

Engagement & Valorisation de la Performance Non Financière

Le Cas du Capital-Investissement

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Outline

1. Introduction

Why a focus on the Private Equity industry?

2. SRI and the Private Equity industry

Where do Private Equity investors stand in terms of SRI?

3. ESG valuation by Private Equity investors

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

4. Conclusion

Consequences for entrepreneurs, private and public investors

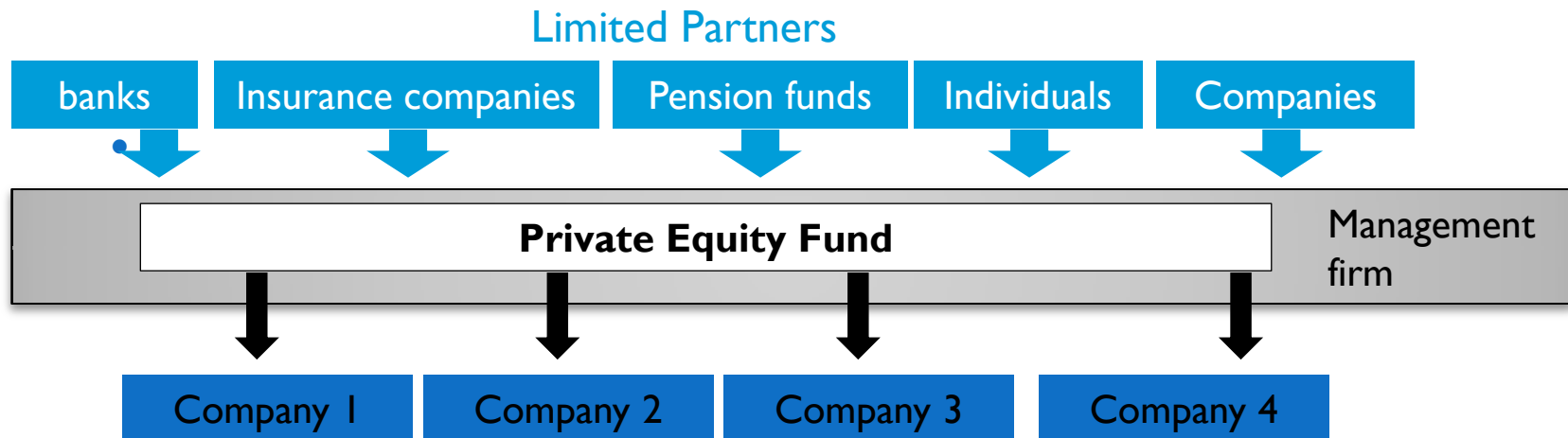


I. INTRODUCTION

Why a focus on the Private Equity industry?

I.I What is Private Equity (PE)?

