility rentals</td>
<td>• If the facility is rented from a shareholder or holding company, the addback would represent the difference in rental market value</td>
</tr>
<tr>
<td>Management fees</td>
<td>• Are added back if the PE firm does not perform tasks deemed essential to the day-to-day operating of the business</td>
</tr>
<tr>
<td>Unrealized gains &amp; losses</td>
<td>• Are added back if an investment undergoes any unrealized gains or losses including from an foreign currency-denominated asset</td>
</tr>
</tbody>
</table>
| One-time expenses      | • Lawsuit and litigation expenses  
|                        | • Transaction fees  
|                        | • Restructuring charges |
| Pro forma adjustments  | • Start-up costs which are non-recurring  
|                        | • Acquisition or merger of entities creates synergies which may result in increased purchasing power and lower costs  
|                        | • Costs associated with discontinued products and business lines |

**CATEGORY 4: REPORTING TRANSPARENCY**

Private equity is an opaque asset class due to limited mandated disclosure and reporting defined by general partner (GP) and limited partner (LP) preferences. The current widely accepted disclosure norms in the industry include unaudited quarterly reports and audited annual reports. These reports provide information on a fund’s performance and also have detailed holding/portfolio company information including the level of equity, debt, type of deal, region and sector/industry exposure; allowing LPs to make adjustments to their portfolio’s allocation as needed. This type of reporting was discussed in the PE firm analysis. With regards to portfolio companies, LPs are taking a greater interest in ESG reporting and valuation methodologies in order to better benchmark performance and align with their own sustainable investment mandates.

**ESG Reporting**

As public markets move towards increased ESG disclosures with a major focus on climate, private market investors are asking GPs to adapt some public market ESG practices to improve risk management as seen in Figure 2.4.1. LPs are using ESG mandates, which vary based on

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type, size and topic of interest (climate, gender equity, etc.), and side letters to align LP and GP ESG interests. In the EU, the SFDR (discussed in Section 1) is requiring some 100 ESG metrics for the portfolio companies. In fact, PE firms report that between all the questionnaires provided by LPs and others, they may be reporting on up to 400 metrics for their PCs. As per the earlier discussion about ESG materiality, it will be far more strategic for PE firms to work with their PCs to prioritize highly material ESG metrics, embed them in their business strategy, and report on them.

The ESG Data Convergence Project is developing six ESG metrics as seen in Figure 2.4.2 for the PE industry, with the engagement of a working group of LPs and GPs. Other organizations like Novata, a public benefit corporation, are building a comprehensive reporting platform for GP reporting. Aided by a global ESG Data Advisory council of experts and a GP Advisory Council of prominent ESG PE firms including EQT and Summa Equity, platforms like Novata are making it easier for GPs and LPs to align, collect, and report on ESG metrics.

Previously, LPs have codified their ESG expectations for GP portfolio company reporting through covenants in limited partnership agreements (LPAs) or side letters. These may stipulate reporting frequency, metrics, format, and other pertinent information as agreed by GPs. However, only large LPs or those with good relationships with their GPs can stipulate such clauses in their LPAs or side letters. With more and more LPs requesting such agreements, the burden on GPs to collect a wide variety of ESG information is growing. The 2022 proposed SEC regulations tackle this by stipulating that side letters requiring data that other investors might consider material may be disallowed unless the same level of transparency is provided to all fund investors. GPs may have to adopt an agreed-upon set of ESG standards for all their investors to avoid withholding material information and creating liability risk.

244. Side letters are ancillary agreements defining specific LP-GP arrangements from specific ESG considerations to amendments in deal terms.
245. “Codify ESG Expectations Within Side Letter Agreements,” ILPA.
Table: Key Metric and Individual Data Points

<table>
<thead>
<tr>
<th>Key Metric</th>
<th>Individual Data Points</th>
</tr>
</thead>
</table>
| **Greenhouse gas emissions** | • Scope 1  
• Scope 2  
• Scope 3 (optional)                                                                 |
| **Renewable energy %**      | • Total energy consumption  
• Total renewable energy consumption                                                    |
| **Board diversity**         | • Percentage of women on board of directors  
• Percentage of under-represented groups on board of directors (optional for non-US companies) |
| **Work-related injuries**   | • Total number of work-related injuries  
• Total number of work-related fatalities  
• Days lost due to injury                                                               |
| **Net new hires**           | • Organic net new hires  
• Total net new hires  
• Annual percent attrition                                                             |
| **Employee engagement**     | • Do you conduct an annual employee feedback survey? (Y/N)  
• Percentage of employees responding to annual survey (optional)                        |

