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INSIGHT

ALIGNING THE HEART, THE HEAD AND THE FEET: A perspective on embedding ESG considerations into Private Equity's value creation approach

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PRIVATE EQUITY

Investment experience in recent years has reinforced our view that there is a compelling opportunity to embed environmental, social and governance (ESG) considerations into the private equity value creation approach. It is also our view that in order to harness these opportunities, there needs to be an alignment of purpose, strategy and actions at the investment team and portfolio company levels - what we describe as aligning "the heart, the head and the feet".

Over the past several years, IFM's Private Equity team has focused on incorporating ESG considerations in a systematic and repeatable way throughout investment decision-making and asset management processes. Although we are at an early stage of a longer journey to learn how to embed ESG most effectively into a unified value creation approach, we believe the potential to create a powerful multiplier effect for returns is clear.

Our work to date has provided us with two key insights regarding the success factors for this unified ESG value creation approach. First, the ownership of ESG objectives needs to sit with the same people who are responsible for investment returns – i.e. the private equity investment team and the portfolio company board. Second, the critical connection point between ESG and value creation relates to how the purpose and culture of portfolio companies are addressed and managed. Getting the combination of these elements right helps to ensure the required focus and drive to pursue improvements in ESG performance, as well as the receptivity across the broader company to embrace these initiatives and deliver sustained results.

ESG considerations assume ever greater importance for private equity

The consideration of ESG factors has become increasingly fundamental to investment strategies across asset classes for investors globally.[1] There is broad recognition that addressing climate risks, supporting social progress and improving the visibility of business impact across value chains need to play a crucial role in the deployment of capital. Investors are increasingly driven by an imperative to manage ESG risks for investment value and returns, as well as the broader system in which they invest and operate.

Consequently, ESG has risen rapidly up the private equity agenda. For many private equity managers, it has become 'table stakes' for delivery on investor expectations and for fundraising. At a minimum, the consideration of ESG-related investment risks has been elevated for investment teams, and the scope for portfolio performance measurement has broadened to include an array of ESG metrics.

However, real engagement with ESG challenges has not been universal. Some private equity investors may still regard ESG as a challenge to the traditional value creation paradigm, concerned that there is an embedded trade-off between financial returns and 'doing good'. Others have started the conversation but stalled at the point of defining metrics and reporting requirements, given the breadth and complexity of the space. Many funds are building dedicated responsible investment teams to manage the ever-expanding ESG agenda and to support their investors' requirements for ESG data and information.

We think there is scope for more firms to change the way they think about the role of ESG in value creation.

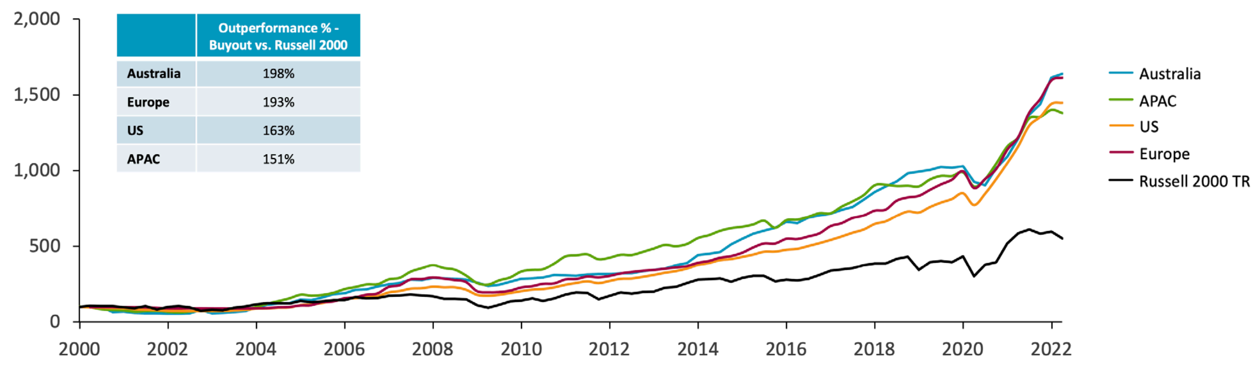
At IFM Private Equity, we initially considered ESG predominantly through a risk management lens. We aimed to avoid downside risks and inoculate our portfolio from reputational damage when we considered ESG matters. However, over the last three years, we have enhanced our approach. It has evolved to integrate ESG considerations into the core private equity playbooks for value creation so that value creation and ESG results are delivered in the same manner.

Creating value is inherent to the private equity investment approach

Top-performing private equity managers pride themselves on an ability to generate high net returns for their investors. Figure 1 demonstrates how private equity returns have consistently outperformed public equity markets over the past 20 years around the world.

The fundamental attraction of this asset class for investors remains its track record of generating alpha and consistently delivering double-digit net returns to investors.

FIGURE 1 PRIVATE EQUITY VS. LISTED MARKETS* – 2000-2022



Past performance does not guarantee future results.

