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CLAIRFIELD INSIGHTS ON ESG & IMPACT INVESTING

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Environmental, social, governance

Environmental, social and governance (ESG) – why has this become such a huge investment topic lately?

The topic of ESG investing started with a letter. In 2004, the former UN General Kofi Annan invited over 50 CEOs of major financial institutions to join the World Bank‘s initiative, designed to integrate ESG into capital markets. Kofi Annan probably could not have imagined ESG investing becoming such a growing priority for institutional investors worldwide, along with another acronym, the SDGs. They represent the 17 Sustainable Development Goals which the United Nations created in 2015 as a roadmap toward a more sustainable world.

Various actors such as governments, private and public companies as well as civil protesters such as the Swedish teenager Greta Thunberg have propelled ESG/SDG investing lately. Tightened regulations have resulted in increasing interest and obligation of institutional investors including asset managers, insurance companies, and pension funds to incorporate ESG criteria in their investment strategies. Equally important, recent initiatives contributed to improving the level of transparency on ESG criteria.

The European Commission, for example, published a first-time taxonomy in June 2019 laying out which economic activities are “green”, making benchmarking for ESG bond market participants easier and more effective. Furthermore, new digital technologies not only revolutionize the corporate world these days. They also significantly improve the quality of ESG data.

How has the view towards ESG changed?

Employees, customers, and governments are all increasingly pressuring companies to play a more prominent role in addressing critical challenges such as climate change and economic inclusion. Medium-sized companies as well as large corporates respond by actively searching for new Corporate Social Responsibility (CSR) projects, in addition to their traditional CSR activities.

Several multinationals initiate social businesses in developing countries either alone or together with strategic partners such as development banks. To mitigate the risk of these direct equity investments they often contribute their own technology and product know-how to those social business start-ups. This type of CSR project resembles venture philanthropy addressing social challenges while supporting business reputation and growth.

More companies, no matter their size, begin to screen their own activities with regard to whether and to which degree they comply with the SDGs. This often leads to investing strategically in their people and processes in order to be more socially or environmentally minded. Also, there is a growing number of companies matching their own SDG profile with their financial investments, including alternative investments such as corporate acquisitions. Another example of a notable change in the approach towards CSR is the

The changing definition of what it means to be a great business

increasing number of corporate VCs focusing on socially responsible startups, often combined with providing pro bono advice. This strategy not only allows investments in new innovative products and services with sustainable growth opportunities. Simultaneously, these "CSR investors" assist in strengthening the business angel scenes in countries such as Germany while attracting and retaining talented staff. I am confident that initiatives like the ones briefly listed above will become common CSR practice.

Fair practices, acting responsibly for the environment, supporting the community – all of these things cost money. How is ESG good for a company's bottom line?

A company strategy consistently incorporating ESG practices will always be financially beneficial, if not immediately then in the medium term. Numerous studies have recently been undertaken showing that companies with sustainable practices outperform companies that have not integrated ESG considerations into operations.

These studies are still rather fragmented and lack scale but companies have already shown in several ways how best to monetize the ESG/SDG potential. The following examples illustrate the link between ESG/SDG compliance and financial performance:

- Penetrate new markets with a focus on environmental sustainability or societal needs that other companies have not done. Despite the initial investment, being a first mover in a market with untapped customer groups is often a wise strategic move leading to long-term profitable growth.
- Identify and invest in new products or business models with a clear ESG/SDG focus that open up new geographic or demographic markets or which allow the development of lower cost products and services for already existing markets.
- Develop more inclusive supply chains that are more cost effective since they depend on fewer suppliers and distributors and allow raw material sourcing closer to the end market.
- Increase sales and support premium pricing on products that have an environmental or social impact and are reasonably sourced. This product strategy, for example, in the consumer goods industry, can also lead to higher customer loyalty.
- Gain a competitive advantage in attracting, engaging and retaining talent. More meaning from work often translates into more robust financials.
- Obtain favorable financing terms since there is a rapidly expanding source of equity and debt funding requiring companies to show genuine commitment to ESG values.

Have you seen ESG taken into consideration in M&A processes?

Despite the struggle of balancing short-term and long-term objectives, I have seen both corporate and private equity sponsors evaluating and subsequently investing in companies having applied ESG criteria.