Figure 2.4.2. ESG Data Convergence Project Draft Metrics

Figure 2.4.3. PE Fund CFO Report Leaders Survey 2021

In addition to using a standardized set of metrics, GPs also need to implement efficient ESG data collection across their portfolio companies. This is a challenge when many portfolio companies have no sustainability strategy and/or limited ESG-related key performance indicators (KPIs) and often no individual responsible for defining and collecting the ESG data. In addition, as material ESG factors vary by industry, region and type of company, there may not be a one-size-fits-all set of ESG data for a firm’s portfolio companies. Flexible financial technology platforms that can collect and aggregate data from portfolio companies are beginning to emerge as public and private market demands for ESG data grows. A 2021 Private Equity Fund CFO survey found 65% of PE firms reported manual collection of ESG data from their portfolio companies, while only 32% used automated data collection tools, as illustrated in Figure 2.4.3. Data collection and reporting is a near-term problem for GPs as proposed regulations in public markets begin to drive more transparency and LPs begin to question the costs of the industry's historic opacity.

Portfolio companies contemplating an initial public offering (IPO) may also benefit from collecting and reporting ESG factors well before the IPO, as illustrated in Figure 2.4.4. Industry surveys have found the benefits provided by pre-IPO collection and reporting of ESG metrics range from improved market reputation to higher valuations. Conversely, there may be a cost in the form of discounted valuations, headline risk, and timing of exits based on the overall ESG policy and reporting.

Novolex, formerly owned by Carlyle, a packaging and food service company, provides a helpful example of portfolio company reporting. Adhering to SASB and GRI reporting standards and frameworks, Novolex addresses the depth of its sustainability initiatives by first laying out a detailed materiality assessment conducted with a third party to identify key issues for the business and key stakeholders. The sustainability report covers the risks and opportunities of their products, including

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raw material sourcing, operations, stakeholder engagement and resource efficiency. Unfortunately, there is no assurance, which is the case for most ESG reports today. For example, an International Federation of Accountants report found that just 51% of 1,269 companies disclosing ESG data had some form of assurance.

**Valuation**
Robust and credible financial metrics are critical for investors to assess investment performance at the portfolio company level and to decide whether to continue investing with the GP in follow-on funds. Discrepancies in valuations can exacerbate the asymmetrical nature of the GP/LP relationship. A study examining 761 private equity investments of CalPERS through 2013 found fund valuations were conservative during a fund's life leading to reduced distributions of 35% except during audits in fourth quarters when valuations were marked up to their appropriate values. Additionally, when fundraising for follow-on funds, GPs inflated valuation multiples until fundraising periods were completed. This highlights how GPs can influence the returns and perceptions of LPs by controlling the valuation of their underlying portfolio companies and subsequent funds.

The Institutional Limited Partnership Association (ILPA), an alliance of GPs, LPs and related industry groups, generated a standardized reporting template for growth and buy-out funds on portfolio company reporting. Beginning with company characteristics from sector/industry, to merger and acquisition (M&A) activity and transaction details, the level of financial information recommended will enable a more granular understanding of individual portfolio company risks and opportunities. Furthermore, key performance indicators are tracked from the time of entry (purchase) to the current quarter or time of exit, which enables LPs to track performance trends. Portfolio-level transaction details are also provided to LPs to inform their portfolio mix over time. The metrics below are proposed by ILPA and represent much of what PE firms should ascribe to:

**Key performance indicators**
1. EBITDA
2. (TTM) Revenue
3. (TTM) CapEx
4. (TTM) Total Equity
5. Total Net Debt
6. Minority Interests and Other Net Assets
7. Total Enterprise Value
8. Cash
9. Management Ownership %
10. Number of Employees
11. Gross Interest Expense
12. (TTM) Interest Coverage Ratio
13. (TTM) Free Cash Flow (before debt service)
14. (TTM) Free Cash Flow (after debt service)
15. (TTM) Book Value Debt

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257. **TTM** = Trailing Twelve Months.
Valuation Multiples

1. Multiple of Revenue
2. Multiple of EBIT
3. Discounted Cash Flows (from an Investment)
4. Multiple of EBITDA

In reporting these metrics, GPs should document their methodologies in calculating these multiples. Not sharing this information limits LPs ability to reproduce the same calculations and casts doubt on the GP's overall performance and credibility. To combat this, GPs will generally provide a copy of their valuation policy to their LPs and inform them ahead of time of any changes to the methodology. Besides providing a valuation policy to LPs, GPs and LPs can engage the services of valuation experts through consultancies or custodial banks to certify the methodology, calculations, and price adjustments of holdings valuations.

Return on Sustainability Investment

We have discussed the collection and reporting of robust financial and non-financial metrics. The newest frontier is collecting metrics on the relationship between the two, or the Return on Sustainability Investment (ROSI) as developed by the NYU Stern Center for Sustainable Business (CSB). Incorporating ESG metrics into valuation can provide clarity into the effects ESG variables have on a company’s revenue, expenses, assets, liabilities, and cost of capital. For example, how might managing climate change improve operational efficiency, reduce risk, and increase sales? How might a robust employee diversity, equity and inclusion (DEI) program improve retention and productivity and how might that be monetized?

