NYU STERN

Center for Sustainable Business

Value Drivers In Private Equity: Building an Accountability Framework for Positive Stakeholder Impact

NYU Stern CSB
research initiative

Outline

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Objectives

1. To assess the impact of private equity (PE) management practices, internally and at the portfolio company level, through the lens of stakeholder value creation and ESG.
2. To formulate a framework of 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 by disseminating results through business and investor media, social media, conferences, and partnerships with other organizations working on private equity's societal impact.

Why?

Private equity controls a growing number of businesses, with significant impact on employees, communities and the environment. While the sector plays an important role in bringing capital and improved management to portfolio companies, it is under scrutiny for practices that exploit workers, communities and the environment, as well as portfolio company assets, ultimately destroying company value. The expanded private markets coverage of the EU Sustainable Financial Disclosure Regulation (SFDR), showcases growing demand for accountability and better jurisprudence.

Research Summary

Literature review: More than 70 research studies reviewed, published between 2009 – 2021.

- **Sample research questions:** What are the relevant impact performance categories for portfolio companies? What about for the PE firm itself? What do we know about value creation by PE for stakeholders? What type of a role do management skills, governance, ESG strategies, holding period, etc. play?
- **Thematic questions:** What are measurable sustainable PE practices being utilized? What practices differentiate impact firms and what if any monetized incentives drive their performance? What is the balance between GP, LP and stakeholder interests that can drive both financial performance and long-termism?

Deep dive case study: Evolution in ownership of a large WI-based pulp and paper company

- Analyze the company's transition through four different owners, including two private equity owners, with a downward spiral that resulted in two bankruptcies under the PE owners and the current idling of the last mill.

Industry review: Collecting feedback on PE responsible investment practices

- Interviews with industry group (CERES, UNPRI and others) and PE firms (KKR, Carlyle, Closed Loop, and others) as well as desk research into best in class PE firm practices.

Firm and Industry Participants

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

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

Categorization of Private Equity Practices

In our Accountability Framework, 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. Fund Management
4. Strategy & Innovation
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 no means an exhaustive list of metrics available. **The data points can be negative or positive.**

Impact Outcome Framework for PE Firms (*Sustainable & Responsible Investment Policies*)

	Impacts	Sample Data Points
Sustainable and Responsible Investment Policies *A sustainable and responsible investment policy defined by firm priorities and monitored implementation*	I. *A robust and credible sustainable investment policy*	i. A defined purpose, scope with mechanisms for measurement and revision within the policy ii. Ownership and accountability of policies taken by leadership, board and/or investment committees
	II. *Monitored implementation of the sustainable investment policy*	i. Key person or persons defined within the policy of educating and promoting the policy across the firm ii. Active ESG due diligence completed on deals (e.g. number of deals rejected due to ESG reasons)

Impact Outcome Framework for PE Firms (*Management & Human Capital*)

	Impacts	Sample Data Points
Management & Human Capital *Management approach is guided by a robust responsible investment strategy and diverse and ESG credentialed senior leaders*	*I. Board, CEO & employee credentials*	i. Diverse board and deal teams with ESG credentials ii. Regular ESG/RI performance tracking at leadership and board levels iii. Dedicated ESG/RI committees iv. Employee sustainability and stakeholder engagement credentials
	II. Firm diversity, culture, and incentives	i. DEI of firm employees ii. DEI talent pipeline including recruiting, retention and promotion iii. Pay equity iv. ESG aligned incentives and/or upward earnings incentives

Impact Outcome Framework for PE Firms (*Strategy & Innovation*)

	Impacts	Sample Data Points
Strategy & Innovation *Describes the firm's capabilities in meeting its sustainable investment policy throughout its pre- and post-investment processes*	*I. Long-term horizon and investment sourcing alignment with ESG and/or UN SDGs*	i. Sourcing of investments in line with firm's sustainable investment policy with respect to region, timeframe, UN SDG progress, sector/industry focus. ii. Holding periods consistent with driving innovation and returns, e.g. perpetual funds vs shrinking of investment cycles iii. Implementing and adhering to sector-specific sustainability guidelines iv. Duty of care toward public goods (even when privately owned) such as water and forests v. Responsible exits

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

Impact Outcome Framework for PE Firms (*Societal Impact*)

