Client Alert:

Dispelling the myths of ESG and why it matters to Private Equity

MARCH 2022

By Sarah Keeling, Tracey Groves, Piers De Wilde and Jack Martin

The heightened focus on Environmental, Social and Governance ("ESG") for business has been one of remarkable escalation. Google analytics show that internet searches for the term "ESG" increased nearly six-fold between March 2017 and March 2022. This rise has not eluded the private equity and wider investment industry, with data provider Visual Capitalist estimating that global ESG assets under management have grown from USD 6 billion in 2015 to USD 150 billion in 2020, a 25-fold increase.

Whilst ESG as a concept is still relatively amorphous, the idea of corporate integrity lies at its heart, encapsulating ethical values and doing the right thing. Here, we explore a selection of myths relating to ESG, and discuss the competitive advantages for private equity firms that act now to identify their priority areas for transformational change, enhanced value creation and elevated business performance.

ESG does create value

The concept of corporate integrity has led some to believe that ESG creates more cost than benefit for companies. Does ESG genuinely deliver competitive advantage? Can it really drive prosperity in terms of people, plant and business? If so, how do we measure that? KPMG's 2021 CEO Outlook found that only 37 percent of UK CEOs believe that their ESG programs actually improve financial performance. However, ESG can be a real driver of value and growth. A strong ESG profile can attract potential investors, employees,

lenders, and vendors. It can also help build organisational brand and retain high performing talent. Moreover, incorporating ESG factors can enhance portfolio returns by reducing volatility, providing protection and lead to longer-term returns. For example, in a 25-year study, academic Alex Edmans found companies that made Fortune's "100 Best Companies to Work For" list generated 2.3 to 3.8 percent higher stock returns per year than their peers.

Conversely, "weak ESG performance is often viewed as a red flag," according to a January 2022 report by the Institute of Directors. Furthermore, 59% of senior executives surveyed by law firm DWF in December 2021 noted that they lost work due to ESG issues, illustrating the potential bottom-line impact.

ESG also provides a different line of sight and a different lens to view operational risk. In early 2022, an external investigation into mining giant Rio Tinto, uncovered a "toxic workplace" culture. Almost half of the Rio Tinto's employees were identified to have experienced bullying in the past 5 years. A third of its female workers also endured sexual harassment, including 21 women who reported an actual or attempted sexual assault. Whilst undoubtedly critical findings in their own right, seen through an ESG lens these findings present a real, existential threat to the company and pose numerous questions. How does Rio Tinto attract or retain employees given this information? Is the company sustainable, given the systemic nature of inappropriate behaviours and identified misconduct? What other corporate failing is Rio Tinto potentially guilty of, given the lack of a moral compass? Where was the robust corporate governance in ensuring good quality processes and procedures to respond to these inappropriate behaviours, built on ethical values and a strong corporate purpose? This is an example of two significant areas of ESG, with culture and ethical decision-making cutting across the 'social' and 'governance' factors of the strategic ESG risk agenda, and a unique line of sight that private equity and other investors should consider as part of their wider due diligence processes and procedures.

ESG can also help show value and ESG data can be used as part of the assessment for return on investment for a private equity firm. The more data a portfolio company can report and disclose, the better its ESG rating, which can lead to several positive impacts, such as access to cheaper finance. However, as a recent report by Bain notes: "collecting quality, comparable ESG data across an investment portfolio is posing real challenges. Investors must navigate numerous methodologies, frameworks, and approaches to translate ESG policies into concrete, data-driven processes and actions."

ESG is here to stay

Nor is ESG a passing phase and purely a preoccupation of a certain generation. It is widely popular across all demographics and here to stay. According to Bain's 2021 Private Equity report, 79% of consumers are changing preferences based on sustainability and 61% of employees believe sustainability should be mandatory for companies. Most importantly for private equity stakeholders, investors have been early adopters and drivers of change, with 88% of limited partners measuring ESG performance indicators ahead of investment. Whilst elements of ESG regulation in the EU have already been enacted, SEC chairman Gary Gensler

is also thought to be an advocate of ESG regulation in the US. Private equity must make sure it takes advantage before regulation becomes mandatory.