PE firm Investindustrial is working with NYU Stern CSB to train its portfolio companies in the ROSI methodology. One of its portfolio companies, Natra, an international chocolate producer and distributor, was able to quantify the value of opportunities in sustainable cocoa sourcing, informed by trends in supply chain traceability, evolving regulation and CSB’s Sustainable Market Share Index. When gauging the financial benefits of sustainable sourcing, customer loyalty, sales and marketing, risk management, and operating efficiency were all considered mediating factors with respect to their impact on company financial statements.

Failure to provide transparent and credible reporting and valuation metrics related to portfolio companies erodes trust in the asset class. Reporting at the portfolio company level provides a granular view into the management of individual assets in a fund. Improper reporting of metrics or incorrect methodologies at the portfolio company level can compound inaccuracies as they are rolled up to the fund level. To prevent such discrepancies, the industry needs to continue defining a set of standardized financial and ESG metrics as well as robust fintech platforms for collecting and aggregating data. In addition, when reporting valuation metrics, GPs need to share relevant documentation on their methodologies and calculations. To further ensure compliance, LPs and GPs should use third-party valuation service providers. And finally, they should begin tracking the return on sustainability investment.

CATEGORY 5: SOCIETAL IMPACT

As discussed for PE firms, today’s environmental and social challenges require portfolio companies (under guidance from the portfolio company’s investment strategy) to pursue an embedded sustainability strategy with key performance indicators, aiming for either an impact or integrated ESG investment thesis. Implementing and progressing societal impact at the portfolio company level begins with identifying material ESG issues related to the company’s operations based on its internal and external operating factors. These factors can then be used in conjunction with a variety of existing or proprietary standards and frameworks to map out pathways of impact, for example, higher efficiency operating practices to sustainable product development. This will help portfolio companies manage ESG risks such as climate change and employee turnover, as well as create new business opportunities that solve societal challenges.

Beyond embedded sustainability, firms can enable portfolio companies to directly engage with stakeholders to gauge the level of impact they are having on not only their employees but also their immediate communities. Through community engagement events, philanthropy and volunteerism, portfolio companies can have a far-reaching impact on society at-large, which can improve corporate reputation and employee engagement with the firm. This section summarizes how to tackle embedding sustainability, track company impacts, and create positive value for stakeholders.

Embedding Sustainability and Tracking Company Impacts
Assessing the material ESG issues for portfolio companies can illuminate risks and opportunities for growth and inform a business strategy that embeds sustainability and drives better financial performance. Portfolio companies should be evaluated on their contribution to environment, social and governance factors, including stakeholder impacts and where relevant, against the UN SDGs. From the effects on their immediate communities to the world at large, PE firms need to carefully and accurately assess their portfolio companies’ current and future footprint. In measuring their impact, portfolio companies need to take into consideration their market characteristics in conjunction with their internal and external operating factors.

Portfolio firms should begin with a materiality assessment and stakeholder mapping, leading to a materiality matrix that prioritizes the material ESG issues that need to be managed for risk or opportunity. SASB and GRI both offer insights into material ESG issues, with SASB focused on a smaller set of topics from the viewpoint of investors. Portfolio firms may wish to include GRI as a guide to additional material ESG topics. See the NYU Stern Center for Sustainable Business guide to materiality matrices for more information.

SASB defines these risks and opportunities and divides them into the categories of business climate, macroeconomic climate, regulatory climate and geographic location, all of which portfolio companies should be evaluated on. SASB suggests that companies begin with understanding the impact of material ESG issues on both internal and external operating factors:

**Internal Operating Factors**
1. Company products and services including relevant inputs in production.
2. The scale and mix of company operations across various sectors and industries with respect to their geographical footprint.

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262. “Enabling Continuous Improvement,” SASB.
External Operating Factors

1. The business climate of a company describes industry characteristics from competitive landscape and pricing power to expectations of stakeholders including NGOs and customers.

2. The macroeconomic climate of a company describes regional and global industry differences that can affect a company’s economic performance like interest rates and commodity prices.

3. The regulatory climate of a company describes the presence and enforcement of current and new regulation including costs of non-compliance.

4. Geographic location of a company describes its access and interaction with its natural environment including the physical effects of climate change. For example, a hotel and lodging company with a majority of its hotels located near the coastline has financial risk related to extreme weather and beach erosion.

By identifying internal and external material operating factors, firms are better equipped to identify and measure the level of impact they can produce with their portfolio company operations. Generation Investment Management, an impact investment manager, provides a detailed analysis of how to use SASB metrics alongside other industry frameworks such as TCFD and Impact Management Project (IMP) to assess and improve the societal impacts of portfolio companies. Figure 2.5.1 identifies industry frameworks available to analyze different aspects of investments.

