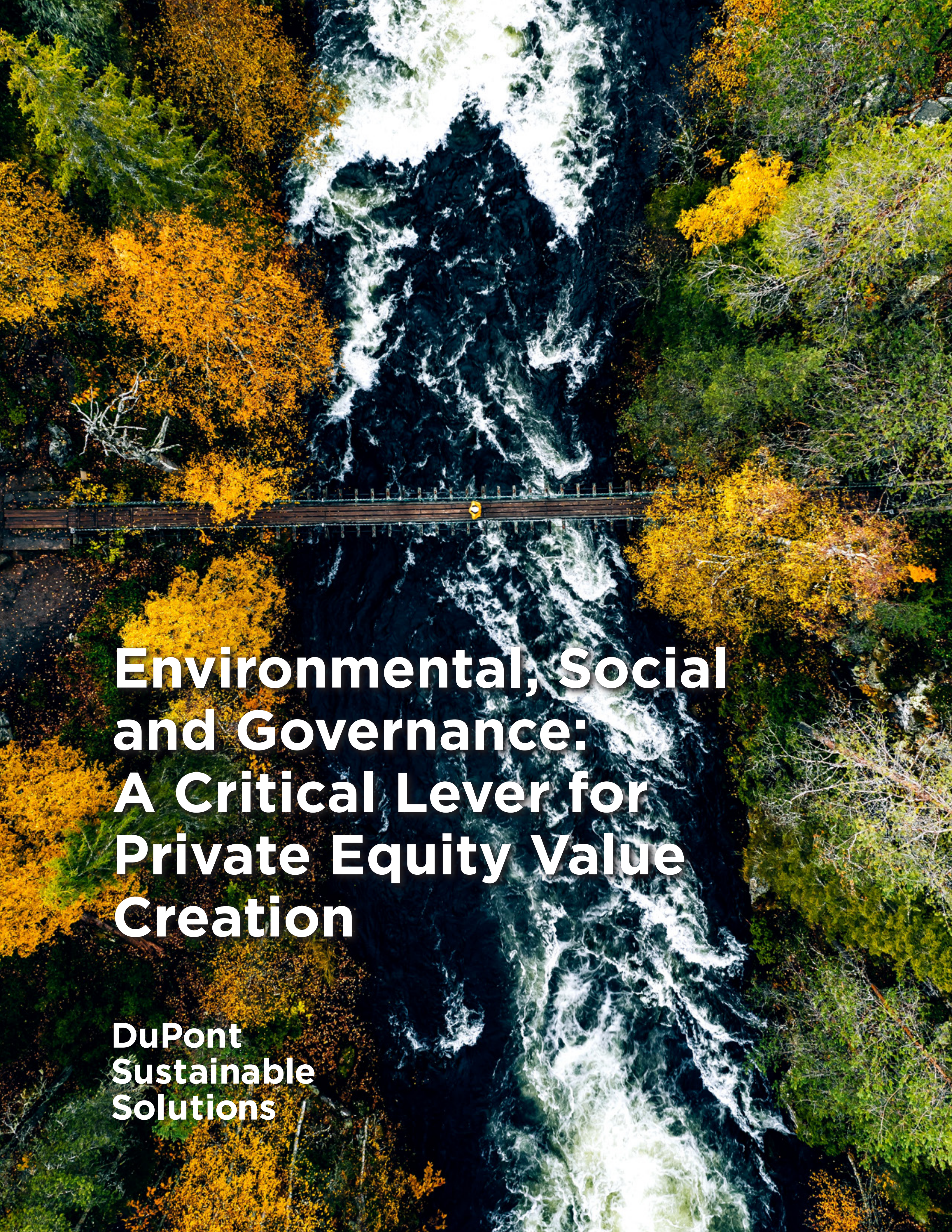


Environmental, Social and Governance: A Critical Lever for Private Equity Value Creation

DuPont Sustainable Solutions

Over the past 20 years, private equity investors have developed a broad set of tools to draw maximum value out of portfolio companies. The focus has shifted from financial engineering to driving topline growth, followed by operational transformation and, more recently, digitalization. Today, as the world's attention turns to global issues around climate change, diversity and inclusion, and corporate governance, a new tool in that toolkit has emerged.

