

# Responsible Investing Framework for Private Equity

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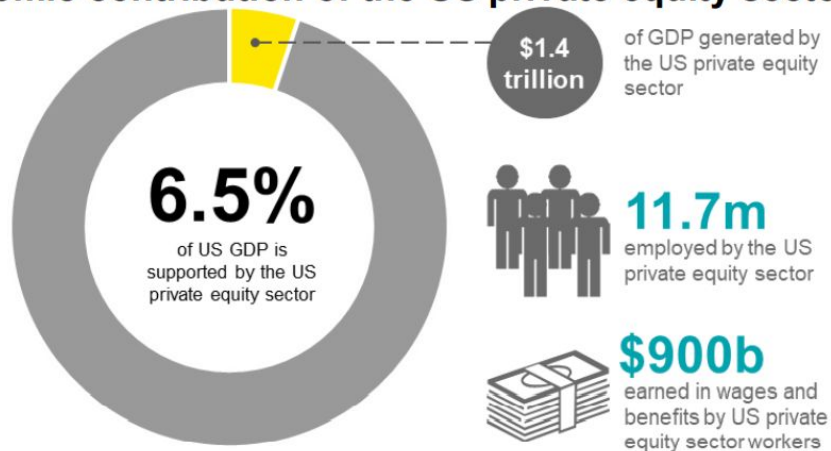
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# Private Equity Has Significant ESG and Economic Impacts

The global private equity market at USD7Tn in 2022 and projected to grow to USD9Tn by 2025

**Figure 2. Economic contribution of the US private equity sector, 2020**



Note: Figure only includes economic activity of the US private equity sector (i.e., the economic activity at US private equity firms and private equity-backed companies). Wages and benefits includes all labor income (i.e., employee cash compensation and benefits, as well as proprietors' income). Wages and benefits is a component of GDP.

Source: PitchBook; Dun & Bradstreet; US Bureau of Economic Analysis; EY analysis.

# CSB PE Responsible Investing Framework Objectives

1. To assess the impact of private equity (PE) management practices, internally and at the portfolio company level, through the lens of responsible investing, stakeholder value creation and ESG.
2. To formulate a framework of responsible PE management practices that create value for all stakeholders and support the long-term viability of the portfolio companies through industry research, interviews and expert engagement.
3. To improve PE practices through engagement with GPs and LPs and disseminating results through business and investor media, social media, conferences and partnerships with other organizations working on private equity's societal impact.

# Research Summary

**Literature review:** More than 60 research studies reviewed, published between 2009 – 2021

**Deep Dive Case Study:** Evolution in ownership of a large WI-based pulp and paper company

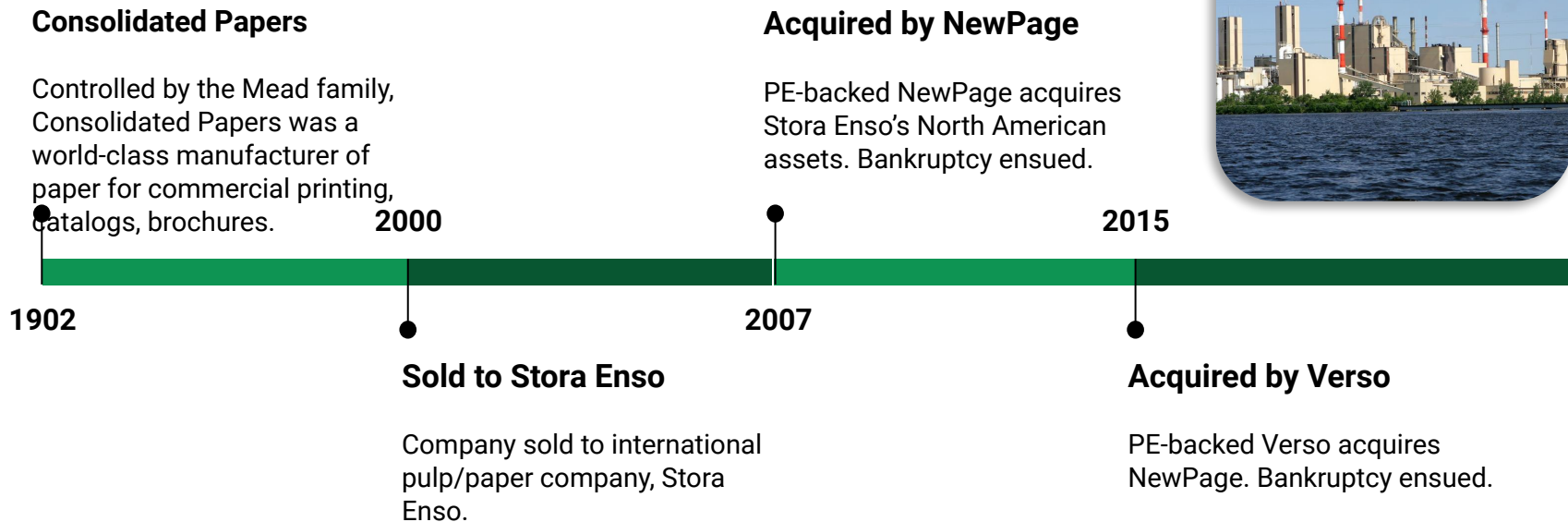
- Analysis of transition through four different owners, including two private equity owners

