Private equity

Easing the barbarians through the gate

Jon Entine uncovers how the responsible investment movement is learning to work with private equity, and vice versa

European trade unions dismiss them acidly as "asset strippers", while in the US they have a reputation for being "barbarians". But private equity firms are being seen in a new light – even as potential champions of the social responsibility cause – in the current challenging times.

It was February 2007. Gwen Ruta, vice-president of corporate partnerships at the Environmental Defense Fund, recalls her surprise when EDF was invited into the negotiations over a proposed buyout of Texas Utilities (TXU).

Jim Marston, head of EDF's Texas office, rushed to San Francisco where he locked himself in a room for 17 hours with the likes of Kohlberg Kravis Roberts's legendary chairman, Henry Kravis, whose earnings, according to one union group, were running at more than $51,000 an hour.

"It was unprecedented that we were invited inside," Ruta says, "but also a huge risk. We wanted to demonstrate that the utility could operate profitably without huge new coal-fired plants. But could we convince the new owners to do so?"

Ruta's caution was understandable. EDF had gone ballistic months before when TXU, which operated some of the dirtiest plants in the US, announced plans to invest $11bn in eleven new coal-fired plants. After being denied a meeting with TXU chairman John Wilder, EDF's president Fred Krupp took the fund to the streets. He helped orchestrate a Stop TXU campaign involving a federal lawsuit, TV ads and the barnstorming of New York and Washington, where he criticised the coal plants as lousy risks, environmentally and financially.

While Wilder put his hands over his ears and TXU's stock price languished, Wall Street heard the sounds of change. Henry Kravis was determined to remake both the image and the practices of the company he co-founded. KKR was mulling an investment in TXU along with the Texas Pacific Group, whose co-founder, David Bonderman, was a WWF board member. Kravis was convinced that the environmental groups held strong cards in what could have become a tough regulatory and public relations battle, and was personally sympathetic to many of their goals. The investment consortium formed an internal green advisory group, and made the radical decision to ask Krupp and a counterpart at the Natural Resources Defense Council (NRDC) to join the talks.

"We didn't want to end up on the wrong side of history," recalls one member of the negotiating team.

They didn't. With the blessing of the enviros, the private equity consortium paid $44bn for TXU with the caveat that plans for eight plants would be dropped. "This investment will strengthen [TXU's] environmental policies and allow it to make significant investments in alternative energy, conservation and efficiency measures," Kravis said when the deal was announced.

Despite the trail-blazing NGO-private-equity partnership, some environmentalists were dubious that the businesses they blamed for damaging the world could be relied upon to help protect it. Greenpeace said the deal took the wind out of its campaign linking coal to global warming. More radical groups, such as the Native Forest Council, condemned the pact, telling the Wall Street Journal that the EDF and NRDC "should be hanged for what they've done".

The deal underscored the growing sophistication of a new generation of financial investors who saw "opportunity" where others used to see "risk".

Over the past four years "clean tech" investments have grown from 2% to 17% of the venture capital market, according to the National Venture Capital Association. Large private equity firms in the UK and US are adopting an array of environmental, social and governance (ESG) screens. In February, Carlyle and KKR took a leadership role at the Private Equity Council, an industry trade group of large private equity firms, to help pass a set ESG investment principles. Council members have publicly committed themselves to an array of engagement practices, including adherence to anti-bribery statutes, talking with stakeholders, and strictly following labour and environmental regulations. Similar guidelines are percolating in Europe.

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Viewing private equity as ethical pioneers may strike some as incongruous. Private equity invests upwards of $600bn in leveraged buyouts, growth capital, venture capital and other investment vehicles. The initial high tide of leveraged buyouts during the late 1980s sparked concerns that have never completely disappeared. By notorious reputation, firms put down a fraction of the purchase price, then switch into harvest mode, investing little, cutting labour costs, turbo-charging cash flow and selling off the company in pieces.

Surrendering to values-based investment?

Asset stripping?

Whether that characterisation is a caricature or the better part of reality, organised labour and their political allies invoke it whenever a takeover threatens jobs. In 2004, unions in the UK howled when CVC and Permira scooped up Britain's venerable AA, Europe's top automobile association, for £1.75bn. Within a year, 3,400 of the AA workforce – 34% – lost their jobs, although those that stayed received a stake in the company and have benefited handsomely. Subsequent takeovers of Birds Eye and National Car Parks also led to layoffs, sparking renewed charges of "casino capitalism" and "asset stripping".

