Engagement & Valorisation de la Performance Non Financière

Le Cas du Capital-Investissement

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Outline

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   Where do Private Equity investors stand in terms of SRI?

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   How much would they pay for a good or poor ESG management?

4. Conclusion
   Consequences for entrepreneurs, private and public investors
1. INTRODUCTION

Why a focus on the Private Equity industry?
1.1 What is Private Equity (PE)?

Private Equity designates all tools and procedures that aim at increasing the equity capital of unlisted firms.
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Private Equity designates all tools and procedures that aim at increasing the equity capital of unlisted firms. ... at all stage of their lives (Seed, Venture Capital, Leveraged Buyouts)
1.2 Why a focus on PE?

- SRI research focused on public financial markets
  - the Private Equity channel received less attention (Scholtens, 2006; Cumming and Johan, 2007).

- An interesting lab to evaluate ESG impact on firm value
  - PE highly efficient at maximizing shareholders’ value by reducing information asymmetry (Jensen, 1986, 1989)
  - Experts in firm monitoring and valuation of non-listed firms (Holmstrom and Tirole, 1997; Ueda, 2004).
  - Already include in their valuation and investment decision non-financial criteria, such as the quality of management (Muzyka et al., 1996) or governance (Kaplan and Strömberg 2009)
2. SRI AND THE PRIVATE EQUITY INDUSTRY

Where do Private Equity investors stand in terms of SRI?
2.1 Research question

What are the characteristics and drivers of the socially responsible investment movement in Private Equity?

2. 2 SRI in Private Equity

- The ESG trend in Private Equity
  - 2009: Responsible Guidelines of the United States Private Equity Council
  - 2009: United Nations Principles for Responsible Investments in Private Equity (over 110 signatories)
  - 2010: Sustainable Development Project of the French PE Association

FIGURE 1 LEGEND: Figure 1 presents the French Private Equity market (data AFIC 2011 and UN PRI 2011) in amounts of funds raised, funds invested and UN PRI signatories.
2.3 Method

- **Hypotheses**
  - on the characteristics of SR PE
    - Information asymmetry reduction; agency costs cut; governance engineering and operational engineering
  - on strategic drivers of SR PE
    - Value creation; risk management; market openings; differentiation
  - on responsive drivers of SR PE
    - reputation

- **Econometrically tested on a unique dataset**
  - French PE industry in 2011
  - 2 sources of data: survey data and public data
2.4 Data

- **Survey data:** 74 PE firms (managing 572 funds)
  - Partnership with Novethic (CDC); return rate 24%

- **Public data:** 309 PE firms (managing 1,496 funds)
  
  Sources: specialized media; press releases; firms’ websites

  - **Main characteristics:** firm age; funds managed; portfolio size;...
  - **Activity:** VC; expansion capital; transmission capital; ...
  - **Ownership structure:** % owned by Partners / PE firm / insurance...
  - **Limited Partners:** industry / sovereign wealth fund, / individual investors...
  - **Investment scope:** geographical scope; sector scope
  - **Management (CEO):** background; gender; founder-owner
  - **Public responsible investment practices:** AFIC Ethics Chart; UN PRI; communication on website; green or social funds; survey answer
2. 5 Main results (1/2)

The responsible investment movement in French PE:

- is a mainstream movement structured under the impetus of large conventional actors

- is essentially strategically driven to create value, improve risk management and differentiate to raise funds (independent firms)

SR in PE appears to have been “thought” global” by large leading actors to improve mainstream business and provide it with new growth tools

- is characterized by engagement, with PE investors typically being much involved in portfolio companies’ management
2. 5 Main results (2/2)

Engagement in Private Equity

- 23% brought ESG issues to company’s supervisory board
- 53% responders used direct monitoring of social issues in company (64% among UN PRI signatories);
- 26% visited companies or plants
- 22% demanded ESG reporting to portfolio companies

- As majority or significant shareholders, PE investors have the potential to actively promote sustainable practices in the firms they own
- Promote ESG issues on strategic grounds (maximizing shareholders’ value) rather than ethical ones
3. ESG VALUATION BY PRIVATE EQUITY INVESTORS

How much would they pay for a good or poor ESG management?
3.1 Research question

How does ESG performance impact firm value and access to equity financing?