Private equity investment continues to grow at a brisk pace, particularly in Asia Pacific, where competition is fierce and the pressure to derive ever-greater value out of already deployed capital is intense.

It's become apparent that no single value creation strategy assures higher returns. Instead, as Vijayalakshmi Vaithianathan, Investment Professional, and Rahul Mukim, Director, at The Carlyle Group assert, "ESG cannot be looked at in isolation from all the other operational levers that are designed to create value as well, because they're all interconnected." A holistic, hands-on approach that is tailored to the individual company or industry has been recognized as more likely to yield the desired results.

Now, as environmental, social and governance (ESG) matters move into the spotlight, the financial impact of companies' response—or lack of response—to them cannot be ignored. To generate maximum value, ESG should be woven throughout a larger, holistic strategy that comprises risk management, operational efficiency, digitalization and strategy alignment from the earliest, pre-deal stages and revisited throughout the deal cycle.

ESG Impact:
Powering Positive Change Throughout the Apparel Supply Chain

The company: Trimco is a global supplier of sustainable trims, packaging and care labels for international fashion and sports brands.

Initiatives: A full playbook, including a commitment to sustainable materials, supply chain transparency, human rights and more was developed to make ESG a core part of Trimco's business. These include:

- Products and packaging utilize recycled plastic and cotton, biodegradable materials, FSC certified paper and even vegan leather made from pineapple fibers and apple peels.
- RFID tags and QR codes help optimize inventory management and supply chain transparency, as well as communicating sustainability claims to brand owners' end consumers.
- Renewable energy and waste reduction is implemented for production sites.
- DEI, health and safety, and talent development programs promote a healthy, engaged workforce.

The result: All wholly owned production sites have adopted Higg Index Sustainable Apparel Coalition standards. Trimco excels at safety and sustainability, and in supporting sustainable supply chains. Today it is recognized as a leader in sustainability best practices.

Value Creation from Due Diligence to Exit

The clock is always ticking on any deal. That's why a comprehensive, integrated plan that assesses current realities and future possibilities must begin during due diligence. Private equity firm KKR & Co, for example, incorporates ESG thinking up front. David Katz, Director of Public Affairs – Asia Pacific, explains, "It allows us to understand from the very outset—what are the opportunities? What are the risks? ESG is not an add-on later in the process. It's at the very top of the investment committee's funnel."

Sarah Pang, Head of ESG and Sustainability at Affinity Equity Partners says her company's approach is similar, "We look strategically at what the portfolio company needs in this new sustainability world, with the challenges of climate change and resource scarcity. Through this process we look to augment capabilities to create value—not just clever financial engineering but by really building something tangible."

Successfully creating and implementing against a detailed ESG roadmap is strongly associated with higher returns in cross-section analysis—especially in growth, buyout and secondary deals.

And yet Katz adds, "There are times when you can't draw a direct line between ESG and a dollar value. We see ESG issues as other business issues—like, how does a sound business plan translate into valuation? You know that not having a sound business plan is a terrible idea." Vaithianathan and Mukim concur, "You won't see outcomes on day one, it's going to take a while." In addition, she suggests that one of the greatest challenges for management can be the desire to see tangible value, so companies "need to have KPIs which are not measuring just the outcome, but also the input." Pang notes that while some of their initiatives can be tied directly to revenue, they also rely on other types of tangible metrics when possible, such as in the Trimco case—the percentage of recycled content or MWh of renewable energy used.

Even if a business is delivering a great rate of return on investment capital on day one, investors need to question how that return can be sustained. For this, it's necessary to look beyond cost cutting and deal structuring. "There's a value preservation play—you do it so you don't get disrupted by other things," offers Kam Xie, Director at FountainVest Partners, "Or

ESG Impact:
Disclosure Strategy Drives Greater Competitiveness

The company: A US-based, publicly listed global provider of electrical equipment and electronics components.