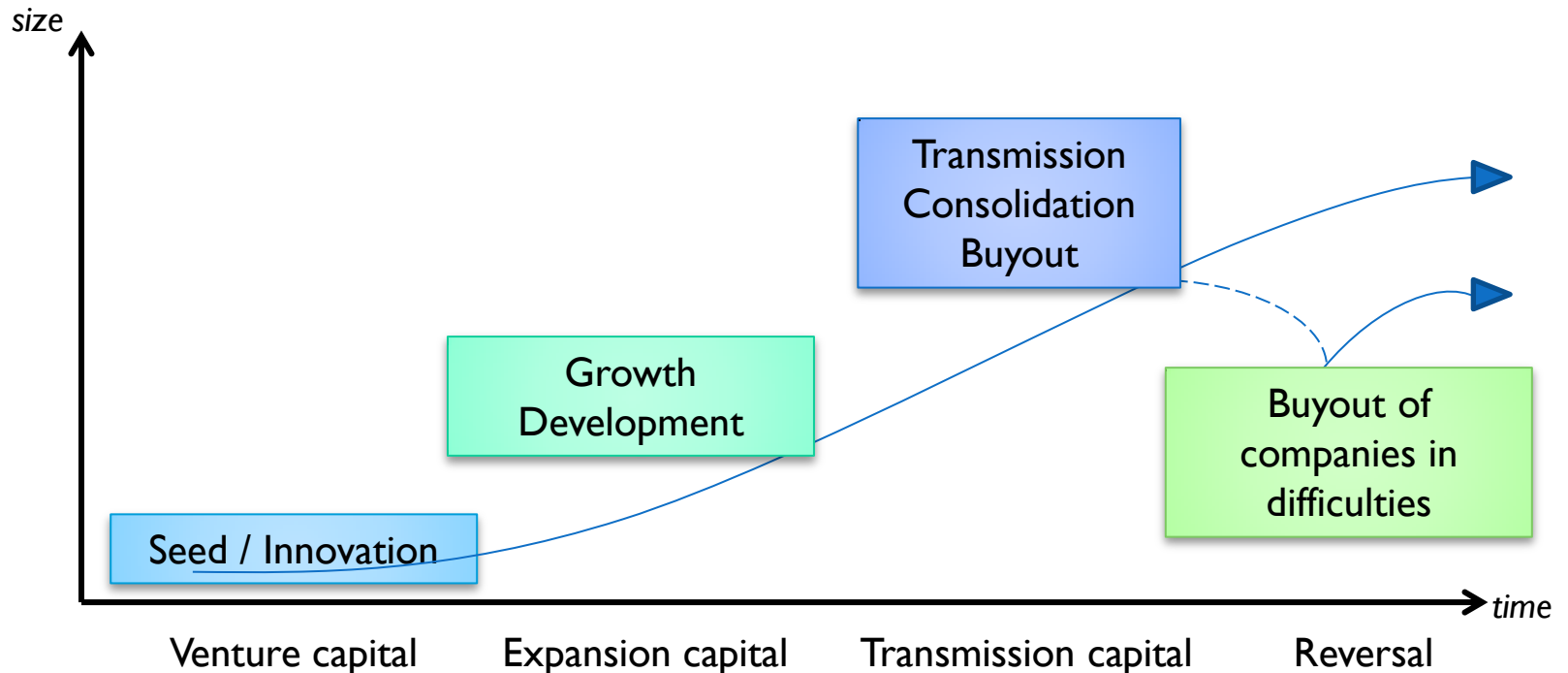
Private Equity designates all tools and procedures that aim at **increasing the equity capital** of **unlisted firms**.



I.I What is Private Equity (PE)?

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?

Working paper: Crifo, P., and Forget, V.D. 2012. *Think Global, Invest Responsible: Why the Private Equity Industry Goes Green.*

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

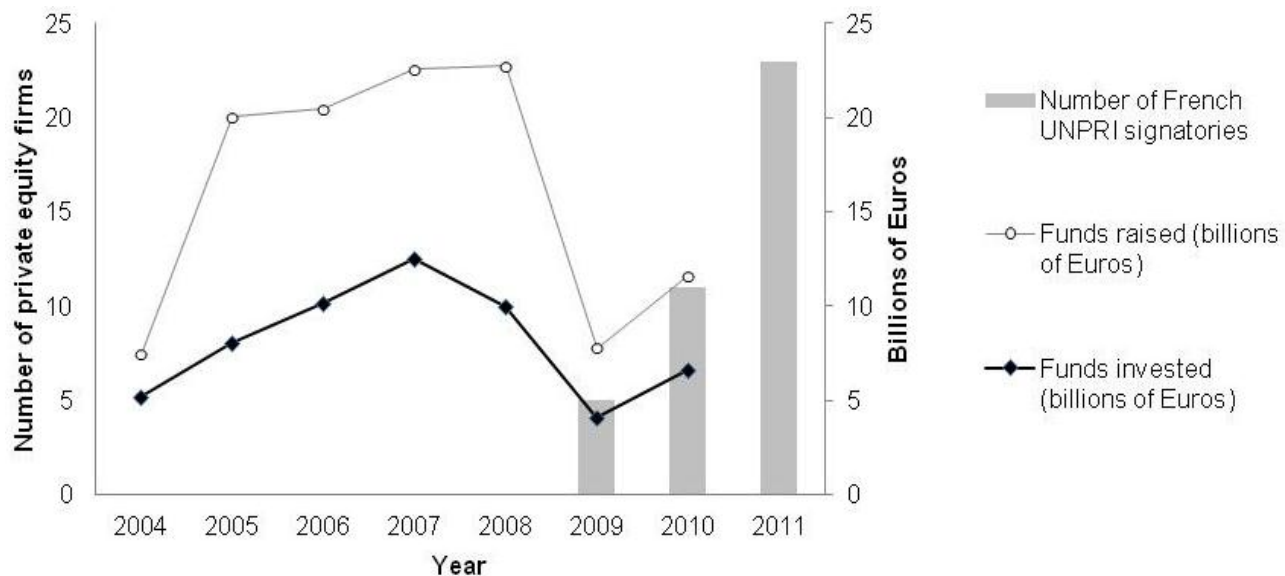


FIGURE 1 LEGEND: Figure 1 presents the French Private Equity market (data AFIC 2011 and UN PRI 2011) in amounts of funds raised, funds invested and UN PRI signatories.