Figure 2.5.1. Source: Generation Case Study from SASB Integrating ESG into Private Equity Report

For example, Generation’s management of Convoy, a digital freight marketplace, began with identifying material sustainability issues in the transportation sector. Convoy as a centralized decision-making platform matches shippers and carriers together, enabling greater efficiencies in routes, earnings and emissions displaced. By identifying material ESG factors in the company’s operations, Generation maximized the efficiency in routes by reducing trucks with empty loads to secure higher earnings and lower emissions.

Having identified greenhouse gas emissions as a material issue, Generation then integrates a variety of frameworks and standards to identify impact and scope across five areas, ultimately contributing to greater societal impact through the means of reduced emissions:

What: Defines the purpose of the company across the outcome areas (based on IMP framework)
- System
- Environmental
- Social

---

263. Taskforce on Climate-related Disclosure.
Based on these five outcome areas, Generation is able to apply TCFD methodology to design a low-carbon pathway and measure progress through the use of SASB and IMP metrics, thus capturing the progress and value of the societal value they are able to derive in reducing emissions. More information on the case can be found in Figure 2.5.2 and Generation’s contribution to SASB’s “Integrating ESG Holistically In Private Equity Report.”

Figure 2.5.2. Generation Case Study from SASB Integrating ESG into Private Equity Report

Carlyle is another PE firm focused on ESG integration which utilizes SASB standards in part with its portfolio companies to drive internal materiality assessments and position portfolio companies for operational success and impact. Carlyle also uses a multitude of frameworks and reporting standards including the Global Reporting Initiative (GRI) and more recently, the World Economic Forum (WEF) and TCFD.

Carlyle worked with a PC they owned at the time, Pharmaceutical Product Development, Inc. (PPD), a leading outsourced clinical trial management and laboratory services company, to improve outcomes for its employees while driving down costs. Through Carlyle’s Healthy Benefit’s Initiative they identified the benefits and coverage its employees would find most valuable. After evaluating the 11,000+ workforce and its demographic breakdown of 70% women and 55% millennials, PPD adjusted its healthcare coverages. Forty-three percent of employees signed up for the new plan in the first year and PPD was able to realize cost savings of more than $13 million or 15% of projected costs, while simultaneously better meeting the needs of its employees. The integration of ESG factors at portfolio companies demonstrates how societal impact can be driven through targeted, ESG-integrated stakeholder initiatives.

Firms such as Insight Partners have taken an active approach to improving diversity within their portfolio company leadership. Insight’s Faces of Change Executive Leadership Academy, launched in 2019, seeks to increase diversity, equity and inclusion (DEI) within its software portfolio.
company leadership through providing networking and coaching opportunities for portfolio company female and minority employees, including executives.\textsuperscript{269} Gainsight, an Insight portfolio company, has embraced the program and sponsored five scholarships to support career development for women executives. Another Insight portfolio company, VTS, has created ongoing initiatives such as the Strategic Diversity and Inclusion Plan (SDIP) to track quarterly progress towards goals, alongside employee training on unconscious bias and improving their recruitment strategies with partner organizations such as Out in Tech and Black Girls Code.\textsuperscript{270}

Summa Equity also demonstrates how firms can best facilitate societal impact within their portfolio investments. They invested in Milarex, an international seafood company selling salmon products, which aligns its products, services and management with the UN SDGs. In 2021, the company was able to report that 93% of its sourced salmon was sustainably sourced, achieving progress toward responsible production and consumption (SDG 12). In addition the company has also pledged to convert to 100% recyclable plastics in its products by 2030.\textsuperscript{271} Milarex's ESG goals aligned with SDG goals can be found in Figure 2.5.3.

Figure 2.5.3. Milarex ESG Goals Aligned to United Nations SDGs \textsuperscript{272}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{milarex_esi_goals.png}
\caption{Milarex ESG Goals Aligned to United Nations SDGs}
\end{figure}

Thematic-focused firms seek to use their investments to progress a cause more focused than the broader SDGs. Closed Loop Partners seeks investments in line with its mandate to further the circular economy and has invested in innovative companies including HomeBiogas, which seeks to transform how small communities access gas using available resources, especially in resource-constrained countries. Farmers, for instance, are able to use the manure from their cattle to produce biogas to use for cooking. One of the company's other products, the BioTiolet, allows its users to recycle their daily human waste into renewable biogas for cooking. Through its investment from Closed Loop, HomeBiogas has begun scaling its products and impact in developed countries while managing its products and operations through the lens of the UN SDGs. As its products directly contribute to a circular economy, HomeBiogas demonstrated its progress toward 14 UN SDGs in its latest impact report.\textsuperscript{273}

**Stakeholder Engagement**

To be successful, portfolio firms need robust stakeholder engagement strategies, ranging from local communities to suppliers to employees. Stakeholder engagement starts with mapping key stakeholders as part of the portfolio company’s materiality assessment. Depending on which ESG issues are most material, different stakeholders will be prioritized. The diagram in Figure 2.5.4 by BSR, a non-profit consulting group specializing in stakeholder mapping and outreach for companies, illuminates a 5-step stakeholder engagement process.