**Industry Review:** Collecting feedback on responsible PE investment practices

Firms	
APG	Generation
Apollo	HCAP Partners
BARN Investments	Investindustrial
Blackstone	KKR
Blue Orange Capital	Summa Equity
Carlyle	TowerBrook
Circulartiry Capital	TPG
Closed Loop	TZP Group
DWM	Warburg Pincus
Encourage Capital	Wellington

Advocacy and Industry Associations	
American Investment Council (AIC)	International Financial Corporation (IFC)
Business for Social Responsibility (BSR)	International Integrated Reporting Council (IIRC)
Carbon Data Platform (CDP)	Omidyar Network
Ceres	Ownership Works
ESG Data Convergence Project	Predistribution Initiative (PDI)
Impact Frontiers	UN Principles for Responsible Investing (PRI)
Institutional Limited Partners Association (ILPA)	

# Case Study: Changing Ownership of Consolidated Papers



# Case Study: Changing Ownership of Consolidated Papers

Two successive PE owners results in bankruptcy

## NewPage (2007 – 2015)



Leveraged buyout  
and substantial debt



Declining  
markets



Frequent CEO  
turnover (7 CEOs)



Failed to avoid  
bankruptcy  
proceedings



Upon emerging from  
bankruptcy it became a  
takeover target

## Verso Corporation (2015 - )



Leveraged  
buyout and  
substantial  
debt



Suffered  
financially



Frequent CEO  
turnover (8  
CEOs)



Faced  
bankruptcy  
proceedings



No  
successful  
course  
correction



Pandemic  
impact

# Case Study: Changing Ownership of Consolidated Papers

## Accountability Indicators of Problematic PE Management

### Financial Engineering:

- High levels of indebtedness
- Recapitalization actions to pay shareholder dividends
- Use of Chapter 11 bankruptcy as a reorganization tool and source of fees

### Lack of Strategic Investment:

- Elimination of R&D
- No investment in capital assets/selling off strategic assets
- No investment in the pivot needed in the industry/pursuing a strategy that differs significantly from peers/competitors

### CEO Turnover and Incentives:

- Frequent, unplanned CEO turnover
- Leadership compensation that incentivizes short term cash generation

### Dissatisfied Stakeholders:

- Fired employees
- Proxy actions by activist shareholders
- Lack of community engagement

# Responsible Investing 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. Reporting Transparency
3. Strategy & Innovation
4. Financial Engineering & Leverage
5. Societal Impact

*Note: Specific impact sub-areas are 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.*



# Responsible Investing Framework Overview: Portfolio Company



# Responsible Investing Framework: Portfolio Companies

**Management & Human Capital.** *Management and human capital decisions in the context of board/C-suite composition, treatment of employees and other stakeholders, and short-vs long-termism.*

Impacts	Sample Data Points
I. Board & C-suite credentials & governance	<ul style="list-style-type: none"><li>• <i>ESG credentials</i></li><li>• <i>Diversity (race, gender, etc.)</i></li><li>• <i>Domain and industry expertise</i></li><li>• <i>CEO turnover</i></li><li>• <i>CEO, executive suite and board terms and incentives aligned with long-termism</i></li></ul>
II. Employee well-being & satisfaction	<ul style="list-style-type: none"><li>• <i>Employee satisfaction and voluntary turnover</i></li><li>• <i>Living wage and benefit structures</i></li><li>• <i>Health and safety</i></li><li>• <i>Employee incentives (bonuses, options)</i></li><li>• <i>Employee owned (or partially) business</i></li><li>• <i>Productivity</i></li></ul>