The Service Employees International Union, one of the biggest US unions, has long promoted a website, behindthebuyouts.com, warning of the evils of private equity. Its leaders dismissed the circumstances of the TXU deal as greenwashing and regularly bash KKR, Carlyle and other private equity firms for allegedly abetting human rights abuses and getting rich on the backs of workers. "What kind of world have we got where Henry Kravis, with his seven houses, lectures us on morality?" SEIU president Andy Stern recently told the Economist.

But such demagoguery is based on selective history. Many buyouts have resulted in turnaround stories rather than labour debacles. For example, when Texas Pacific

Private equity performance

The private equity world has evolved dramatically over the past two decades, and even more so as the debt markets have collapsed. Its investments have consistently outperformed the broader market.

Despite their slash-and-burn reputation, large private equity firms increased capital expenditures more than five times faster than total capital spending, and almost 24 times faster (**85%** compared with **3.5%**) than the average of all US companies in the three years after an acquisition, according to Robert Shapiro, a former commerce department official in the Clinton administration and chairman of Sonecon, and Dr Nam Pham, founder and president of NDP Group.

Public pension funds, which had originally shunned private equity, now invest nearly **$500bn** through private equity firms in the US alone. The 20-year Private Equity Performance Index average return for funds was **12.8%** in 2007, compared with **9.4%** for the Nasdaq and **8.1%** for the S&P 500, according to Thomson Financial.

Private equity firms are generally performing better than other asset managers during the current crisis, though valuations are difficult to judge because they are not as transparent in their reporting as public firms.

Private equity's knights lost reputation

bought Italy's Ducati Motorcycles in 1997, it was near insolvency. By the time it exited in 2006, it was solidly in the black, sales had tripled and staff had doubled to more than 1,000.

For the most part, the ESG movement among private equity has been client-driven. In 2005, the UN secretary-general convened a group of pension funds and other investors that eventually led to the drafting of what became known as the Principles for Responsible Investment (PRI). It called for such modest (but revolutionary for the financial community) commitments as incorporating ESG analysis and disclosure practices. The PRI is now investor-led with board representatives from many of the world's largest pension funds, including France's FRR, Previ in Brazil, the BT Pension Scheme and the CalPERS, with $180bn in assets.

In June 2007, London-based Doughty Hanson became the first large private equity firm to endorse the PRI. "The push has really come from the pension funds, that's the reality," says Guy Paisner, an investor relations specialist at DH. "The field is filled with many 'dyed in the wool' capitalists. But if investors write a half-billion-dollar cheque and insist that you review for ESG issues that's a pretty big incentive to take these things seriously. We do, and it's paying off for everyone."

To sceptics, these initiatives and the new Private Equity Council principles are just words on paper. After all, Enron had best-in-sector ethics guidelines and look how much good that did. Still, while such pronouncements are standard green gruel for public companies, they are the first such commitments by the private equity community.

Action and implementation

"The real test is how long after someone is a signatory before there are signs of real action," says Tom Rotherham, special adviser to the PRI on private equity, and head of corporate responsibility at Radley Yeldar. "This is about fiduciary duty, not aspirations. Signatories are left to define their own approach to implementation, based on their own commercial interests, but we'd expect to see signs of change, certainly in six months."

In light of the current mess, there is no question that financial institutions are polishing their images because of concern over restrictions governments might impose. "Regulation is coming and it's going to come in a very major way," Henry Kravis warned the audience at the World Economic Forum in Davos in January. It is better to self-regulate than to have oversight forced upon you.

The private equity industry is also hopeful that its embrace of greater disclosure will help finally shake the "barbarians at the gate" image forged in the wake of KKR's 1988 takeover of RJR Nabisco and the publication of a best-selling book with that title.

> ***"We now use environmental, social and governance measures as part of our due diligence in acquisitions"***
>
> *Ken Mehlman, KKR*

"I hate hearing that phrase," says Ken Mehlman, head of global public affairs at KKR. "I don't believe it's an accurate portrayal of who KKR was then but it's certainly not who we are today. We're committed to responsibly steward the companies we own. We're committed to sustainability."

Mehlman, a lawyer by training, who cut his teeth litigating environmental issues, has an impressive CV, including being a partner at Akin Gump Strauss in Washington DC, head of the Republican National Committee, and manager of George Bush's 2004 campaign. Kravis and George Roberts recruited him to KKR last year in part to help strengthen the budding relationship with EDF.

"There was instant chemistry at KKR," Mehlman says. "I believe strongly that free enterprise, when it's focused, can bring value to all stakeholders, not just shareholders. The sustainability initiative launched with the TXU deal has prompted us to look at things we had not examined before; it's made us even more disciplined. We now use environmental, social and governance measures as part of our due diligence in acquisitions and across portfolios."