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 1496 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

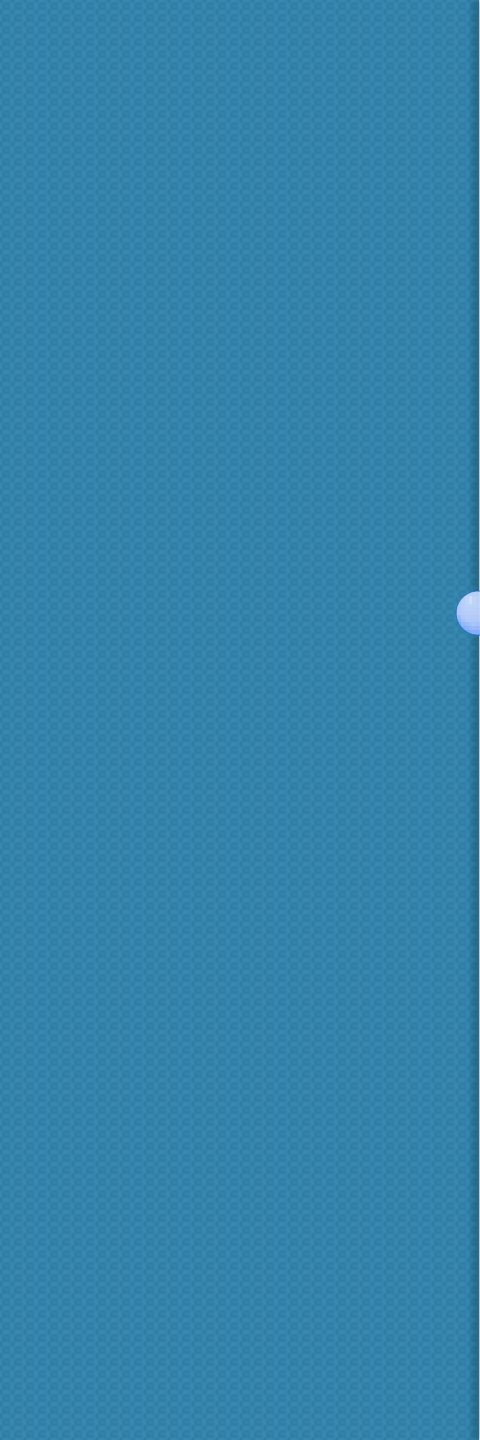
- is characterized by **engagement**, with PE investors typically being much involved in portfolio companies’ management

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?

Working paper: Crifo, P., Forget, V.D., Teyssier, S. 2012. *Valuing Non Financial Performance: An Experiment With Professional Private Equity Investors.*