# Responsible Investing Framework: Portfolio Companies

**Management & Human Capital.** *Management and human capital decisions in the context of board/C-suite composition, treatment of employees and other stakeholders, and short-vs long-termism.*

Impacts	Sample Data Points
III. Job creation & loss	<ul style="list-style-type: none"><li>• <i>Job training including transferable skills for long-term job market preparedness</i></li><li>• <i>Career development, internal promotions</i></li><li>• <i>Involuntary turnover, outsourcing, offshoring and automation</i></li><li>• <i>Net job creation</i></li></ul>
IV. Multi-stakeholder approach and long-termism	<ul style="list-style-type: none"><li>• <i>Robust engagement of community, employees, NGOs and other stakeholders</i></li><li>• <i>Feedback mechanisms for collecting and addressing stakeholder concerns in a timely manner</i></li><li>• <i>Management and risk decisions to promote long-term resiliency and profitability</i></li></ul>

# Responsible Investing Framework: Portfolio Companies

**Reporting Transparency.** *The credibility and transparency of material ESG and financial information from portfolio companies.*

Impacts	Sample Data Points
I. Reporting ESG	<ul style="list-style-type: none"><li>• Audited financially material ESG metrics to internationally accredited standards</li><li>• Audited ESG performance trends</li><li>• Reporting financial impacts of ESG (ROSI)</li></ul>
II. Reporting financial performance	<ul style="list-style-type: none"><li>• Reporting multiple financial performance metrics i.e. IRR, PME, DPI, RVPI and TVPI</li></ul>

# Responsible Investing Framework: Portfolio Companies

**Strategy & Innovation.** *The operational management of portfolio companies through assessments of material issues including ESG, long-term sustainable capital pivots and appropriate due diligence of M&A transactions.*

Impacts	Sample Data Points
I. Operational management	<ul style="list-style-type: none"><li>• <i>Appropriate R&amp;D investments</i></li><li>• <i>Novel and strategic IP developed</i></li><li>• <i>Assessing and mitigating material ESG issues</i></li><li>• <i>Managing value chain risks and resiliency including climate and human capital risks</i></li></ul>
II. Sustainable capital investments	<ul style="list-style-type: none"><li>• <i>Capital investments to improve company's sustainability performance and innovation (% of EBITDA)</i></li></ul>
III. M&A Management	<ul style="list-style-type: none"><li>• <i>Inclusion of ESG factors in decision-making</i></li><li>• <i>Strategic Positioning (market reach, brand management, product diversity, industry headwinds, etc.)</i></li><li>• <i>Financial Stability (debt capacity of acquiring companies)</i></li><li>• <i>Conglomeration of debt-loaded companies and exits</i></li></ul>

# Responsible Investing Framework: Portfolio Companies

**Financial Engineering & Leverage.** *The use of financial mechanisms to increase portfolio company profitability and distributions to investors*

Impacts	Sample Data Points
I. Debt-loading	<ul style="list-style-type: none"><li>• <i>Asset-stripping</i></li><li>• <i>Creation of secondary debt obligations to pay shareholder distributions</i></li><li>• <i>Dividend recaps</i></li></ul>
II. Use of Chapter 11 bankruptcy as a reorganization tool	<ul style="list-style-type: none"><li>• <i>Appointment of bankruptcy experts to the board</i></li></ul>
III. Capital Structures	<ul style="list-style-type: none"><li>• <i>Structuring capital structures for positive impact (ESG-linked credit)</i></li></ul>
IV. Tax structuring and accounting	<ul style="list-style-type: none"><li>• <i>Value of tax avoidance as a result of corporate tax maneuvering</i></li><li>• <i>Use of EBITDA add backs</i></li></ul>

# Responsible Investing Framework: Portfolio Companies

**Societal Impact.** *Embedded sustainability driving well-documented, improved performance on ESG issues, stakeholders and impact indicators such as UN SDGs.*