	Impacts	Sample Data Points
Societal Impact *How well the PE firm and its portfolio companies are contributing to positive impacts and reducing negative societal impacts*	*I. Transparent ESG and impact reporting for PE firm and portfolio companies*	i. Adoption of credible ESG standards and frameworks (e.g. SASB, IRIS+) ii. Annual reporting of firm and portfolio company impact in line with sustainable investment policy iii. Independent third party audit of ESG iv. Compliance with EU SFDR, SEC and other regulatory ESG labeling requirements v. Financed emissions (Scope 3)
	I. Formal or informal commitments to decarbonization, DEI, living wage, and other impacts	i. Net Zero Asset Managers, SBTI ii. Living wage assessments iii. DEI goals iv. B Corp
	I. Embedded sustainability	i. 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. Reporting Transparency
3. Strategy & Innovation
4. Financial Engineering & Leverage
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.**

Impact Outcome Framework for Portfolio Companies (*Management & Human Capital*)

	Impacts	Sample Data Points
Management & Human Capital *Management & human capital decisions in the context of board/C-suite composition, treatment of employees and other stakeholders, and short-vs long-termism.*	*I. Board & C-suite credentials & governance*	i. ESG credentials ii. DEI (race, gender, etc.) iii. Domain and industry expertise iv. CEO and senior management team turnover v. CEO, executive suite and board terms and incentives aligned with long-termism
	II. Employee well-being & satisfaction	i. Employee satisfaction and voluntary turnover ii. Living wage and benefit structures iii. CEO vs. employee pay ratio iv. Health and safety v. Employee incentives (bonuses, options) vi. Employee owned (or partially) business vii. Productivity

Impact Outcome Framework for Portfolio Companies (*Management & Human Capital*)

	Impacts	Sample Data Points
Management & Human Capital *Management & human capital decisions in the context of board/C-suite composition, treatment of employees and other stakeholders, and short-vs long-termism.*	*III. Job creation & loss*	i. Job training including transferable skills for long-term job market preparedness ii. Career development, internal promotions iii. Involuntary turnover, outsourcing, offshoring and automation iv. Net job creation
	IV. Multistakeholder approach and long-termism	i. Robust engagement of community, employees, NGOs and other stakeholders ii. Feedback mechanisms for collecting and addressing stakeholder concerns in a timely manner iii. Management and risk decisions to promote long-term resiliency and profitability

Impact Outcome Framework for Portfolio Companies (*Strategy & Innovation*)

	Impacts	Sample Data Points
Strategy & Innovation *The 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*	*I. Operational management*	i. Appropriate R&D investments ii. Novel and strategic IP developed iii. Assessing and mitigating material ESG issues iv. Managing value chain risks and resiliency including climate and human capital risks
	II. Sustainable capital investments	i. Capital investments to improve company's sustainability performance and innovation (% of EBITDA) ii. Materiality assessments
	III. M&A Management	i. Inclusion of ESG factors in decision-making ii. Strategic Positioning (market reach, brand management, product diversity, industry headwinds, etc.) iii. Financial Stability (debt capacity of acquiring companies) iv. Poor management and aggregation of debt-loaded companies and exits

Impact Outcome Framework for Portfolio Companies (*Financial Engineering & Leverage*)

	Impacts	Sample Data Points
Financial Engineering & Leverage *Use of financial mechanisms to increase portfolio company profitability and distributions to investors*	*I. Debt-loading*	i. Asset-stripping ii. Creation of secondary debt obligations to pay shareholder distributions iii. Dividend recaps
	II. Use of chapter 11 bankruptcy as a reorganization tool	i. Appointment of bankruptcy experts to the board
	III. Capital Structures	i. Enabling capital structures for positive impact (ESG-linked credit) ii. EBITDA add backs and adjusted EBITDA
	IV. Tax structuring and accounting	i. Value of tax avoidance as a result of corporate tax maneuvering

Impact Outcome Framework for Portfolio Companies (*Reporting Transparency*)

	Impacts	Sample Data Points
Reporting Transparency *The credibility and transparency of material ESG and financial information from portfolio companies*	*I. ESG Reporting*	i. Audited financially material ESG metrics to internationally accredited standards ii. Audited ESG performance trends iii. Reporting financial impacts of ESG (ROSI)
	II. Financial Reporting	i. Reporting multiple financial performance metrics i.e. IRR, PME, DPI, RVPI and TVPI

Impact Outcome Framework for Portfolio Companies (*Societal Impact*)

