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

NYU Stern CSB research initiative
Outline

- Objectives
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- PE Accountability Framework
- Value Driver Matrix
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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

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

<table>
<thead>
<tr>
<th>Sustainable and Responsible Investment Policies</th>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>A sustainable and responsible investment policy defined by firm priorities and monitored implementation</td>
<td><strong>I.</strong> <em>A robust and credible sustainable investment policy</em></td>
<td>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</td>
</tr>
<tr>
<td></td>
<td><strong>II.</strong> <em>Monitored implementation of the sustainable investment policy</em></td>
<td>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)</td>
</tr>
</tbody>
</table>
**Impact Outcome Framework for PE Firms (Management & Human Capital)**

<table>
<thead>
<tr>
<th>Management &amp; Human Capital</th>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| **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)

## Strategy & Innovation

*Describes the 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>
<tbody>
<tr>
<td>i. <strong>Long-term horizon and investment sourcing alignment with ESG and/or UN SDGs</strong></td>
<td>i. Sourcing of investments in line with firm’s sustainable investment policy with respect to region, timeframe, UN SDG progress, sector/industry focus.</td>
</tr>
<tr>
<td>ii.</td>
<td>ii. Holding periods consistent with driving innovation and returns, e.g. perpetual funds vs shrinking of investment cycles</td>
</tr>
<tr>
<td>iii.</td>
<td>iii. Implementing and adhering to sector-specific sustainability guidelines</td>
</tr>
<tr>
<td>iv.</td>
<td>iv. Duty of care toward public goods (even when privately owned) such as water and forests</td>
</tr>
<tr>
<td>v.</td>
<td>v. Responsible exits</td>
</tr>
</tbody>
</table>
## Fund Management

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

<table>
<thead>
<tr>
<th>Impacts</th>
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</tr>
</thead>
</table>
| 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)

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| **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 |

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**Societal Impact**

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

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| 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)*

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| **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 |

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

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| 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 |

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

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Debt-loading</strong></td>
<td>i. Asset-stripping</td>
</tr>
<tr>
<td></td>
<td>ii. Creation of secondary debt obligations to pay shareholder distributions</td>
</tr>
<tr>
<td></td>
<td>iii. Dividend recaps</td>
</tr>
<tr>
<td><strong>II. Use of chapter 11 bankruptcy as a reorganization tool</strong></td>
<td>i. Appointment of bankruptcy experts to the board</td>
</tr>
<tr>
<td><strong>III. Capital Structures</strong></td>
<td>i. Enabling capital structures for positive impact (ESG-linked credit)</td>
</tr>
<tr>
<td></td>
<td>ii. EBITDA add backs and adjusted EBITDA</td>
</tr>
<tr>
<td><strong>IV. Tax structuring and accounting</strong></td>
<td>i. Value of tax avoidance as a result of corporate tax maneuvering</td>
</tr>
</tbody>
</table>
Impact Outcome Framework for Portfolio Companies *(Reporting Transparency)*

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. ESG Reporting</strong></td>
<td>i. Audited financially material ESG metrics to internationally accredited standards</td>
</tr>
<tr>
<td></td>
<td>ii. Audited ESG performance trends</td>
</tr>
<tr>
<td></td>
<td>iii. Reporting financial impacts of ESG (ROSI)</td>
</tr>
<tr>
<td><strong>II. Financial Reporting</strong></td>
<td>i. Reporting multiple financial performance metrics i.e. IRR, PME, DPI, RVPI and TVPI</td>
</tr>
</tbody>
</table>
**Impact Outcome Framework for Portfolio Companies (Societal Impact)**

<table>
<thead>
<tr>
<th>Impacts</th>
<th>Sample Data Points</th>
</tr>
</thead>
</table>
| 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 |

Societal Impact

Embedded sustainability driving well-documented, improved performance on ESG issues, stakeholders, and impact indicators such as the UN SDGs.
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**
- Robust impact, including ESG framework adoption, execution and adherence
- Long time horizons and investment sourcing alignment w/ ESG and/or UN SDGs
- Prudent handling of dry powder (opportunity cost vs holding time frame)

**Creation Divers**
- Transparency of ESG & financial performance metrics and methodologies
- CEO-aligned incentives with longtermism and positive employee impacts
- Increased research expenditure and sustainability-driven capital investments
- Prudent management of debt capital structures for good

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

**Portfolio Company**
- **Management & Human Capital**
  - Poor CEO-aligned incentives and employee outcomes
- **Reporting Transparency**
  - Elimination of products/services not conducive to short-term value creation
- **Strategy & Innovation**
  - Incorrect and misleading use of ESG & financial performance metrics and methodologies
- **Societal Impact**
  - Stakeholder value depletion and poor alignment with ESG & UN SDGs
- **Financial Engineering & Leverage**
  - Excessive debt loading & creation of secondary debt obligations

**Negative Value**

**Creation Drivers**

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NYU STERN Center for Sustainable Business
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
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)


- Leveraged buyout and substantial debt
- Declining markets
- Frequent CEO turnover (7 CEOs)
- Upon emerging from bankruptcy it became a takeover target

**Verso Corporation (2015 - )**

- Leveraged buyout and substantial debt
- Declining markets
- Frequent CEO turnover (8 CEOs)
- Failed to avoid bankruptcy proceedings
- Suffered financially
- Faced bankruptcy proceedings
- Pandemic impact
- No successful course correction
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
Contacts

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Paul Fowler, *Author, Consolidated Papers/Wisconsin Rapids Case Study*
Email: paul.fowler@diligentiaconsulting.com
<table>
<thead>
<tr>
<th>Factor</th>
<th>Weight (1-100%)</th>
<th>Score (0-100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope 1 &amp; 2 Emissions</td>
<td>30%</td>
<td>20 (emissions above industry avg)</td>
</tr>
<tr>
<td>Company Diversity</td>
<td>20%</td>
<td>100 (high employee diversity)</td>
</tr>
<tr>
<td>Employee Turnover</td>
<td>35%</td>
<td>50 (industry avg employee turnover)</td>
</tr>
<tr>
<td>CEO to Employee Pay Ratio</td>
<td>15%</td>
<td>100 (low CEO to employee pay ratio)</td>
</tr>
<tr>
<td><strong>Overall Weighted Score</strong></td>
<td><strong>58.50</strong></td>
<td><strong>(out of a possible 100)</strong></td>
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