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 -, --)*

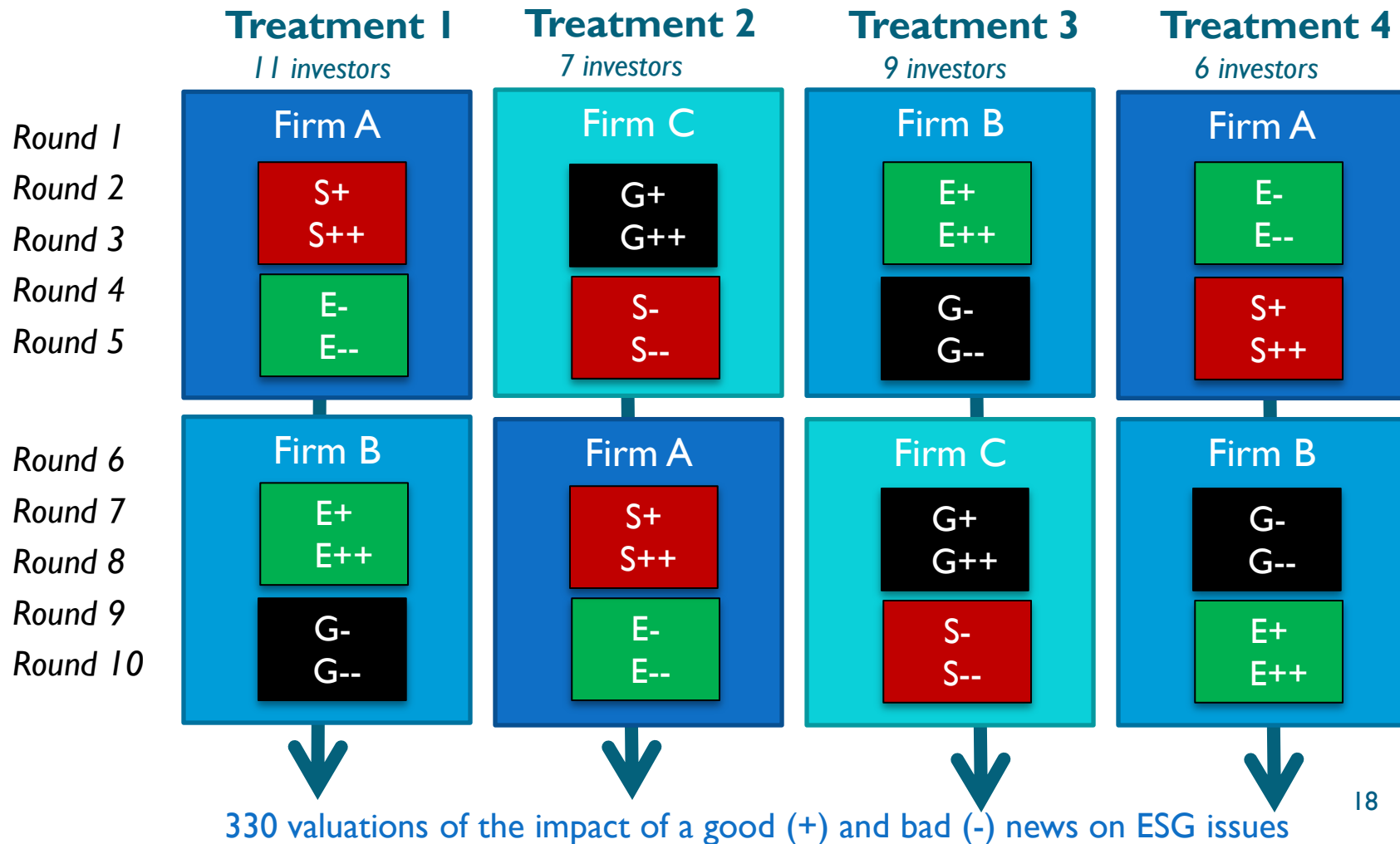
3.2 Experiment design (2/3)

- Case studies

	FIRM A	FIRM B	FIRM C
Sector	Catering	Packaging	Electronic components
Employees (size)	1 600	227	2 608
Good news	Social S+ , S++	Environmental E+ , E++	Governance G+ , G++
Bad news	Environmental E- , E--	Governance G- , G--	Social S- , S --

3.2 Experiment design (3/3)

- Treatments



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

RESUME

Le Groupe B est fabricant de solutions d'emballage à destination des industriels de l'agro-alimentaire. Il a deux activités : l'emballage et les produits de cuisson ; et deux métiers : transformateur et distributeur. Il compte aujourd'hui 227 employés.

Le Groupe B est présent sur son marché de niche (144 M€ au total), avec 35% de parts de marché sur son segment et 15% de parts sur certains segments. Le marché du papier/carton agro-alimentaire est un marché à forte concurrence, relativement certain, risque faible, qui suit le volume la consommation de produits agro-alimentaires. Le marché a été en légère régression en volume sur 2008 et 2009 du fait de la crise (moins de volume), mais devrait reprendre sa croissance, tiré notamment grâce à la croissance de la population (0,8% par an). Les clients du Groupe B sont des grossistes, des enseignes de grande surface, des restaurateurs (caneal de distribution b2b, grande proximité) et des grands industriels de la restauration.

Du fait de la concentration du groupe sur le marché agro-alimentaire, l'activité a connu deux exercices difficiles en 2008 et 2009 (-4,6%). La pression sur les prix existe mais est relativement limitée. Les concessions ont été faites par certains concurrents sur cette période pour maintenir le volume.