Figure 2.5.4. BSR’s Five-Step Approach to Stakeholder Engagement

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Warburg Pincus summarizes the positive stakeholder engagements of its healthcare-related companies during COVID in Figure 2.5.5, backing up its ESG policy which states, “be accessible to, and engage with, relevant stakeholders either directly or through representatives of portfolio companies, as appropriate.” For example, during COVID-19, Warburg set up an online resource portal for its portfolio companies and engaged public health and human capital experts to help portfolio companies navigate employee health and safety concerns. Warburg's portfolio companies meanwhile addressed stakeholder concerns through their direct business operations.

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BSR’s diagram above lays out how portfolio companies and firms can facilitate the process for stakeholder engagement through a more formalized approach.

When PE firms and their portfolio companies do not consider the impact of their business strategies on key stakeholders, negative outcomes can result. For example, reports find that private equity is behind the consolidation of the news industry in recent decades. As mentioned previously, one study found that between 2002 and 2019, private equity firms increased their ownership in US newspapers from 5% to 23%. In an effort to reduce costs, they centralized reporting to focus on national content and reduced reporters and editors by more than 8%, leading to an observed decrease in participation in local elections.

Creating positive stakeholder outcomes requires company values and strategy focused on positive societal outcomes as well as stakeholder mapping and engagement to understand unintended consequences.

In addition to working toward positive stakeholder outcomes through its business activities, the portfolio company can also support communities through philanthropy and employee volunteerism. Corporate philanthropy allows companies to align their values and company culture with their giving. With the passing of the CARE Act in 2020, corporate charitable deduction amounts increased from 10% to 25% for 2020-21, giving corporations more incentives to make charitable contributions. Consistently engaging in corporate philanthropy reduced the incidence of misconduct by corporations in China. Another study concluded that corporate charitable giving caused employees to place a higher level of trust in their managers.

Volunteerism of employees in their immediate communities, supported by the portfolio company, can have positive effects. In a study of 373 firms, researchers found employee volunteering programs had a significant positive effect on the productivity of employees up to six years later. Additionally, the study found that CEO incentives for long-term goals had a significant positive correlation with more extensive employee volunteer programs, which supports the case that aligned company culture can drive value.

In 2015, Warburg Pincus created a Volunteer Week for its portfolio company employees and in 2020, brought together more than 50 of its portfolio companies across four continents to take part in volunteering activities. With the onset of the pandemic, Warburg Pincus implemented a portfolio company donation matching program to lessen exposure. Warburg’s portfolio companies also engaged in community outreach activities during COVID to lessen the burden on their communities.

CONCLUSION
We hope we have demonstrated that private equity has a clear pathway to creating value for stakeholders and the planet while generating superior returns. These goals are not mutually exclusive and in fact, short-term, value extractive behaviors destroy financial value in the medium- and long-term. It is in everyone's interest—investors, corporates, communities, employees, and General Partners—to put in place policies, governance, strategies, and KPIs that drive responsible and sustainable investing in portfolio companies.

This framework provides an assessment tool for LPs, GPs and stakeholders to review policies, practices and impacts and advocate for course corrections, if necessary. However, in the course of this research, it became clear to us that additional tools are needed to support PE firms in their transition to more responsible and sustainable investment approaches. Therefore, NYU Stern Center

280. The increase occurred during the 2020 pandemic and only includes cash contributions which have to be itemized accordingly in returns.
for Sustainable Business is embarking upon a second phase of work, aiming to develop decision-making useful tools for LPs, GPs, and other stakeholders. While the proposed industry/company tools will support a broad responsible investing approach, climate action will be a core component given the urgency of 2030 interim climate targets and increasing global regulatory mandates on climate change. Forward-thinking and early-moving GPs will be interested in using this framework to guide decision-making, as will Limited Partners who wish to translate the framework findings into tools to drive change and accountability through their due diligence and review. Therefore, as a first step, we will interview Limited Partners to understand their current challenges with GPs including ESG and climate change due diligence, and proceed to create targeted tools and trainings to assist them as market paradigms change.

Examples of the types of tools we propose to develop:

1. Guidelines that provide guidance for the ownership lifecycle, from due diligence to post-exit, for the strategic aspects of the responsible investing framework including topics such as M&A management, responsible exits, and building capital structures for good.