Some private equity actors appear to have realised the staying power of ESG and have begun to embrace it. Jean-Rémy Roussel, Managing Partner of CVC Equity Partners noted in 2021 that "ESG isn't just about recognising what customers and other stakeholders really want and turning that into a strategy that creates tangible value." Other large players are actively investing in ESG related or friendly funds and companies, illustrated by KKR's May 2021 acquisition of environmental consultancy ERM. For Andros Payne, Managing Partner of Humatica, which provides organisational effectiveness for private equity clients, good governance in particular will serve as the "foundation" for positive ESG policy. At the end of 2021, more than 3,000 institutional investors and private equity firms had signed up to the United Nations' Principles for Responsible Investment; it is important that private equity firms ensure their portfolio companies also adopt these goals but there is far more work to be done.

Strong ESG policy and adoption can help attract and retain funding from investors and limited partners like pension funds, who increasingly operate with strict investment criteria. Moreover, management teams with a demonstrable track record of embedding ESG practices provide an additional indicator of their overall effectiveness.

ESG does not exclude industries

Another myth of ESG is that it excludes or dismisses industries, whether that be oil and gas or defence. Micael Johansson, Chief Executive Officer of Swedish defence provider SAAB Group recently told the Financial Times that he was "frustrated" that his company was viewed as "not sustainable." However, SAAB's vision as laid out on their website is striving to "keep people society and people safe," an unarguably laudable goal. It is important that we must be cognisant that there are different challenges in each sector, look beyond the explicit products or solutions and instead, examine the intrinsic and extrinsic motivators of any business when it comes to ESG and the context in which they are driven. These motivators must be manifested consistently in what, why and how the company operates in order to demonstrate corporate integrity and a commitment to doing the right thing.

Act now

Whilst ESG regulation and governance may be coming down the track, private equity and their stakeholders should not wait for this and instead act now. A December 2021 survey of senior executives by law firm DWF showed that 63% of businesses would consider "appointing consultancy style services to help implement ESG into business," indicating how ESG has entered the boardroom.

A "one size fits all" approach to ESG will not work given the diverse stakeholder priorities that will differ across the end-to-end scope of ESG, based on areas of risk and materiality, as well as variable expectations. Furthermore, many will be at different stages of their ESG journey and the vision of what good looks like will be dependent on risk profiles, stakeholder scrutiny, and strategic goals and aspirations.

About the Authors

Sarah Keeling, a Partner with StoneTurn, is a former senior British government official with more than 24 years of experience in national security and intelligence matters in the U.K. and overseas. She assists companies, family offices and their counsel on operational, reputational and investment risk matters worldwide.

Tracey Groves, a Partner with StoneTurn, brings more than 30 years of experience in corporate governance, ethical conduct and behaviors, regulatory compliance, risk assessment, and culture change. She counsels leaders of complex, global organisations on environmental, social and governance (ESG) strategies that accelerate growth and innovation, drive ethical conduct and culture, and unlock responsible business performance.

Piers de Wilde, a Managing Director with StoneTurn, has more than 15 years of experience in business intelligence and investigations. He focuses on pre-transactional due diligence, litigation support, specialist investigations and strategic intelligence.

Jack Martin, an Executive with StoneTurn, specialises in business intelligence and investigations. He focuses on litigation support, asset tracing and recovery, strategic and cross-border investigations, investigative and pre-transactional due diligence.

Sarah Keeling
Partner,
StoneTurn
skeeling@stoneturn.com
+44 (0)20 7427 0417

Tracey Groves
Partner,
StoneTurn
tgroves@stoneturn.com
+44 (0)20 7898 3426

Piers de Wilde
Managing Director,
StoneTurn
pdewilde@stoneturn.com
+44 (0)20 7427 0416

Jack Martin
Executive,
StoneTurn
jmartin@stoneturn.com
+44 (0)20 7898 3425

Leaving no stone unturned.

StoneTurn, a global advisory firm, assists companies, their counsel and government agencies on regulatory, risk and compliance issues, investigations and business disputes. We serve our clients from offices across the U.S., U.K. and in Germany, Brazil, South Africa and Singapore, assisted by a network of senior advisers around the world.

StoneTurn.com

© 2022 StoneTurn UK Limited,. All rights reserved.

StoneTurn