Drivers were not merely the avoidance of potential litigation or own investor pressure. The additional ESG lens was applied with a view of evaluating the cultural fit of the target company, reducing future business risks as well as building sustainable competitive advantages eventually resulting in a higher company evaluation. Various private equity firms I worked with in the past not only use ESG criteria for identifying target companies. They also use them as KPIs to measure and report on the progress of their portfolio companies. Not surprisingly, some of the largest global private equity firms have already raised impact funds.

TPG, for instance, has raised the largest global private equity impact fund (USD 2 billion) to date and is about to raise a new USD 3 billion fund. This year, KKR topped the USD 1 billion fundraising goal for its first Global Impact Fund which invests in businesses providing commercial solutions that specifically contribute measurable progress toward one or more of the SDGs.

The millennial generation, which is already actively involved with socially responsible investing, will soon make inroads into decision-making levels at corporates, institutional investors, family offices, and foundations. In this capacity, they will surely be another driver in making ESG analysis a standard tool in the M&A process.

Going forward, will "The ESG Factor" play an increasingly important role in corporate finance and particularly for Clairfield ?

The straightforward answer is "Yes, indeed!" In 2018, assets managed by funds incorporating a socially responsible vision amounted to USD 30.7 trillion around the world. This is ten times higher than in 2006, according to the latest data published by the Global Sustainable Investment Alliance. ESG due diligence will become a core element in corporate finance advisory, despite its relative newness.

It will comprise more than just a thorough environmental due diligence."Impact M&A" will address the target company's control systems, gender diversity of its business and board, health and safety standards of its workforce and suppliers, governance structures to avoid corruption, and numerous other aspects. Definitive standards around this set of indicators have not yet been accomplished, but strong efforts into the standardization of ESG criteria are ongoing.

In the Clairfield Annual Outlook 2021 you may already see successfully completed transactions mapped against ESG and SDG criteria reflecting what Peter Drucker once said, "Every single social and global issue of our day is a business opportunity in disguise."

Alexander Klemm is chairman of Clairfield International. He is also a managing partner of Clairfield in Frankfurt.

Private equity and ESG policies

We have all heard of to the importance of environmental, social and governance (ESG) issues which have become mandatory considerations for company management, private equity, and institutional investors.

Investors go even further by saying that sustainability goes hand in hand with performance. Mainstream private equity funds are neither impact investors nor venture capitalists. Even so, leading investor groups are putting their money into companies offering innovative products and solutions to sustainability challenges in our economy and society. Superior investors will strive to successfully combine these objectives with aspirationally exceptional financial performance.

A growing number of European private equity firms publish ESG annual reports setting out investment principles that embrace ESG in transactions and management of respective portfolios. Guidelines can be found in signing up to Principles of Responsible Investment (PRI), a UN initiative launched in 2006 by Kofi Annan in order to incentivize financial investors to integrate ESG issues into investments on a voluntary basis. Some 2,300 signatories have made this commitment. Various academic publications have tracked the stance private equity is taking in regard to ESG (see P. Crifo, C.D. Forget, “Think global, invest responsible: why the private equity industry goes green”, Journal of Business Ethics, August 2013, Vo. 116, Issue 1, pp. 21-48, and ditto, “The price of ESG practise disclosure: an experiment with professional private equity investors”, Journal of Corporate Finance, February 2015, Vol 30, pp. 168-194).

The private equity environment is accustomed to addressing ESG factors in themselves. However, managing ESG investment under a broader structure is an approach that is fairly new. It also raises challenges for M&A advisors. Today, private equity general partners follow frameworks for managing ESG considerations and engaging in buy side transactions, which may converge to best practice. This transaction framework includes, firstly, an assessment of risk factors in the pre-investment process starting with target business compliance to local laws, business best practice and a view on reputational risk. Secondly, targeted process-driven procedures in the investment process will limit ESG risk exposure due to rigorous discipline in assessing ESG risks of a target. Thirdly, integrating results from such procedures into the investment process itself, as well as subsequent ESG monitoring, reporting and investor accountability will provide an effective ESG framework for investors.