Depuis 2009, le Groupe B a entrepris de consolider son positionnement sur des segments en croissance et de se diversifier par croissance externe. L'acquisition du fonds de commerce d'un petit acteur prometteur de l'emballage a ainsi été effectuée. L'activité du Groupe B auprès des industriels, notamment à l'international. Les commandes ont été très résilients sur le terrain pour défendre les positions du Groupe B. En dépit de ses chiffres, le Groupe B n'a jamais autant gagné de clients et contrats et a développé de nouveaux débouchés possibles. Pour soutenir son plan d'action offensif, une véritable fonction de marketing développement a été mise en place en 2010, ce qui donne un nouvel élan à la société. L'image du Groupe B est en train de se moderniser, et cette évolution crée une certaine distance avec ses concurrents traditionnels.

Malgré la crise, le Groupe B confirme donc son positionnement de valeur de fonds de portefeuille, structurellement peu volatile.

BUSINESS PLAN

PnL Consolidé	2010	2011	2012	2013	2014	2015	2016	2017
Chiffre d'Affaires	41,6	43,4	44,9	48,3	47,8	49,3	50,9	52,5
% croissance	-1,7%	4,4%	3,2%	3,2%	3,2%	3,2%	3,2%	3,2%
EBITDA	6,0	6,9	6,2	6,5	6,7	6,9	7,2	7,4
% Chiffre d'Affaires	14,3%	13,5%	13,8%	14,1%	14,1%	14,1%	14,1%	14,1%
EBIT	4,4	4,4	4,8	5,0	5,3	5,5	5,6	5,8
% Chiffre d'Affaires	10,6%	10,4%	10,8%	11,1%	11,1%	11,1%	11,1%	11,1%
Free Cash Flow	2,3	2,4	3,0	2,5	2,9	3,3	3,7	4,3
Compl	2,3	4,7	7,7	10,2	13,1	16,4	20,1	24,4

HISTORIQUE

COMPTÉ DE RESULTAT (M€)		2009	2010
Chiffre d'affaires		39,4	41,6
% variation A-1 CA		-1,4%	-1,8%
Coûts matériels		-21,8	-20,2
Marge Brute		21,8	21,8
% CA		51,1%	51,1%
Total charges		-16,1	-5
% variation A-1		0,3%	-3,9%
EBITDA		6,6	6,4
% CA		16,9%	15,0%
% variation A-1		-5,5%	-3,0%
Amortissements et provisions		-1,6	-1,6
% CA		-3,7%	-3,7%
EBIT		5	4,4
% CA		12,7%	10,7%

Capex opérationnel : 1.2 M€ par an en moyenne

TRANSACTIONS COMPARABLES

Multiples Transactions comparables			
	Multi CA	Multi EBITDA	Multi EBIT
Max	1.1	9.0	12
Min	0.5	5.5	8.0
Moyens	0.9	6.7	10.0

MULTIPLES BOURSIERS

Sociétés Comparables	Cours (€)	Market Cap (€)	Valeur d'entreprise (€)	Multiple CA/LTM	Multiple EBITDA/LTM	Multiple EBIT/LTM
PBB Industries SA	28.80	104.82	176.17			
VPK Packaging	31.07	272.55	329.49	0.53x	6.09x	13.09x