	Impacts	Sample Data Points
Societal Impact *Embedded sustainability driving well-documented, improved performance on ESG issues, stakeholders, and impact indicators such as the UN SDGs.*	*I. Societal impacts in line with company operations, products and services measured by ESG and/or UN SDG progress*	i. Contribution towards positive or negative material ESG and stakeholder outcomes (e.g. emissions, employee turnover) ii. Contribution toward the UN SDG targets
	II. Engagement with local communities and/or social and environmental impacts	i. Supporting the local community (philanthropy, volunteering) while avoiding greenwashing ii. Lawsuits related to social and environmental issues iii. News coverage related to social and environmental issues
	III. Embedded sustainability	i. ESG is embedded in the organization's business strategy along with performance–based KPIs and supported by an appropriate level of investment

Accountability Framework: Audience and Prioritization

Inform the following audiences on responsible PE investment practices and their impacts on different stakeholder and the processes by to measure their accountability

1. General Partners
2. Limited Partners
3. Community Stakeholders
4. Civil Society Groups
5. Regulators

Priority Areas

- To be developed - -guidance on how to prioritize

Value Driver Matrix

Positive

Value Creation

Negative

Positive Value Creation Divers

Private Equity Firm

- Implementation, training and monitoring of firm's written sustainable investment policy by key person(s)
- Long time horizons and investment sourcing alignment w/ ESG and/or UN SDGs
- Robust impact, including ESG framework adoption, execution and adherence
- Prudent handling of dry powder (opportunity cost vs holding time frame)

Portfolio Company

- CEO-aligned incentives with longtermism and positive employee impacts
- Transparency of ESG & financial performance metrics and methodologies
- Increased research expenditure and sustainability-driven capital investments
- Positive societal impacts in line with operational, product and company services
- Prudent management of debt capital structures for good

Management & Human Capital | **Strategy & Innovation** | **Societal Impact** | **Fund Management** | **Management & Human Capital** | **Reporting Transparency** | **Strategy & Innovation** | **Societal Impact** | **Financial Engineering & Leverage**

Negative Value Creation Drivers

Private Equity Firm

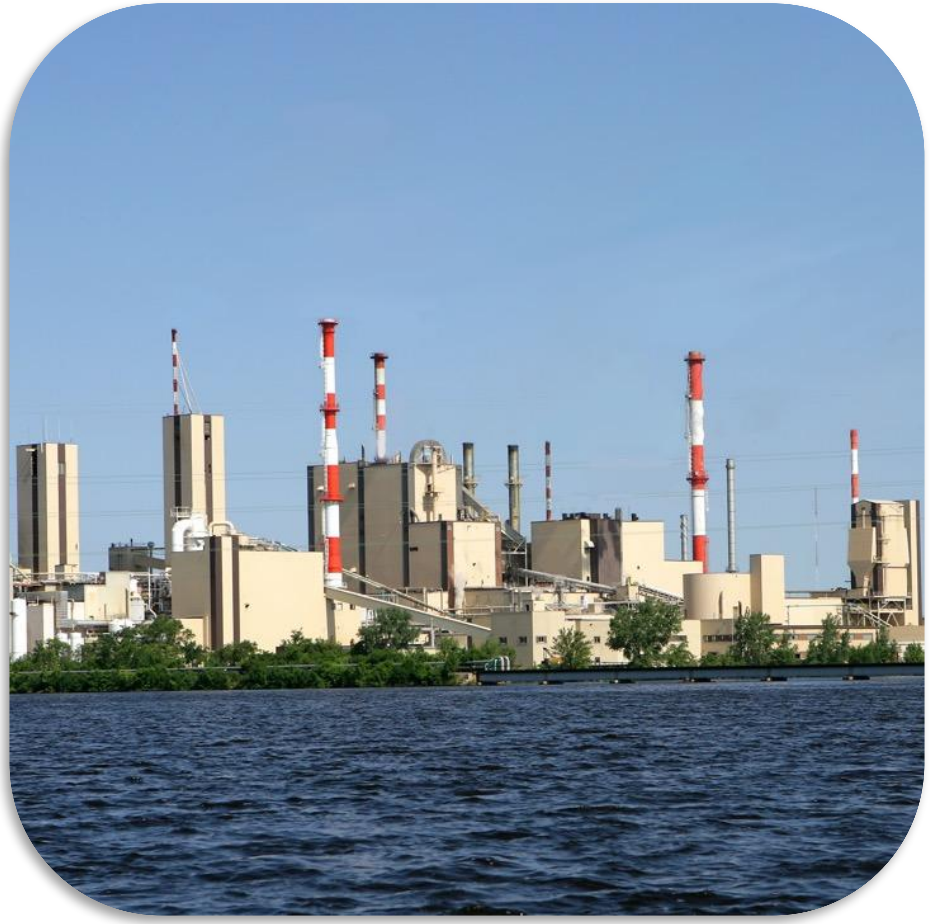
- Poor monitoring of written sustainable investment policy or lack thereof
- Short time horizons and extractive strategies incl. in regions with high corruption, poor human rights records, etc.
- Transfer of value from stakeholders to shareholders & inadequate or no adoption of ESG
- Use of subscription credit lines to inflate performance and overpaying for portfolio companies