It is real life actions that mark the difference between merely following ESG standards and wholly integrating these into all phases of the investment process as set out below, which M&A advisors should be mindful of when assisting their private equity investing clients:

The pre-investment phase:

- Exclude prohibited sectors as defined.
- Determine scope and focus of ESG due diligence.
- Perform pre- and post-closing ESG due diligence by identifying ESG risks and opportunities, profiling momentum and direction, and creating a roadmap to address ESG issues.
- Establishing ESG firm valuation drivers and pricing considerations.

Ownership phase:

- Engagement with management and the company.
    - present ESG due diligence results and discuss with management.
    - develop ESG KPIs and roadmap.
- Establish ESG reporting and continuous benchmarking with peer group and industry best practice standards.

Exit:

- Maximize ESG contribution to return on investment (ROI).
    - Highlight ESG performance and value add by ESG improvement to new owners of the business.
    - Prepare business to be sold proactively addressing ESG due diligence issues by new investors.

ESG issues clearly also impact M&A advisors when assisting investor groups in buying or selling businesses. A recent survey (Mergermarket/IHS Markit, Q1 2019) set out that ESG is on the rise and steadily becoming a more prominent feature in advisory work in terms of asset or target selection for investors, due diligence requirements, and exit considerations. Respondents of the Mergermarket survey say that climate change and greenhouse gas emissions, along with human rights and labor standards, are the specific ESG issues of most concern. ESG considerations are developing rapidly and it is imperative for private equity investors and M&A dealmakers to form strategies to address these concerns and harness the desire to do good in their work in the very near term.

Mathieu Cornieti is the CEO of Impact Partners, a European social-impact private-equity fund with EUR 110 million in assets under management.

Purpose and profit

The *banlieues*, troubled urban districts of Paris, attracted international attention in 2005 when a former French president said he wanted to clean up these unruly districts with a Kärcher high-pressure hose. The *banlieues* are also home to some incredible entrepreneurs who play a vital role in creating employment among those most in need. Unfortunately, their limitations dictate a much more challenging path to receive support to grow their businesses. As a social investment fund, we make providing that support and financing one of our priorities.

Clearly any action that supports the creation of employment in these disadvantaged urban pockets is a win for French society. But supporting entrepreneurship and creating jobs is not a necessity only in the French banlieues. Social issues may have certain local characteristics in different countries, but such cultural nuances are irrelevant. It is a necessity of society everywhere to create jobs. Entrepreneurs with social impact goals have an incredible opportunity to influence the growth of their respective communities. This is the focus of Impact Partners and our investment philosophy.

Impact Partners was launched in 2007 as one of the first social impact private equity funds in Europe. It now employs over 30 people and is poised to open an office in Frankfurt. Founded in Paris, we now manage some EUR 110 million in assets under management. Our investor base includes over 100 individual, private and public institutional investors who are committed to supporting entrepreneurs focused on social impact. Entrepreneurship for social impact is our passion. To date, we have invested in over 100 situations. Currently we are supporting 28 entrepreneurs in deprived urban areas who have created programs for disabled workers and apprenticeships. We have invested in the “circular economy” such as recycling and logistics companies. Additionally, we support inclusive education, e-learning, and programs for the unemployed.

In business today, management, institutional investors, and private equity funds require attention to environmental, social, and governance (ESG) issues. Impact investors go further by maintaining that sustainability, and social impact goes hand in

Impact Partners improves communities by supporting social entrepreneurs

hand with business performance. Impact Partners lives out our investment philosophy and commitment to social growth every day. As an investor, Impact Partners needs to act and be seen as uncompromisingly professional. Impact investors are not charities but very demanding investors, not in a philanthropic niche, but mainstream private equity that aims to make a profit.

We connect with German cultural and social issues in Germany and French issues in France. But we are united by one common endeavor: to support social entrepreneurs in their communities. We value our partnership with Clairfield in this pursuit, as they help us connect with investors and seek new opportunities. With luck and hard work, in a few years, these successful entrepreneurs will need M&A advice and Clairfield can help! This is yet another vision of the circular economy.

SECURIVIEW NEXT GENERATION SOC
backed by
IMPACT PARTENAIRES
was sold to
LINKBYNET

+QUE PARFAIT Propreté & Services Associés
backed by
IMPACT PARTENAIRES
was sold to
ARMOR GROUPE

ecolotrans véhicule vos valeurs
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IMPACT PARTENAIRES
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was sold to
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