3.3 Experiment procedures (3/4)

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

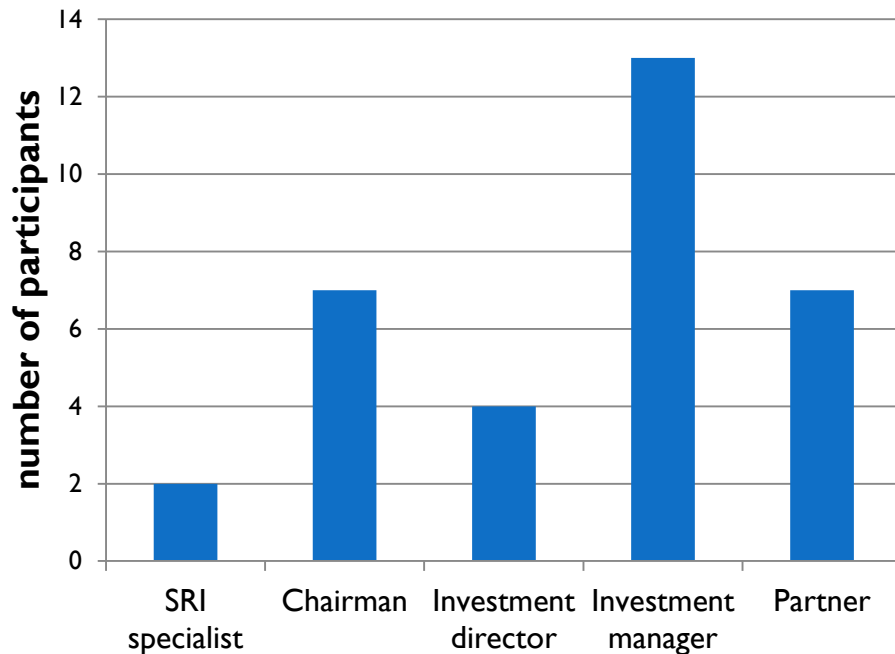


- 2nd case study idem
- Short questionnaire (socio-economic characteristics, understanding, strategy, ESG training, beliefs on ESG factors, risk aversion, altruism)
- About IH30

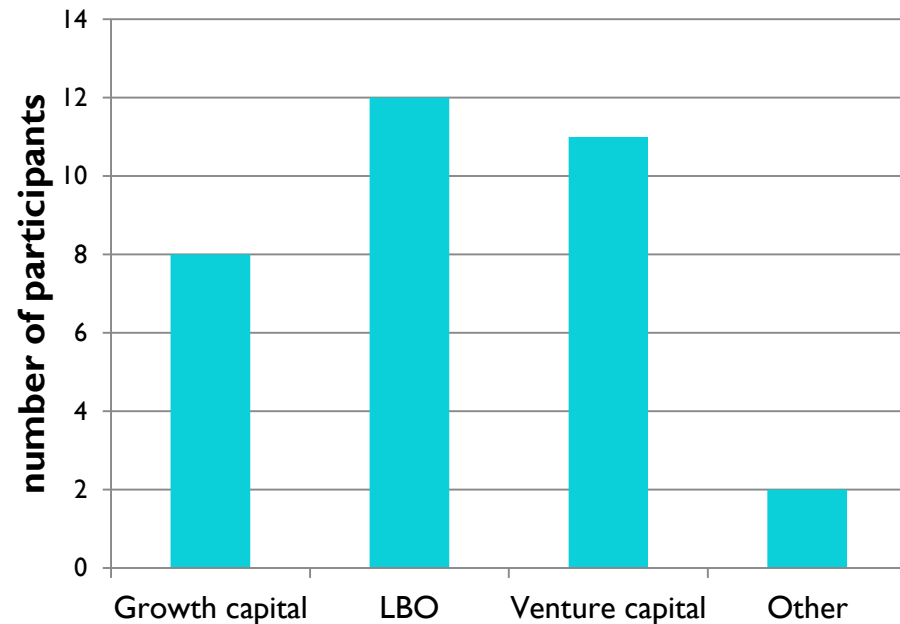
3.3 Experiment procedures (4/4)