3.2 Experiment design (1/3)

- **A framed field experiment**
  - With professional private equity investors
  - in partnership with professional associations (AFIC, AFG)

- **Based on 3 fictive case studies**
  - To ensure realism and credent context
  - different industries, firm sizes, and ESG issues

- **Testing 4 treatments**
  - Each treatment uses 2 case studies
  - Each treatment tests a different set of ESG factors / signs (+ or -) / quality (+, ++ or -, --)
3.2 Experiment design (2/3)

- Case studies

### FIRM A
- Sector: Catering
- Employees (size): 1,600
- Social: S+, S++
- Environmental: E-, E--

### FIRM B
- Sector: Packaging
- Employees (size): 227
- Environmental: E+, E++
- Governance: G-, G--

### FIRM C
- Sector: Electronic components
- Employees (size): 2,608
- Governance: G+, G++
- Social: S-, S--
3.2 Experiment design (3/3)

- Treatments

**Treatment 1**
11 investors

- Firm A
  - S+
  - S++
  - E-
  - E--

- Firm B
  - E+
  - E++

- Firm C
  - G+
  - G++
  - S-
  - S--

**Treatment 2**
7 investors

- Firm A
  - S+
  - S++

- Firm B
  - G-
  - G--

- Firm C
  - E+
  - E++
  - S-
  - S--

**Treatment 3**
9 investors

- Firm A
  - G+
  - G++

- Firm B
  - E+
  - E++

- Firm C
  - S-
  - S--

**Treatment 4**
6 investors

- Firm A
  - E-
  - E--
  - S+
  - S++

- Firm B
  - G-
  - G--

- Firm C
  - E+
  - E++

330 valuations of the impact of a good (+) and bad (-) news on ESG issues
3.3 Experiment procedures (1/4)

- Sequence of events in a session
  - Agreement form & instructions read aloud
  - 1st case study:

  **Round 1**
  How much €?
  Invest or not?
3.3 Experiment procedures (2/4)

Example of case study handed over to participants
3.3 Experiment procedures (3/4)

- Sequence of events in a session
  - Agreement form & instructions read aloud
  - 1st case study:
  - 2nd case study idem
  - Short questionnaire (socio-economic characteristics, understanding, strategy, ESG training, beliefs on ESG factors, risk aversion, altruism)
  - About 1H30
3.3 Experiment procedures (4/4)

- 33 Participants
  - 24 to 57 years old (mean 39)
  - 73% were men
3.4 Incitation mechanism

- **Payoffs (based on Klemperer, 2004)**
  - For each case study, one round is randomly chosen
  - The “winner” is the one who proposed the highest firm valuation and decided to invest at this round
  - If the “winner” made a good deal, she earns a *Price* worth 120€ (capital gain) for a 1H30 session.
    - good deal: valuation < median valuation × 1.1
  - If the “winner” made a bad deal, she loses her *Price* (capital loss).
    - bad deal: valuation > median valuation × 1.1

- **Reputation incentive**
  - High competition between investors
3. 5. Results (1/8)

- Results on firm valuation
  - Firm A in treatments 1 and 2
3.5 Results (2/8)

- Results on firm valuation
  - Firm B in treatment 1 and 3
3.5 Results (3/8)

- Results on firm valuation
  - Firm C in treatment 2 and 3

![Graph showing firm valuation results](image-url)
3.5 Results (4/8)

- Results on firm valuation

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<th>GLS model (random effects)</th>
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* p-value < 10%; ** p-value < 5%; *** p-value < 1%.
3.5 Results (5/8)

- Results on firm valuation in the fixed-effects model

  - **Environment**: positive news led to a significant increase in firm value of 2.6%; decrease -5.9% if negative
  - **Social**: positive news led to a significant increase in firm value of 2.5%; decrease of -5.5% if negative
  - **Governance**: decreased of -7.7% if negative

Sustainable and unsustainable practices asymmetrically affect firm valuation by private equity investors
3.5 Results (6/8)

- Results on investment decision
3.5 Results (7/8)

- Results on investment decision

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3.5 Results (8/8)

- Results on firm valuation in the fixed-effects model
  - **Governance**: positive news led to a significant increase in firm value of 2.5%; decrease -1.9% if negative

Only Governance appears core in the investment decision
4. CONCLUSION

Consequences for entrepreneurs, private and public investors
4. Conclusion

- **Main findings**
  - Private Equity investors are engaging in ESG management
  - ESG information impacts on firm value is asymmetric
  - A bad ESG news significantly reduces firm value by about 5%
  - Only Governance impacts the investment decision, respectively positively and negatively for a good or bad news

- **Consequences for entrepreneurs**
  - unsustainable practices are unlikely to prevent access to equity financing (unless too risky)
  - Yet they increase the cost of equity capital for entrepreneurs and destroy shareholders’ value
  - Improving ESG management might enable entrepreneurs to protect their firm value and access to equity capital.
  - Need to implement indicators to assess and monitor ESG performance
4. Conclusion

- Consequences for private equity investors
  - the ability to properly evaluate the extra-financial performance of a target firm could constitute a negotiation tool in acquisition stages
  - Possibility to create value by financing poorly ESG managed firms and improving their practices
  - Limited by expertise on CSR management

- Consequences for public equity investors
  - ESG are likely to increasingly impact IPOs and PTPs performance (movement of firms between private and public equity markets)
  - Governance appears key for investment attractiveness
  - Experience sharing on engagement practices