The engagement: The client worked with KKS Advisors to create a disclosure strategy and implementation program to better understand and ultimately meet market expectations for ESG practices.

The solution: KKS drew upon deep experience with ESG ratings and data analysis, ESG integration in portfolio management, financial materiality, and market analysis. The KKS team mapped out a tactical approach for the client to disclose the most market-relevant ESG information as well as focus areas for short- to medium-term performance improvement.

The result: Upon implementing disclosure and performance improvement recommendations, the client's ESG ratings improved, leading to their inclusion among the World's Most Ethical Companies. An improved reputation, stemming from transparency and commitments by the C-suite and board, positioned the company competitively against global peers.

for certain sectors, you can make good use of the ESG framework for a value creation strategy." Digitalization, data-driven growth, cost and pricing transformation, and new products, for example, can drive value throughout the deal cycle. ESG is increasingly critical for accumulating value and is becoming a core element in more sophisticated, innovative value creation playbooks.

Good ESG Performance is Good Business

As owners and lenders, investors have a vested interest in seeing companies actively address ESG issues that may affect short- and long-term value by mitigating risk and maximizing returns. "(In the) near term, ESG can create a competitive advantage," suggests Xie. "Eventually, if you do it well, there's tangible value at a true rate."

As attention to ESG impacts becomes more mainstream, investor influence and successfully implementing against a specific plan consistently prove to enhance value and increase shareholder returns. Jaclyn Seow, Head of ESG & Impact at Openspace Ventures agrees, "We see our role as trying to build strong foundations—not just trying to raise the valuation and get out. We intend for these companies to be around for years to come".

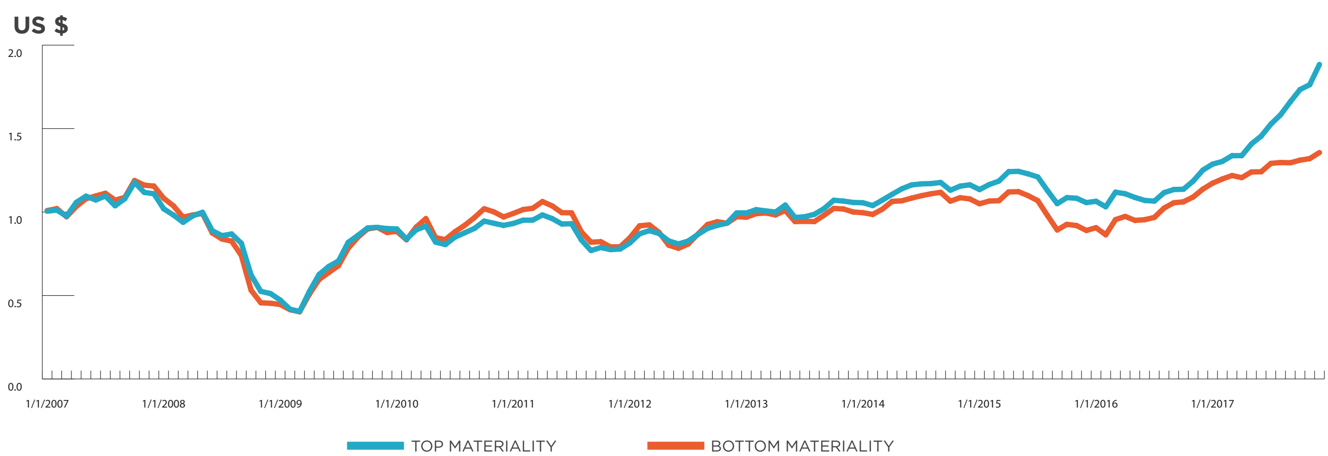
Academics and practitioners have presented extensive evidence on the benefits of integrating ESG criteria into the investment process.