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

Participants' post



Participants' expertise

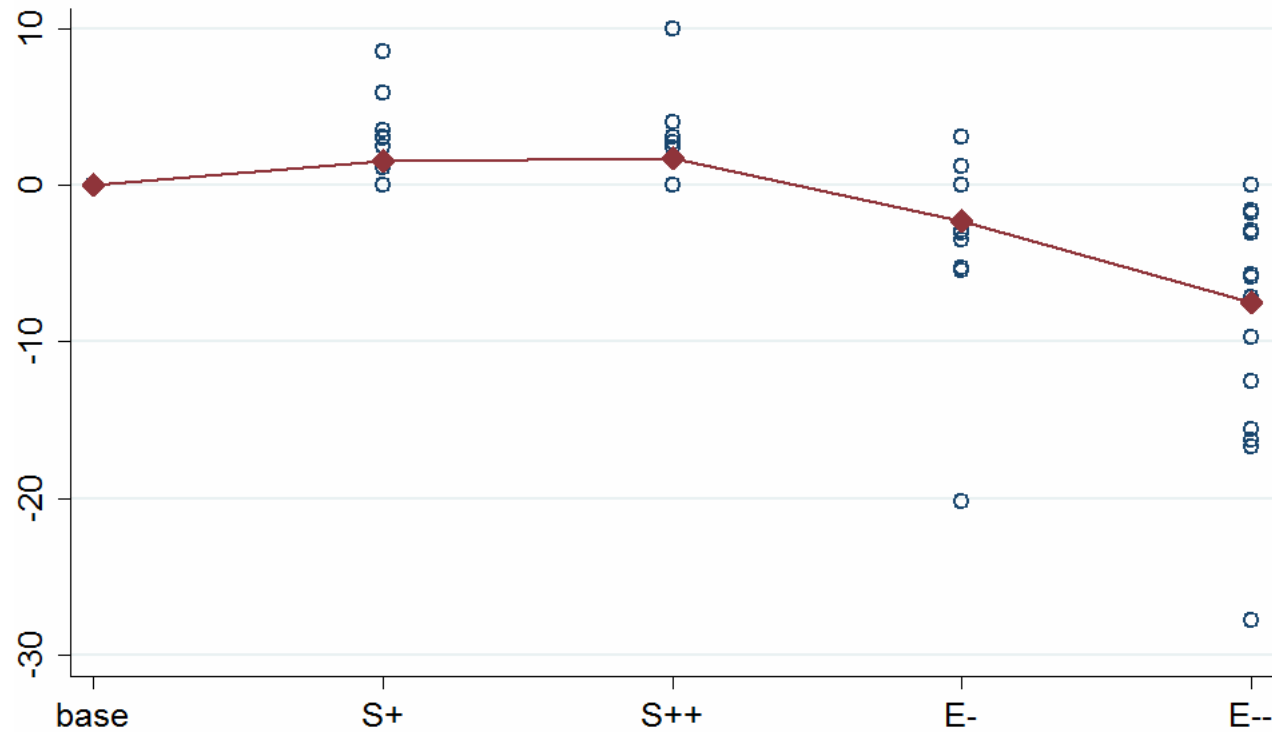


3.4 Incitation mechanism

- 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 IH30 session.
 - good deal: valuation < median valuation x 1.1
 - If the “winner” made a bad deal, she loses her Price (capital loss).
 - bad deal: valuation > median valuation x 1.1
- Reputation incentive
 - High competition between investors

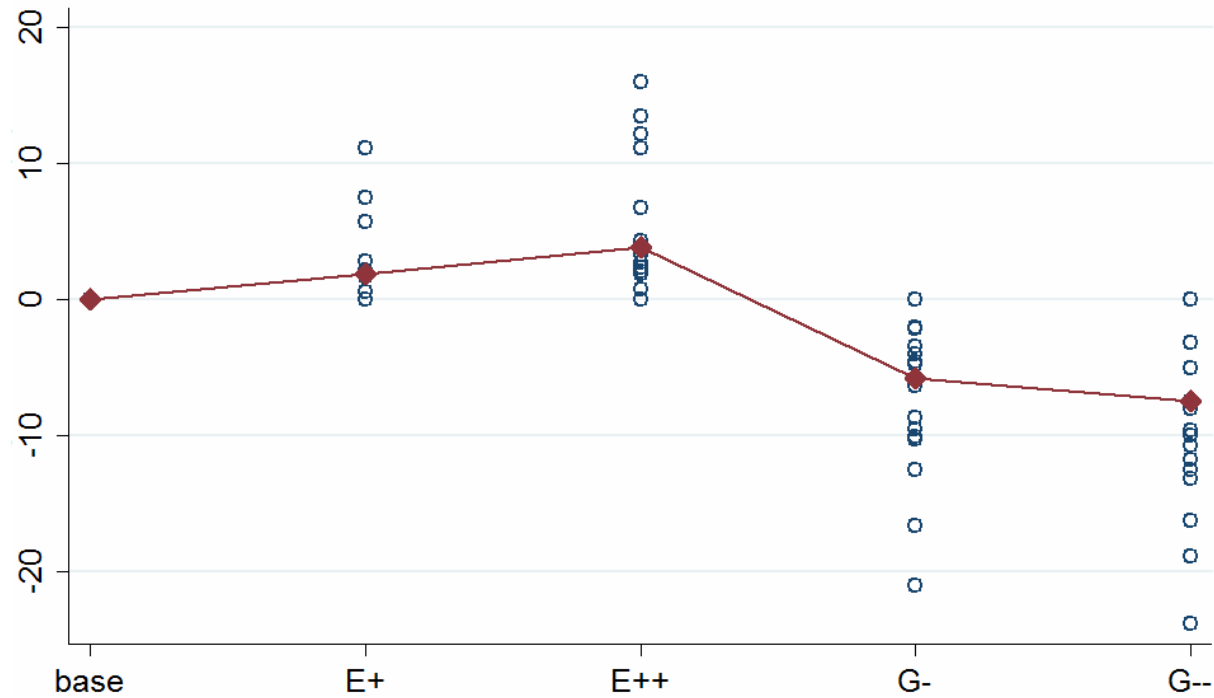
3.5. Results (1/8)

