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How ESG can create value in your portfolio: enhancing sales and valuations

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Using ESG (environmental, social & governance factors) to drive value creation in a portfolio company requires a different approach to meeting the increasing ESG demands of investors - the main driver of ESG in PE in recent years.

PE firms are now getting to grips with how ESG can drive value creation in specific portfolio companies, while bridging this agenda with portfolio-wide / investor agendas.

How can they best do this?

- The first step is to recognise that ESG can drive value creation in two distinct ways: it can support sales growth during PE ownership and enhance valuations by addressing the concerns and agendas of potential future investors at exit.
- The second step is to recognise that both types of value creation often require very different approaches – what creates value for customers can be very different from what creates (or protects) value in the eyes of investors

1:

ESG and sales growth.

There are big differences between how ESG can support sales growth in B2C, B2B and B2G businesses.

B2C. For B2C, the greatest value creation opportunity is through the development of marketing-led ESG consumer offers (e.g. around organic, vegan, emissions or labelling/certification schemes, like Fair Trade.) But ESG can also yield product quality benefits if used to identify and manage suppliers who can deliver higher quality products. (For example, suppliers that don't have good health & safety systems tend not to have good systems for quality control).

B2B. The relevance of ESG to B2B sales growth is becoming more apparent, as the private sector cascades its own ESG policies or regulatory demands into its supply chain, through tenders and contracts. ESG criteria are becoming more prominent in tenders, award criteria and in the use of supplier platforms like Sedex (which shares supplier data across over 60,000 members) and Ecovadis.

The main ESG value creation component in B2B is not just about meeting tender requirements but anticipating changes, building up robust ESG tender credentials and educating corporate customers and the market about specific aspects of ESG. The company is not simply a standard 'taker' – waiting for new standards to emerge – but actively shapes what the market demands. The packaging market is a good example of this.

B2G. The ESG B2G agenda is the most interesting and subject to rapid change, as ESG public procurement agendas reflect the political outlook and policy priorities of particular governments.

In the UK, for example, ESG in public procurement is understood in terms of social value, which focuses on the wider social, economic and environmental benefits of a good or service (or new development in the built environment).

Government guidance issued last year, which will be reinforced through procurement legislation this year, has delivered a step change in public procurement, with public sector bodies using social value and procurement as a way to 'help local communities to manage and recover from the impact of COVID-19' (the leading outcome listed in the guidance).

The value creation potential then of ESG in B2G is partly about ensuring that B2G companies stay on top of political developments, but also recognising that the priorities of public sector customers can vary significantly from area to area, given differences in the local challenges that need addressing.

There is much in common between these different audiences and agendas, but crucial differences in emphasis and language. This means that PE firms should not simply try to transplant the language, tools and framework of ESG (which is still investor focused) on to portfolio companies and they should recognise the differences between B2C, B2B and B2G audiences. Many corporates and public sector organisations have often very limited familiarity with the concept of ESG itself.

Social value, for example, shares many things in common with ESG and sustainability/CSR (the framework and language of most corporates) but places much greater emphasis on quantifiable local outcomes and impacts (which reflects the fact that most public sector bodies that embrace social value operate in specific geographies and communities, such as councils, housing associations, educational institutions, etc.)

2:

ESG and enhancing valuation at exit

While there is plenty of research on the correlation between responsible companies (however defined) and stock market valuations and share price increases, there is little on how ESG efforts (beyond sales growth outlined below) in a particular unlisted company can result in higher valuation at exit – and how this can 'derisk' an asset for a potential buyer,

There are several ways in which a good, focused ESG agenda can be used to do this. Here are just a few:

Materiality assessments, which determine the social and environmental issues of most importance to a business and its key stakeholders, can help give an organisation (and its investors) a good idea of key external issues and trends, including potential drivers of demand.

The sector materiality standards and reports produced by SASB (the Sustainability Accounting Standards Board, which is increasingly used as a reference for sector-specific materiality and reporting) and ratings agencies like MSCI and Sustainalytics also provide good sector benchmarks, based on extensive and trusted third party research across industry, government, NGOs and investors.

The Governance aspect of ESG drives an enhanced focus on non-financial risk management and how this can affect the core business (especially when informed by materiality assessments). This also connects with political and regulatory risk (and opportunity) as ESG risks and opportunities are often driven by the former, or vice versa (e.g. plastics packaging).

Buy-side political & regulatory or ESG due diligence challenges management teams to what extent they undertake horizon scanning of these issues and develop mitigation plans accordingly

ESG can be an important differentiator to investors in sectors where the overall sector reputation may be poor and where general investor and IC sentiment may be uneasy with investment in the sector, especially if this may bring unwelcome political or public attention to the PE firm or its investors.

Investors shouldn't be expected to merely take the word of a management team when asked if they are responsible or truly committed to ESG. There needs to be strong evidence to back up such claims: impressive policies can be written quickly, but robust ESG DD asks for evidence of supporting systems, governance and training – along with at least 18-24 months of auditable KPIs and demonstrable progress against roadmaps.

The ESG agenda on equality, diversity and inclusion is a powerful driver of investment in human capital. This is particularly important where human capital is a key element in any valuation – in respect of ensuring that there is a good talent pipeline and where the the recruitment and retention of good people is crucial.

The diversity and inclusion agenda can also be used to avoid groupthink, by highlighting the value of diverse perspectives and the importance of a 'speak up' culture, which promotes innovation and also encourages speaking out about bad practices in the workplace, whether in relation to staff relations, quality or health and safety.

Conclusion

Finally, despite their differences, all the activities outlined above benefit from common elements and foundations: connection with an overarching corporate mission or purpose, evidence of performance and progress, and demonstrably robust systems and processes, aligned with sector or corporate best practice.

It is here that a PE firm's ESG manager can add a lot of value, by ensuring all the portfolio companies use similar tools, reference points and evidentiary requirements. For ESG value creation in particular portfolio companies, PE firms can help present and facilitate a variety of ESG value creation options, but the strategy and delivery need to be owned by management teams.

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