For example[1]:

- Academic research into US companies in the first decade of the 2000s showed that companies experienced improved accounting performance and governance after successful corporate social responsibility engagements[4].
- A stock performance analysis of 188 companies on a focus list by California Public Employees' Retirement System found that ESG-engaged companies performed significantly better than their peers—15.27% above the Russell 1000 Index over a 14-year period[5].
- Dialogues involving 225 investment organizations between 2007 and 2017 showed that, after engagements deemed successful based on predetermined criteria and scoring, target companies experienced improved return on assets while unsuccessful engagements demonstrated no change[6].
- Analysis of a large European asset manager with 660 companies confirmed that 60% and 53% of the firm's engagements on social and environmental issues respectively succeeded against predetermined ESG dimensions, and that excess stock returns were higher after successful outcomes[7].

It's important to note that not all investments in ESG will have the same impact. Sustainability is a good example—the number of companies issuing sustainability reports has grown from just 12% in the early 1990s to 80% of worldwide companies in 2020[3]. However, in order to enhance

Performance of top vs bottom materiality portfolios (2007-2017)



Based on a sample of top 100 commercial banks by market capitalization, KKS Advisors found that an annually rebalanced portfolio of the top 20 banks (ranked by material ESG factors) outperformed a portfolio of the bottom 20 banks by a significant margin, particularly after 2013.[2]

value, investments in sustainability, diversity and governance must go beyond simple compliance and reporting—initiatives must be material to the industry. Get it right, and companies with good ratings on material ESG issues have been shown to significantly outperform companies with poor ratings on the same issues[2]. Investors are increasingly becoming aware of this and are seeking specific sustainability information, as well as referring to issue- and industry-specific materiality indices, to guide asset allocation decisions and the creation of relevant, impactful roadmaps.

KKR, for example, notes that even as they take a materiality driven approach to ESG, three cross-cutting issues are integrated into every transaction—diversity and inclusion, data security and privacy, and a better understanding of how a company is addressing climate change. For Openspace Ventures, which invests mostly in technology, the gaps being identified are often not only about avoiding environmental, social or governance risks. They include value creation through employee retention, building a responsible brand and driving strategic and operational efficiency.

Maximum Value Creation Begins with Total Integration and Engagement

It's clear that ESG can be a game changer, but only when private equity investors make it a core component of value creation strategies starting at the pre-deal stage. Due diligence and a deep understanding of the materiality of ESG initiatives, as well as a detailed roadmap laying out specific actions, will help the company achieve sustainable value creation throughout the investment lifecycle. And, as Vaithianathan pointed out, it's a competitive differentiator, as many "Western customers are now imposing ESG policies on the supply chain. And that really trickles down all the way across the globe, be it a small player or a large supplier."

In addition, because a transformative ESG blueprint will touch upon a wide variety of operational and strategic areas, it must be fully interwoven with risk management, performance improvement and other initiatives to function as a complete value creation ecosystem.

Investors also need to recognize the important role they play in guiding and implementing ESG practices and systems in portfolio companies. Investor influence strategies such as dialogues with company management, shareholder proposals and proxy voting, and public policy engagement, are all key to maximizing impact and returns.

Even if a portfolio company doesn't have an ESG value creation roadmap in the 100-day plan, ESG can be adopted mid-tenure. While timelines vary widely, three to six months of design and planning and another nine to twelve months of concentrated implementation against material objectives can be enough to realize results.

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About DuPont Sustainable Solutions

DuPont Sustainable Solutions (DSS) is a leading provider of operations management consulting services that enable organizations to protect their employees and assets, realize operational efficiencies, innovate more rapidly and build workforce capability. By leveraging its DuPont heritage, deep industry and business process expertise and diverse team of expert consultants, DSS helps clients turn operations management into a competitive advantage.

About KSS Advisors

A wholly owned subsidiary of DSS, KKS Advisors is a leading consultancy firm providing innovative solutions that enable organizations to capture the enduring benefits of a sustainability approach. Applying our unique, research-backed approach, we work with corporations, foundations, NGOs and investors on sustainable strategies that deliver lasting impact. Our vision is to reshape markets, creating a world where business and investment decisions are made for the long term, taking environmental, social and governance factors into account. With offices in London, Boston and Athens, and associates around the world, our reach is global, and our focus is on efforts which foster systemic change.

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