Impacts	Sample Data Points
I. Societal impacts in line with company operation, product and services measured by ESG and/or UN SDG progress	<ul style="list-style-type: none"><li>• <i>Contribution towards positive or negative material ESG and stakeholder outcomes (e.g. emissions, employee turnover)</i></li><li>• <i>Contribution toward the UN SDG targets</i></li></ul>
II. Engagement with local communities and/or social and environmental impacts	<ul style="list-style-type: none"><li>• <i>Supporting the local community (philanthropy, volunteering) while avoiding greenwashing</i></li><li>• <i>Lawsuits related to social and environmental issues</i></li><li>• <i>News coverage related to social and environmental issues</i></li></ul>
III. Embedded sustainability	<ul style="list-style-type: none"><li>• <i>ESG is embedded in the organization's business strategy along with performance-based KPIs and supported by an appropriate level of investment</i></li></ul>

# Responsible Investing Framework: Private Equity Firm

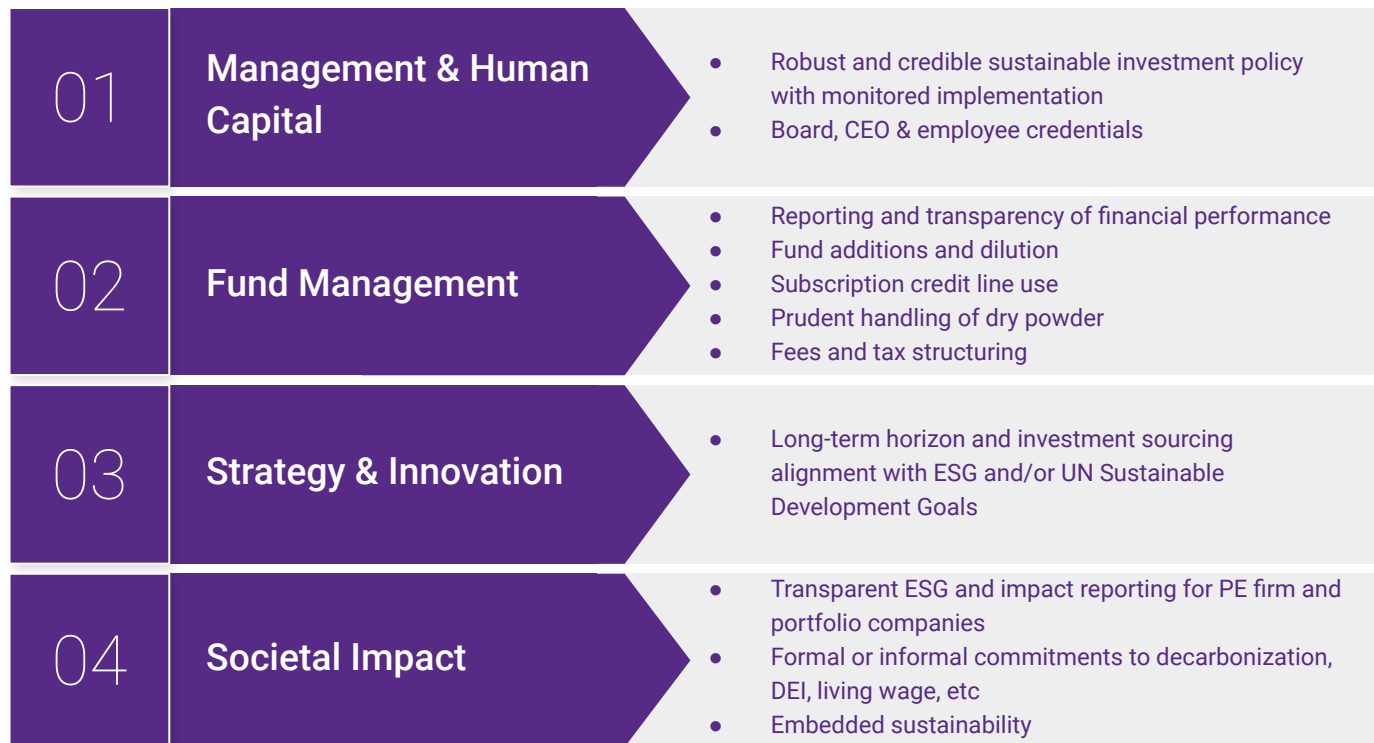
The following impact categorizations were derived through a rigorous academic literature review, and expert interviews with PE firms and civil society groups.