2. An ESG valuation model for PE (pre and post-investment) based on CSB’s Return on Sustainability Investment (ROSI).

3. A guide to embedding sustainability at PE firm-level and with portfolio companies, with climate strategy examples. The format would be an asynchronous mini-course with examples and links to additional resources. We see the need for this through the work we have done with PE firms looking for training on ESG for their portfolio companies. Generally, both the PE firm and the portfolio companies have a very rudimentary understanding of sustainability and next to no understanding of how it drives financial value (thus limited interest in adoption).

4. An LP due diligence questionnaire (assuming LPs identify this as helpful). On the climate front, we will include recommendations for metrics that LPs should require that GPs track amongst their portfolio companies, based on existing standards and guidance.

These tools would primarily be targeted at PE’s general partners, limited partners, and portfolio companies, however, we also propose to develop tools for communities, and workers, as well as ensure that the tools are available to key civil society players.

Please reach out to us at NYU Stern CSB if you are interested in the framework and/or participating in the second phase. You can contact: sustainablebusiness@stern.nyu.edu.
## APPENDIX 1

### DEI Standards, Tools, and Coalitions for PE

<table>
<thead>
<tr>
<th>Coalitions</th>
<th>Goal</th>
<th>Process</th>
<th>Firms</th>
<th>Citation</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 Percent Coalition</td>
<td>For senior leadership and boards of directors to reflect gender, racial and ethnic diversity of the US, first working towards women holding 30% or more of board seats</td>
<td>National forum for members to develop strategies to influence companies to increase diversity</td>
<td>Apax, Apollo, Berkshire Partners, Blackstone, Carlyle, Francisco Partners, GI Partners, Global Infrastructure Partners, Insight Partners, KKR, Longitude Capital, Neuberger Berman, Sun Capital, Palladium Equity Partners, the Sterling Group, TCV, TPG, Vista Equity Partners</td>
<td><a href="https://www.30percentcoalition.org/members-of-the-coalition">https://www.30percentcoalition.org/members-of-the-coalition</a></td>
</tr>
<tr>
<td>MLT Black Equity at Work Certification</td>
<td>Gives the roadmap and the recognition to help and encourage employers across America to pursue Black equity with the same effort as their pursuit of earnings and other key priorities</td>
<td>Finds the balance between rigor and achievability. Firms with the certification commit to: 1. Increasing employee representation at every level 2. Ensure pay equity between Black and White employees, provide just compensation and equitable benefits 3. Creating an anti-racist workplace where Black employees feel they belong, are valued and can advance 4. Progressing towards proportionate spending in Black-owned businesses 5. Providing annual contributions to nonprofits that increase Black equity and investing in Black equity-focused financial institutions</td>
<td>Ares, Bain, BlackRock, City, Wellington Management</td>
<td><a href="https://www.mltblackequityatwork.org/about-the-certification/">https://www.mltblackequityatwork.org/about-the-certification/</a></td>
</tr>
<tr>
<td>Hispanic Promise</td>
<td>A call to action for business leaders and companies of corporate America to create a more inclusive work environment for Hispanic employees</td>
<td>It is a non-legally binding sign of intention to showcase commitment to diversity and inclusion; includes access to annual reports on the progress of the initiative and insightful material on US Hispanics.</td>
<td></td>
<td><a href="https://www.werealhuman.org/promise/">https://www.werealhuman.org/promise/</a></td>
</tr>
<tr>
<td>Coalitions</td>
<td>Goal</td>
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<td>Citation</td>
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<tr>
<td>Increasing Diversity in Innovations Diversity Pledge</td>
<td>To address the issue of underrepresented investors</td>
<td>Steps include: 1. Learning about underrepresented investors 2. Raising internal awareness 3. Determine baseline investor data 4. Examine and explore root causes and potential groups 5. Benchmark organization’s data 6. Advocate and raise awareness</td>
<td>BlackRock, Microsoft, Paypal</td>
<td><a href="https://increasingdivi.org">https://increasingdivi.org</a></td>
</tr>
<tr>
<td>Sponsor for Educational Opportunity</td>
<td>Separates a more equitable society by closing the academic and opportunity gap for motivated young people, setting the standard for academics, mentorship, community, positive peer pressure and a powerful, lifelong network</td>
<td>Programs: 1. SEO Scholars - Eight year program for students in underserved high schools to provide academic and career support in college 2. SEO Career - Recruit high performing Black, Latinx, and Native American students to get great summer internships which lead to full-time jobs</td>
<td>Ares, Berkshire, Blackstone, Carlyle, KKR</td>
<td><a href="https://www.seo-usa.org/career/">https://www.seo-usa.org/career/</a></td>
</tr>
<tr>
<td>The Investment Diversity Exchange</td>
<td>Promote diversity &amp; inclusion within the investment industry. The organization is the united front for the voice of minorities. TIDE is a woman-owned, minority firm globally promoting ethnic and gender diversity within the investment industry.</td>
<td>TIDE holds conferences throughout the year that promote diversity in the investment industry. To become a member, a firm must pay a fee per year. Members gain access to their flagship and popup events</td>
<td></td>
<td><a href="https://www.tideexchange.com/">https://www.tideexchange.com/</a></td>
</tr>
<tr>
<td>Women Association of Venture and Equity</td>
<td>WAVE is committed to the development and advancement of women in private equity and venture capital. WAVE achieves this objective through a series of developmental and networking events organized in financial centers each year.</td>
<td></td>
<td></td>
<td><a href="https://women-wave.org/">https://women-wave.org/</a></td>
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</tbody>
</table>
The goal of the ILPA Diversity in Action initiative is to motivate market participants to engage in the journey towards becoming more diverse and inclusive and to build momentum around the adoption of specific actions that advance DEI over time.