*TWRR Index of net returns assuming investment in every fund; Buyouts used as a proxy for 'Private Equity'; Russell 2000 is an index that tracks 2,000 small-cap listed companies and is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group and is used as a proxy for 'Listed markets'

Source: Burgiss Private IQ database; Returns as at 31 March 2022; Buyout funds only; Australian returns are in AUD, APAC and US returns are in USD and Europe returns are in EUR

[1] An indicator of this is the growing number of investors signing on to the United Nations Principles for Responsible Investment (UNPRI), which reached 4,900 in May 2022, collectively representing US$121 trillion of asset under management globally.

At IFM, our approach to private equity value creation is underpinned by four core beliefs:

1 The best leadership teams deliver the best results
Talented, motivated and aligned leadership teams are critical to delivering results.

2 Great companies need an ambitious and data-driven strategy
Think big, then plot a course to get there with a data-driven view of what it takes to win, a customer-centric approach and the application of technology for competitive advantage.

3 Execution priorities have to be properly resourced and visible
There are only ever a handful of initiatives that materially drive value; these need maximum focus, to be driven at pace and to be closely tracked by the board.

4 An engaged organisation delivers better and more sustainably
Purpose-driven cultures attract and retain talent, are more innovative and results-oriented and operate with greater integrity to generate better quality results.

In aggregate, few private equity practitioners would disagree with the above beliefs as common foundations of private equity investment success. We have discovered that, for all the same reasons, these elements of strong leadership, data-driven strategy, well-resourced priorities and an engaged organisation play a crucial role in embedding ESG into a unified value creation approach.

In our experience, the maxim that "culture eats strategy for breakfast" is true. We believe that culture is where value creation and ESG combine to power investment returns. A culture underpinned by a clear purpose that nurtures employee engagement and performance can make a huge contribution to unlocking value and delivering both financial and non-financial impact.

THE HEART: aligning a company's 'noble purpose' with value creation

Company culture is the beating heart of any business. Attempting to drive change that runs counter to the culture of a company is destined to fail. Conversely, aligning value creation to a company's culture accelerates impact.

While a senior management team can rally around the creation of shareholder value (after all, in most private equity investments they are shareholders themselves), for the majority of employees this is a less motivating force. Instead, people want to work for a company that aligns with their values and focuses on achieving a higher order purpose to which they can subscribe.

When considering a new investment, we are keen to understand what the business stands for and its reason for existence beyond profit

– what we describe as the company's 'noble purpose'. Many companies are very clear on this. For others, defining their noble purpose is the first, crucial step in a value creation plan. When a noble purpose is clearly articulated and placed at the centre of the company's culture it can have tremendous power to drive engagement, attract and retain talent and inspire discretionary effort.

We require a potential investment's noble purpose to be clearly explained in Investment Committee papers and for the investment team to be responsible for nurturing this purpose through the life of the investment. In most cases, the noble purpose is an expression of how the company improves the lives of customers and other stakeholders and makes for a better or fairer society or ecosystem. Where the broader organisation rallies around these objectives, it is simpler to connect ESG considerations to the company culture and, in so doing, empower the organisation to make positive improvements. Building this receptiveness to value creation strategies that incorporate ESG considerations is a key success factor of our work to date.

THE HEAD: incorporating ESG into investment strategy

Company strategy is about focus and the allocation of scarce resources. In the pressurised environment of a private equity investment where there is a mandate to generate returns quickly, peripheral strategies can be sidelined by necessity. For this reason, we have discovered that ownership of the ESG agenda must sit with the investment team and portfolio company boards. Without this top-down drive, good intentions are overwhelmed by other priorities.

Our investment teams state the ESG-linked objectives and first year deliverables in our investment papers. The teams are then responsible for integrating these goals into company strategy and planning processes with associated tracking and reporting.

Far from marginalising dedicated responsible investment or ESG teams, this approach makes these teams more crucial. Their expertise, advice and support are essential to help build investment teams' knowledge and understanding of ESG issues and to help think through appropriate ESG management strategies for individual assets. However, the ultimate responsibility and

CASE STUDY

Genie Solutions

Genie Solutions is a Brisbane-based software company providing practice management software and value-added software tools to medical specialists. IFM's investment from 2017-22 supported a transformation from desktop to cloud-based software.

Cultural change was central to Genie's overall transformation and investment thesis. It underpinned the change to the business model required to deliver Software as a Service (SaaS) and was crucial to retain and motivate a software development team that expanded fourfold in the early years of our ownership.

Genie's culture was built on the noble purpose to "Help medical practitioners deliver better health outcomes". The 'Objectives & Key Results' for every team member were traced back to this purpose, i.e. aligning the heart and head. From an ESG perspective it became simple to connect priority initiatives such as the drive to achieve carbon neutrality (achieved in 2021) back to the business's purpose.