Portfolio Company

- Poor CEO-aligned incentives and employee outcomes
- Incorrect and misleading use of ESG & financial performance metrics and methodologies
- Elimination of products/services not conducive to short-term value creation
- Stakeholder value depletion and poor alignment with ESG & UN SDGs
- Excessive debt loading & creation of secondary debt obligations

Case Study: Changing Ownership of Consolidated Papers: Two Successive PE Owners Drive It Into Bankruptcy

- Established in 1902 in Wisconsin Rapids; controlled by the Mead family
- World-class manufacturer of paper for commercial printing, catalogs, brochures
- In 2000, company was sold to international pulp/paper company, Stora Enso
- PE-backed NewPage acquired Stora Enso's North American assets in 2007. Bankruptcy ensued.
- PE-backed Verso acquired NewPage in 2015 bankruptcy ensued.

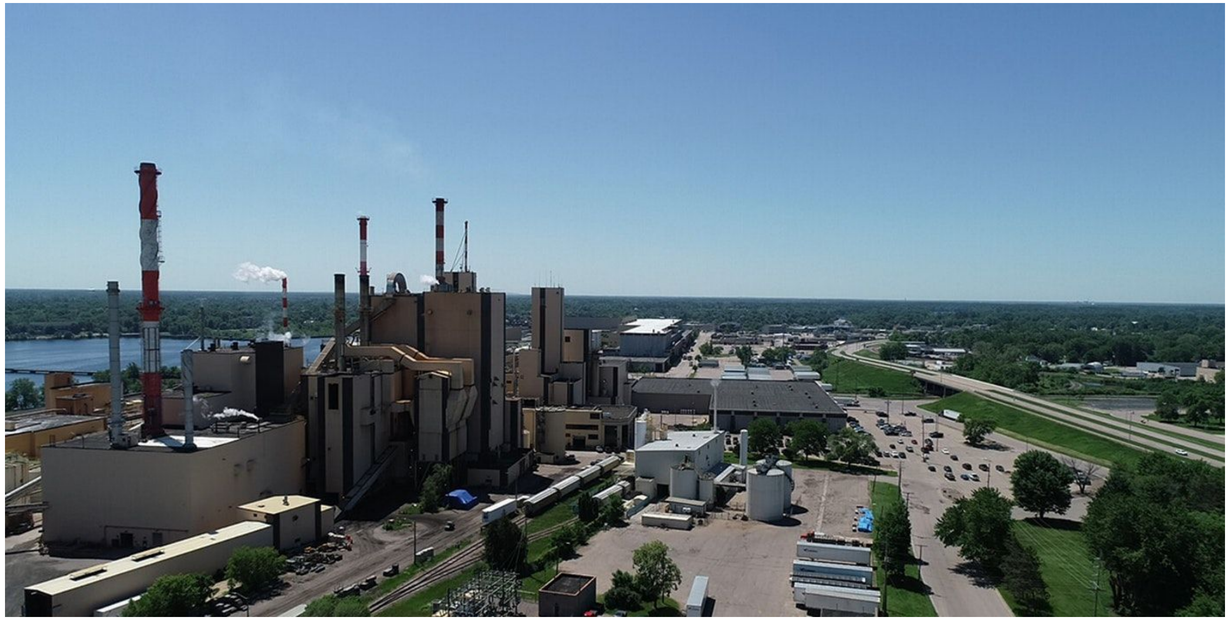


Ownership Hurdles (Non-PE Owner)

Stora Enso (2000 – 2007)

Over-paid to purchase Consolidated Papers

Fundamentally mis-read trends in commercial printing markets and increased its investments in coated paper



Ownership Hurdles (PE owners side by side)

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

WI Case: 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

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Factor	Weight (1-100%)	Score (0-100)
Scope 1 & 2 Emissions	30%	20 (emissions above industry avg)
Company Diversity	20%	100 (high employee diversity)
Employee Turnover	35%	50 (industry avg employee turnover)
CEO to Employee Pay Ratio	15%	100 (low CEO to employee pay ratio)
Overall Weighted Score	58.50 (out of a possible 100)	