Members must follow all of four the foundational activities plus two of the additional suggested activities:

- Has in place a DEI statement or strategy, communicated publicly, and/or a DEI policy communicated to employees and investment partners, that addresses recruitment and retention*
- Tracks internal hiring and promotion statistics by gender and race/ethnicity**
- Has in place organizational goals that result in demonstrable practices to make recruitment and retention more inclusive
- Requests (LPs) or provides (GPs) DEI demographic data, e.g., ILPA Diversity Metrics Template, for any new commitments (LPs) or new fundraises (GPs)**

* In addition, participating organizations should address harassment, either within the DEI policy or within a separately articulated policy or statement.

** At a minimum, gender data. Racial/ethnic data to be provided in jurisdictions allowing for the capture and reporting of such information.

Optional Activities:

- Tracks gender and race/ethnicity statistics within partner organizations (LPs: managers; GPs: portfolio company boards/management teams)***
- Has assigned senior-level DEI accountability, aligned with an investment or senior management role
- Provides unconscious bias training for employees on an ongoing basis
- Has in place diverse employee resource groups
- Incorporates contributions towards advancing DEI into employee performance reviews
- Commits to encourage and promote diversity within boards of directors at portfolio companies
- Requests (LPs) or provides (GPs) DEI demographic data, e.g., ILPA Diversity Metrics Template, for all funds, i.e., not solely new commitments/new fundraises**
- Supports DEI research in the private markets industry by participating in surveys that capture data on diversity in the workforce
- On a programmatic basis, supports industry efforts to educate underrepresented groups about careers in private markets

*** At a minimum, gender data. Racial/ethnic data to be provided in jurisdictions allowing for the capture and reporting of such information.
## SFDR articles outlining forms of disclosure