In May last year, just as Mehlman joined, KKR and EDF announced an innovative Green Portfolio project. "[We worked] to test a set of analytic tools to help companies improve in several key environmental performance areas, including greenhouse gas emissions, waste, water, forest resources and chemicals," he says.

AA

In March, KKR and EDF released initial results of their pilot partnership at three companies: US Foodservice, Primedia and Sealy. Total savings in 2008 came to $16.4m and prevented more than 25,000 tonnes of greenhouse gas emissions.

"It's real savings, but in dollar terms, it's still modest," Ruta acknowledges, noting that she was concerned the press might downplay the results. "Ken had the opposite reaction, he's so enthusiastic. 'Look at the environmental results,' he said, 'and it's just our first steps. These are good examples of how smart companies can cut costs and support the environment!' It was weird. I was concerned about the money KKR saved; he was trumpeting the environmental savings and expanding commitments to other portfolio companies. It was a 'Freaky Friday' moment."

Under the partnership terms, KKR did not pay any money to EDF. Whatever business tools that are created are shared with other companies, including rivals. EDF posts best-practice profiles, and case studies from the partnership on greensavings.kkr.com.

"Our goal is not just to change things at KKR, but also to create a model to demonstrate business benefits in the sector," Ruta says. "We definitely want to draw upon the management systems already in place in private equity, and combine that with our expertise about environmental issues to create real value for the environment, for the portfolio companies and for the overall business."

Ken Mehlman adds: "We're making ESG part of our DNA. This is a process. We're going to make mistakes, but we're committed to learning and improving on our environmental and social practices. We're already seeing the benefits and we are rolling initiatives out across our portfolio."

Sustaining momentum

Still, the jury is out on how far this movement in the private equity world will carry. With the financial sector going through a game-changing crisis, it's unclear how far private equity firms will go in instituting ESG reforms that cut into profits. The corporate responsibility advocates' feel-good mantra, "win win", often falls flat in the ruthlessly competitive world of international business. Margins are in a terrible vice. Many private equity executives whom Ethical Corporation talked to were too busy harvesting the low hanging fruit – publicising what are still marginal environmental savings from nips and tucks – to hazard a prediction of what might happen if their NGO partners recommended major reforms that could hurt the bottom line.

Considering how poorly many debt-bloated acquisitions are performing, it is also not clear what the market for distressed debt might look like when the credit markets finally thaw. While a handful of recent buyouts are holding their own – KKR's acquisition of discount chain Dollar General was timely, for example – Hilton Hotels, Claire's Stores, Harrah's, Michaels and other heavily indebted companies have seen their valuations crash. US and European public and corporate pension funds took devastating hits on their private equity investments, and are suddenly cautious about funnelling new money into what they were once led to believe were lower risk opportunities. If the investor-client side comes to think the firms are more talk than action, they might withhold investments and the ESG imperative could fade.

Pension funds are suddenly cautious about funnelling new money into what were lower risk opportunities

"The tricky part is I'm not sure how private equity groups will communicate the implementation of the principles to stakeholders," says Jesus Arguelles, a portfolio manager with the Alternative Investment Management programme at CalPERS, a leader in pushing for ESG reforms. "Historically, some private equity firms would only disclose information to their limited partners, but now many have recognised the benefits of communicating with other stakeholders. The big picture is: this is good business – for them and for us." ■

Early adopters

Doughty Hanson is the first large private equity to hire a dedicated executive, Adam Black, to run its sustainability practice and is now addressing environmental, social and governance issues in its annual review.

"We're not doing it to earn brownie points," says Doughty Hanson's Guy Paisner. "We are doing it for cold, commercial, opportunistic reasons. Firms that operate in a sustainable way significantly de-risk their business model and ultimately attract higher valuations in the capital markets."

Cases in point: energy efficiency audits at rug manufacturer **Balta** have cut energy costs by as much as **12%**, saving **€575,000** per plant; and a pilot programme launched late last year at **Avanza**, Spain's largest urban bus operator, is on target to save an estimated **4,000 tonnes** of carbon a year, which equates to some **€1.4m**.

"Some in the private equity community call this a fad," says David Gordon of **Riverside**, a Cleveland-based private equity firm focused on the small end of the middle market. "We believe it's consistent with running lean and effective businesses."

In 2007 Riverside hired eco-entrepreneur Paul Farrow to develop sustainability benchmarking toolkits based on triple bottom line values. "Aligning values is one sure way to get everyone pulling together," Farrow says. He earned millions of dollars by designing kayaks made from recycled polyethylene used to make milk and laundry jugs.

"This is an early stage process," he says. "Each company will be encouraged to do a baseline assessment to identify risks and opportunities, and we'll increasingly include sustainability factors when we screen new investments and refine strategic plans."

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