Importantly, the business also felt empowered to take action. Rather than focusing on targets for female representation, the leadership team focused on building the best employee value proposition. This aligned with both building a better-quality business and reinforcing the culture. A range of improvements were made to employee benefits, including parental leave policies, access to online training, and offering free skin cancer screening checks. The result was a business that accelerated annual growth from 10% to more than 25%, while also increasing female representation at whole of company and management levels to more than 40% in a traditionally male-dominated sector.

At exit, Genie Solutions achieved a premium valuation.

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ownership for delivering results needs to sit with the investment team to ensure the necessary prioritisation.

Increasingly, there is a clear investment returns imperative to this strategic thinking. Companies that demonstrate a strong ESG track record tend to represent lower risk, higher quality companies, that are attractive to investors and, therefore, attract a premium valuation. Value creation and ESG improvement are regularly one and the same.

THE FEET: moving to tangible actions and continuous improvement

Positive intent alone does not yield results. Overcoming inertia to move to action is the third component that is critical to progressing value creation plans which incorporate ESG considerations.

The breadth and technical complexity of ESG issues and priorities can be daunting for the non-ESG specialists in an investment team who are required to take action. These people may be wary of missteps or accusations of 'greenwashing'. In these circumstances inertia can be a rational response.

To get the feet moving, we have found that it is important to define and measure an ESG baseline. We seek to do this within the first year of ownership across both a common suite of ESG metrics and bespoke metrics that directly measure progress against the company's noble purpose. This helps to enable the setting of data-driven, ambitious targets that may require a shift in thinking across the broader organisation. It also provides the measurement system to support a 'closed loop', continuous improvement approach.

CASE STUDY

My Plan Manager

Adelaide-based My Plan Manager (MPM) is a mission-driven business managing the plans and payments for participants in the Australian Government's National Disability Insurance Scheme (NDIS). IFM has been an investor in the business since 2019.

MPM has a vision for a more inclusive society and its noble purpose is to “Deliver consistently better outcomes for the broader disability community”. As part of the business's strategy to differentiate and deliver on its purpose, the Board committed to becoming the first plan manager to be accredited carbon neutral and the business achieved this in 2021.

Initially, MPM went through a process to measure its baseline emissions. The team then set gross emissions reductions targets for activities such as waste reduction and staff commuting. The Board is re-engaged every six months to review progress and results and approve the targets and actions proposed for the next six months, fostering a continuous improvement approach.

The emissions reduction action plan is driven by the Head of People & Culture together with a sustainability working group, comprising people from across the business. An example of this group's work is the office move it led, which has not only contributed to reduced emissions, but also a better office environment, helping to re-ignite the culture after Covid-driven working from home arrangements.

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We have found that it is important to simplify ESG objectives and frame actions that are easily understood and straightforward to mobilise. At IFM, we recast ESG as three groups of actions for the company:

1. Eliminate carbon emissions
2. Stimulate stakeholder engagement and participation
3. Generate transparency for optimal decision making

Effectively embedding these actions helps to empower the broader organisation to act and to innovate and can reinforce the company culture. It builds an action and results focused mindset that seeks continuous improvement. And it aligns with the need for great companies to have robust governance and risk management.

These groups of actions provide us with a framework for creating 'action toolkits', which can be transferred easily across the broader portfolio and to new investments. We think that over coming years this will enable us to make more meaningful ESG related impact faster.

We also note that execution is much easier to achieve if there is close alignment between the company's values and noble purpose and if the board has already endorsed the strategy. The heart and the head drive the feet.

Adding an extra dimension to value creation

The private equity asset class has been honing and refining its approach to value creation for more than 40 years, and it continues to improve approaches all the time.

ESG considerations can add a new dimension to value creation. Financial results and ESG results can be generated together, and we believe that investment returns are likely to be lower if improved ESG performance outcomes are not delivered.

We think that this opens up an exciting new horizon for private equity investors to demonstrate how to integrate ESG considerations into value creation and, in the process, debunk the view that there is a trade-off between ESG considerations and investment returns (in fact frequently there are synergies).

The embedding of ESG considerations and outcomes into the private equity value creation toolkit is still in its infancy, but we believe progress will be rapid for those who invest in the concept. It will require investment teams to take the same level of ownership for ESG results as they have traditionally for financial results, leveraging the expertise of responsible investment specialists. It will require a greater focus on building and nurturing purpose-driven cultures within portfolio companies and connecting value creation strategies to a company's noble purpose. It will also require private equity operatives to expand what they already do well – driving action, measuring impact and closing the loop – to incorporate ESG considerations.

We would like to see private equity becoming known not just for its ability to generate financial returns, but also for its capacity to create financial value by integrating ESG considerations. We look forward to being part of this next phase of private equity innovation.

> **“Investment experience in recent years has reinforced our view that there is a compelling opportunity to embed ESG considerations into the private equity value creation approach.”**

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