1. Management & Human Capital
2. Fund Management
3. Strategy & Innovation
4. Societal Impact

*Note: 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 no means an exhaustive list of metrics available.*



# Responsible Investing Framework Overview: Private Equity Firm



# Responsible Investing Framework: PE Firms

**Management & Human Capital.** *Management approach is guided by a robust responsible investment strategy and diverse and ESG credentialed senior leaders.*

Impacts	Sample Data Points
I. A robust and credible sustainable investment policy with monitored implementation	<ul style="list-style-type: none"><li>• <i>Implementation and monitoring of firm's written sustainable investment policy by an executive leader</i></li><li>• <i>Separate ESG investment sub-committee</i></li><li>• <i>ESG aligned incentives and/or upward earnings incentives</i></li><li>• <i>Amount and recipients of donations made by the firm including political lobbying</i></li></ul>
II. Board, CEO & employee credentials	<ul style="list-style-type: none"><li>• <i>Diverse board and deal teams with ESG credentials</i></li><li>• <i>Employee sustainability and stakeholder engagement credentials</i></li><li>• <i>Diversity of firm employees</i></li></ul>

# Responsible Investing Framework: PE Firms

**Fund Management.** *Fund management practices with respect to handling dry powder, subscription credit lines, additional fundraises, and reporting.*

Impacts	Sample Data Points
I. Reporting and transparency of financial performance	• <i>Use of PME with consideration of market cap, industry/sector and leverage size</i>
II. Fund additions and dilution	• <i>Number of top-up, annex funds and multiple fund investments</i>
III. Subscription credit line use	• <i>Reporting and transparency of subscription credit line use</i>
IV. Prudent handling of dry powder	• <i>Dry powder management practices with respect to time horizons (investments in liquid cash &amp; cash equivalents vs. less liquid holdings)</i>
V. Fees	• <i>Amount and types of fees charged by the PE firm to the portfolio company</i>
VI. Tax structuring	• <i>Domicile of master fund and amount of tax avoidance</i>

# Responsible Investing Framework: PE Firms

**Strategy & Innovation.** *Describes the firm's capabilities in meeting its sustainable investment policy throughout its pre- and post-investment processes.*

Impacts	Sample Data Points
I. Long-term horizon and investment sourcing alignment with ESG and/or UN SDGs	<ul style="list-style-type: none"><li>• <i>Sourcing of investments in line with firm's sustainable investment policy with respect to region, timeframe, UN SDG progress, sector/industry focus.</i></li><li>• <i>Holding periods consistent with driving innovation and returns, e.g. perpetual funds</i></li><li>• <i>Accounting for timing diversity in condensed fundraising periods</i></li><li>• <i>Implementing and adhering to sector-specific sustainability guidelines</i></li><li>• <i>Duty of care toward public goods (even when privately owned) such as water and forests</i></li><li>• <i>Responsible exits; incidences of bankruptcies post-sale of debt-loaded companies</i></li></ul>

# Responsible Investing Framework: PE Firms

**Societal Impact.** *How well the PE firm and its portfolio companies are contributing to positive impacts and reducing negative societal impacts.*

Impacts	Sample Data Points
I. Transparent ESG and impact reporting for PE firm and portfolio companies	<ul style="list-style-type: none"><li>• <i>Adoption of credible ESG standards and frameworks (e.g. SBTI, UN SDGs) and impact KPIs</i></li><li>• <i>Annual reporting of firm and portfolio company impact in line with sustainable investment policy</i></li><li>• <i>Independent third party audit of ESG</i></li></ul>
II. Formal or informal commitments to decarbonization, DEI, living wage, and other impacts	<ul style="list-style-type: none"><li>• <i>Net Zero Asset Managers</i></li><li>• <i>Living wage assessments</i></li><li>• <i>DEI goals</i></li></ul>
III. Embedded sustainability	<ul style="list-style-type: none"><li>• <i>ESG is embedded in the organization's business strategy along with performance-based KPIs and supported by an appropriate level of investment</i></li></ul>

# Responsible Investing Framework: CSB Next Steps

1. Publish a white paper on the framework, together with cases that provide pathways to positive societal and financial performance
2. Engage stakeholders in the review and feedback of the framework
3. Develop responsible investing tools for PE such as ESG valuation methodologies, guidance on helping portfolio firms embed sustainability in business strategy, responsible exits, asset owner due diligence question based on the framework, community tools, etc.
4. Co-host a private equity for responsible investing summit in 2023.