<table>
<thead>
<tr>
<th>SFDR Article</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 1: Subject Matter</td>
<td>This Regulation lays down rules for financial market participants and financial advisers on transparency with regard to the integration of sustainability risks and the consideration of adverse sustainability impacts in their processes and the provision of sustainability-related information with respect to financial products.</td>
</tr>
<tr>
<td>Article 2: Definitions</td>
<td>A list of term definitions used within the regulations</td>
</tr>
<tr>
<td>Article 3: Transparency of sustainability risk policies</td>
<td>Financial market participants shall publish information on policies on the integration of sustainability risks in the investment decision-making process.</td>
</tr>
<tr>
<td>Article 4: Transparency of adverse sustainability impacts at entity level</td>
<td>Where principal adverse impacts (PAI) of investment decisions are considered a financial market participant shall publish on its website; (i) description of the principal adverse sustainability impacts (ii) a statement on its due diligence policies in relation to PASI and (iii) a brief summary of engagement policies. Compliance is on a “comply or explain” basis.</td>
</tr>
<tr>
<td>Article 5: Transparency of remuneration policies in relation to the integration of sustainability risks</td>
<td>The remuneration policies of the financial market participant must contain information on how the remuneration policies are consistent with the integration of sustainability risks.</td>
</tr>
<tr>
<td>Article 6: Transparency of the integration of sustainability risks</td>
<td>Description of the manner in which sustainability risks are integrated in investment decisions in respect of financial market participants. Assessment of likely impact on the returns of the financial products. Compliance is on a “comply or explain” basis.</td>
</tr>
<tr>
<td>Article 7: Transparency of adverse sustainability impacts at financial product level</td>
<td>1. By 30 December 2022, for each financial product where a financial market participant applies point (a) of Article 4 (1) or Article 4(3) or (4), the disclosures referred to in Article 6(3) shall include the following: (a) a clear and reasoned explanation of whether, and, if so, how a financial product considers principal adverse impacts on sustainability factors; (b) a statement that information on principal adverse impacts on sustainability factors is available in the information to be disclosed pursuant to Article 11(2). 2. Where a financial market participant applies point (b) of Article 4(1), the disclosures referred to in Article 6(3) shall include for each financial product a statement that the financial market participant does not consider the adverse impacts of investment decisions on sustainability factors and the reasons therefore.</td>
</tr>
<tr>
<td>Article 8: Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures</td>
<td>1. If a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices, the information to be disclosed pursuant to Article 6(1) and (3) shall include the following: (a) information on how those characteristics are met; (b) if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics. 2. Financial market participants shall include in the information to be disclosed pursuant to Article 6(1) and (3) an indication of where the methodology used for the calculation of the index referred to in paragraph 1 of this Article is to be found. 3. The ESAs shall, through the Joint Committee, develop draft regulatory technical standards to specify the details of the presentation and content of the information to be disclosed pursuant to this Article.</td>
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<tr>
<td>SFDR Article</td>
<td>Description</td>
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</table>
| Article 9: Transparency of sustainable investments in pre-contractual disclosures | 1. If a financial product has a sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall be accompanied by the following: (a) information on how the designated index is aligned with that objective; (b) an explanation as to why and how the designated index aligned with that objective differs from a broad market index.  
2. Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall include an explanation on how that objective is to be attained.  
3. Where a financial product has a reduction in carbon emissions as its objective, the information to be disclosed pursuant to Article 6(1) and (3) shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.  
4. Financial market participants shall include in the information to be disclosed pursuant to Article 6(1) and (3) an indication of where the methodology used for the calculation of the indices referred to in paragraph 1 of this Article and the benchmarks referred to in the second subparagraph of paragraph 3 of this Article are to be found.  
5. The ESAs shall, through the Joint Committee, develop draft regulatory technical standards to specify the details of the presentation and content of the information to be disclosed pursuant to this Article. |
| Article 10: Transparency of the promotion of environmental or social characteristics and of sustainable investments on websites | Maintain websites with the following information for each financial product referred to in Article 8(1) and Article 9(1), (2) and (3): (a) a description of the environmental or social characteristics or the sustainable investment objective; (b) information on the methodologies used to assess, measure and monitor the environmental or social characteristics or the impact of the sustainable investments selected for the financial product, including its data sources, screening criteria for the underlying assets and the relevant sustainability indicators used to measure the environmental or social characteristics or the overall sustainable impact of the financial product; (c) the information referred to in Articles 8 and 9; (d) the information referred to in Article 11. |
| Article 11: Transparency of the promotion of environmental or social characteristics and of sustainable investments in periodic reports | Financial products referred to in Article 8(1) or in Article 9(1), (2) or (3), shall include additional information on the sustainable characteristics (varies based on the product’s classification) |
| Article 12: Review of disclosures | Ensure that website disclosures required by Article 3, Article 5 and Article 10 stay up to date |
| Article 13: Marketing communications | Ensure marketing materials do not contradict the information disclosed pursuant to SFDR |
## APPENDIX 2

### Firm, Industry, and Non-Profit Participants

<table>
<thead>
<tr>
<th>Firms</th>
<th>Industry and Non-Profit Groups</th>
</tr>
</thead>
<tbody>
<tr>
<td>APG Partners</td>
<td>American Investment Council (AIC)</td>
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<tr>
<td>Generation Partners</td>
<td>International Financial Corporation (IFC)</td>
</tr>
<tr>
<td>Apollo</td>
<td>Business for Social Responsibility (BSR)</td>
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<tr>
<td>HCAP Partners</td>
<td>International Integrated Reporting Council (IIRC)</td>
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<tr>
<td>BARN Investments</td>
<td>Carbon Data Platform (CDP)</td>
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<tr>
<td>Investindustrial</td>
<td>Omidyar Network</td>
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<tr>
<td>Blackstone</td>
<td>Ceres</td>
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<tr>
<td>KKR</td>
<td>Ownership Works</td>
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<tr>
<td>Blue Orange Capital</td>
<td>ESG Data Convergence Project</td>
</tr>
<tr>
<td>Summa Equity</td>
<td>Predistribution Initiative (PDI)</td>
</tr>
<tr>
<td>Carlyle</td>
<td>Impact Frontiers</td>
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<tr>
<td>Towerbrook Partners</td>
<td>Private Equity at Work</td>
</tr>
<tr>
<td>Circularity Capital</td>
<td>Institutional Limited Partners Association (ILPA)</td>
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<tr>
<td>TPG</td>
<td>UN Principles for Responsible Investment (PRI)</td>
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<td>Closed Loop</td>
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<td>TZP Group</td>
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<td>DWM</td>
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<td>Warburg Pincus</td>
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<td>Encourage Capital</td>
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<td>Wellington</td>
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APPENDIX 3

Case Study

APPENDIX 4

Bibliography


