ESG Grows Up

An executive summary of the Privcap video series “ESG in Private Equity Comes of Age”

Andy Kuper
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Key Findings

1. ESG in private equity has moved from the realm of “hope” to “proof”
2. PE firms with deep experience in ESG are refining how they report its impact to investors
3. ESG risk mitigation is not simply about killing deals, but recognizing opportunities

The Panelists

Andy Kuper
Founder, CEO, LeapFrog Investments

Michael Rogers
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Expert Takeaways

1 ESG in private equity has moved from the realm of ‘hope’ to ‘proof’

Portfolio managers who embrace ESG know, for a broad range of reasons, that companies that conform to the standards usually perform better. They focus on long-term rather than short-term wealth creation; they improve governance; choose responsible partners; manage more efficiently; minimize corruption; and build reputational and competitive advantage.

But for many years, managers couldn’t prove the ESG case. They could offer investors the hope that adherence to environmental, social and corporate governance standards would amplify returns; they didn’t have the metrics to verify it. Now they do. Here’s why: As large investors like insurance companies, family offices and pension funds seek high-growth opportunities in today’s low-growth world, they also seek assurance that these (usually riskier) investments are not flat-out unsafe.

“You can see a very significant movement among pension funds and insurers and family offices toward, ‘How do I get to high growth while having adequate protection?’” says Andy Kuper, founder and CEO of LeapFrog Investments.

And one way to get that assurance is to measure ESG—because, as stated above, companies that adhere to ESG standards tend to perform better. The upshot is that there is now strong demand for metrics that measure ESG and new standards have been developed to meet this demand.

New initiatives, such as the Global Impact Investing Network (GIIN) and its IRIS metrics, are introducing shared, rigorous, and quantitative standards for measuring value within companies through ESG-type mechanisms, Kuper explains. In the U.S., the Sustainability Accounting Standards Board has been working to define what could be material ESG-related issues for companies throughout the U.S. economy, using the existing definition of materiality as defined by the Supreme Court and the SEC.

“Why did Prudential buy it? Because they knew they were reputationally protected,” Kuper says. “They knew Express Life had best-in-class governance and that they were going to get high growth out of Africa. The very outsized returns generated in this instance were directly attributable to ESG interventions.”

Andy Kuper
LeapFrog Investments

ESG is not just a feel-good policy adopted by PE firms to help their investors feel more positive about their footprint in emerging markets. When applied correctly, ESG initiatives produce significant upside in the portfolio.

When LeapFrog acquired a life insurer in Ghana called Express Life, it installed best-in-class governance with the appropriate audit committees and independent directors. It also redesigned the company’s product line to deliver affirmative social impact in the community. And, in just two years, Express Life grew its customer base from 60,000 to 800,000 and was ultimately purchased by Prudential UK.

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PE firms with deep experience in ESG are refining how they report its impact to investors

Kuper’s LeapFrog Investments is the first billion-dollar group dedicated to equity impact investing. His firm has been involved with ESG for almost 10 years, and he says one key insight is that financial reporting and ESG reporting should not be separated.

“Because then portfolio company CEOs would focus on the financial,” he says, “and at the end of the quarter an analyst would tick through all the ESG boxes that we provided. So we created integrated reporting.”

LeapFrog’s integrated reporting includes metrics that enable the firm to be quantitative and rigorous with regard to, say, a company’s social dimension. When reporting on an insurance company, for example, LeapFrog looks at metrics like what portion of the capital the insured pays in premiums goes back to them in benefits. It looks at renewal ratios, because the number of people returning to buy the product is an indi-
Overfishing is a huge threat to oceans around the world. The long-term result: dead oceans. Rogers recalled one PE-backed seafood restaurant chain that decided to do its part to end overfishing.

The restaurant stopped serving some of the most popular yet overfished species, such as tuna, and instead started offering more esoteric fish varieties on its menu. "The restaurant was actually able to allow the seafood groups that were overfished to grow back," Rogers says. "From a supply chain perspective, that was really doing something for the environment."

The restaurant chain also made progressive moves in-house. It launched a program to help low-level kitchen workers become chefs, so as the chain opens new restaurants, it can promote people from lower-level positions. "Very quickly, they were able to not only address the environment but also do social good," says Rogers. "I'm happy to say the restaurant chain is doing very well, which proves there really is economic benefit to ESG."

ESG risk mitigation is not simply about killing deals, but recognizing opportunities

ESG screening certainly helps PE firms avoid companies that one day might cause an environmental disaster or be caught in a corruption scandal. But more often ESG screening helps them find diamonds in the rough.

"There are numerous examples of deals where we've taken a close look and said, well, this is probably not something we want to be invested in," says Elizabeth Seeger, director of public affairs at KKR. "In other cases, we see that there might be an opportunity to create a code of conduct, implement employee training, engage with stakeholders, then utilize our internal resources as well as our network of internal partners to support the company in that journey. And that's a success—not saying 'no' to deals, but finding ways to improve the performance of a company through this diligence screen."

Identifying risks is the first part of ESG screening. The second is finding a way to mitigate them. "One of the things we've seen with the ESG component is that it has moved from more of a compliance component to more of an opportunistic one," says Michael Rogers, global deputy private equity leader at EY. "How do we take advantage of that? How do we make this a differentiator? Firms like KKR and LeapFrog are out in front and now we see most of the industry drafting behind that knowledge, taking advantage of it and putting their own programs in place."
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Privcap is a digital media company that produces events and thought-leadership content for the global private capital markets. Privcap Media offers communications services to market participants.

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