ESG topics that drive portfolio value creation in Private Equity

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Years of ESG-related financial commitment and technical development in private equity have resulted in a state of practice where investors are beginning to settle, by consensus, on the most common elements of ESG programming at the fund/firm level. These elements include policy, due diligence integration, planning at the portfolio company level, metrics and monitoring activities with portfolio companies, and externally facing reporting. Not all private equity programs include each of these aspects, but leading programs include some flavor of them all. While these components make up the essential organs of healthy and successful ESG programs, they are not necessarily the place where the commercial value of ESG programming presents itself first. ESG initiatives can find the most direct route to value creation at the portfolio company level. It is here that ESG can help or impact the bottom line, the value of which can in turn be harvested at exit. The following discussion explores several of these opportunity areas in detail. These topics are not presented to suggest that other ESG topics are less important, but only to illustrate where we at Bridge House Advisors have found the most success in implementing ESG strategies to create tangible value for our clients and their key stakeholders. Put another way, these are the ESG topics that we've seen cause the deal teams to sit up in their chairs.

ESG Topic 1: Energy & Resource Efficiency

This area of opportunity is arguably well-understood within the private equity sector, yet few managers have been successful at fully exploiting it. By now, the results achieved by Blackstone's Portfolio Operations Group, and some of the tactics they employ, have been well communicated as the program has been in place for several years (Sustainability: Myth, Madness and Magic). While it's true that every private equity firm does not have a sandbox the size of Blackstone's, the fact remains that a set of proven energy and resource efficiency tactics directed at the right portfolio companies (think 80% of the total energy and utility spend across the fund) should be able to drive some tangible cost savings.

Bridge House is currently working with a large fund manager to help them develop and deploy a program at the fund level that will drive energy and utility demand reduction at selected portfolio companies. The approach, as per one of the fundamentals discussed in the Blackstone piece, starts with analysis of energy performance data using a variety of benchmarking techniques. This enables the identification of not only the best companies, but the best assets within the companies, to focus first on driving cost savings as quickly as possible. Analysis of eight (8) companies in the fund, prioritized by a number of factors (most importantly their current annual consumption and cost of utilities), revealed the following upside:

- A conservative annual cost savings potential of **$23M**.
- Near-term (i.e., quick start) cost savings opportunities at six (6) of the companies worth **$6.7M**.

ESG Topic 2: Climate Risk & Mitigation

During the **PEI's Responsible Investment Forum** event back in March in NYC, one of the most repeated words over the 2-day event was "climate", either from a physical risk or energy transition perspective. As the private equity sector sorts through inbound climate-related inquiries from LPs, Bridge House Advisors is seeing two potential, yet different, courses of action begin to emerge: 1) understanding the climate-related risks faced by portfolio companies within a fund and quantifying the associated financial impacts, and 2) understanding the carbon footprints of portfolio companies and developing strategies to reduce carbon emissions, including the purchasing of offsets.

Both approaches have merit. The former is focused on understanding the potential external impacts of climate change on your portfolio companies, identifying which companies are most at risk, quantifying the financial impact under future climate change scenarios, and developing plans to mitigate, should they occur. The latter, carbon footprinting, is focused on understanding the individual contributions of your portfolio companies on global climate change and developing practical strategies to reduce carbon emissions. The right approach will be a function of the types of companies in the fund. Direct heavy emitters of greenhouse gases (think energy production, agriculture and forestry, heavy industry and transportation) will likely need to understand their carbon footprint for a variety of reasons, including exposure to future regulatory regimes, carbon emissions trading, and evaluation of emerging technologies that can reduce emissions. Other industry sectors, whose largest component of their carbon footprint is the electricity that they purchase (called Scope 2) may benefit more from a detailed understanding of the potential threats to their business due to the effects of climate change.

So, where can value creation occur? It's true, the above is focused primarily on risk mitigation (although an energy efficiency initiative, as discussed above, can result in tangible operational cost savings and reduce a company's carbon footprint). Bridge House's perspective is that the value of these efforts will be realized at exit. **Climate-resilient assets will simply be worth more 4 to 5 years from now when you are positioning the company for sale**. We believe that a portfolio company that is able to articulate its material climate risks at the asset level, can estimate the financial impact of these risks under a few carefully applied scenarios, and can present thoughtful mitigation strategies – combined with a track record of strong financial performance, of course – will command a higher valuation compared to similar companies that lack this insight.

ESG Topic 3: Impact & Tracking

As per Bridge House Advisors' 3-part thought leadership series on ESG and Impact Investing (2019), there is a supply-demand imbalance, particularly in North America, between large funds designated for environmental or societal "impact" and the availability of investment targets at scale that are "impact ready", i.e., companies who are capable of quantifying and tracking their broader impacts that match up with the impact objectives of these funds. Our message to middle and upper-middle market private equity investors is this: You might have several companies in your current fund that have compelling impact on the environment or society, and, if you were to investigate, quantify, and begin to talk about that broader impact, you might have an opportunity to exit to an impact fund --- and be the recipient of a higher financial return. According to a 2019 Bain & Company report in the Asia-Pacific region (Private Equity Investor Embrace Impact Investing), "the median multiple on invested capital was 3.4 for deals with social and environmental impact, compared with 2.5 for other deals." This trend bodes well for private equity and their portfolio companies who make investments in Impact Opportunity Assessments (IOA).

Take, for example, Buyouts' pick for the 2019 Middle Market Deal of the Year: FFL Partners. Bridge House Advisors prepared an IOA for the Crisis Prevention Institute (CPI) as FFL prepared to exit this investment, which, according to both FFL and CPI, added to the already strong financial performance of the business. The key headlines of CPI's broader societal impact were as follows:

- **Violence against women**: From 2017-2019, 183 violent incidents against women (which would have resulted in at least one day out of work) were likely avoided.
- **School suspensions**: From 2017-2019, 51 public high school student suspensions were likely avoided.
- **Anti-psychotics**: Annually, 703 deaths related to psychotropic drug usage were likely avoided.

ESG Topic 4: Environmental Insurance Recovery

Yes, this is still a thing. Prior to 1985, general business insurance policies typically did not exclude pollution liabilities. Further, these policies were generally setup as "**occurrence based**" rather than "**claims based**". So, fast forward to today, if a policy holder can demonstrate that pollution occurred during the policy period the coverage may still be valid.

Insurance companies are aware of these legacy policies, as most have established financial reserves for them which ties up working capital. These carriers are often motivated to negotiate a settlement for these policies to clear the books and lower their reserves. In fact, there is an established precedent of negotiated settlements on these legacy policies with many of the Fortune 500. The earliest cases were litigated, which was not ideal for either party, thus the willingness to settle.

There is still a window of opportunity to potentially pursue Environmental Insurance Recovery at the portfolio company level. Here are some of the key criteria to determine if an opportunity exists:

- Company operations pre-date major environmental laws (i.e., pre-1985);
- Company operations are environmentally sensitive: chlorinated solvents, plating operations, petroleum, PCBs, etc.;
- Corporate still has rights to legacy insurance policies; and
- Environmental liabilities are likely > $10M.

Now here's the key: settlements are based on **Possible** Loss Exposures, not Actual or Likely Loss Exposures. Meaning, you don't have to prove the existence of contamination to meet up at the negotiating table. Rather, you only have to make a credible argument on the potential for contamination. One-time settlements can be significant:

- Energy Company: $8M with one insurer; total recovery **~$10M**.
- Bearings Manufacturer: **~$7M**.
- Material Manufacturing Company: **~2M** recovered to date with several significant demands outstanding.
- Large Municipal Airport: **~$8M** recovered.

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