- Results on firm valuation
 - Firm A in treatments I and 2



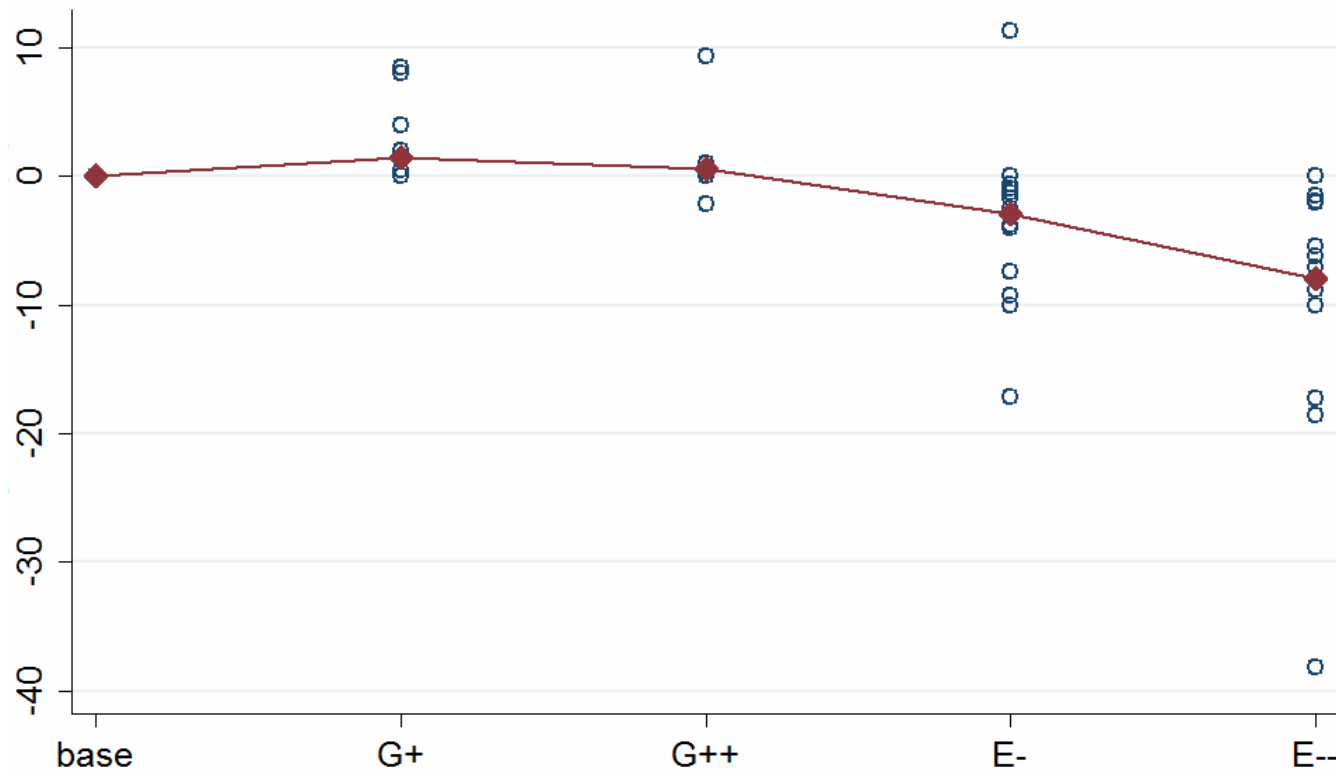
3.5 Results (2/8)

- Results on firm valuation
 - Firm B in treatment I and 3



3.5 Results (3/8)

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



3.5 Results (4/8)

- Results on firm valuation

Estimation of the impact of extra-financial information on the change in firm valuation

variable	GLS model (random effects)		Fixed-effects model	
	Estimate	Std. Er	Estimate	Std. Er
good environmental news	2.40 **	1.04	2.65 **	1.18
bad environmental news	-5.26 ***	1.06	-5.90 ***	1.23
good social news	1.63	1.05	2.54 **	1.22
bad social news	-5.05 ***	1.21	-5.52 ***	1.42
good governance news	1.26	1.21	0.95	1.41
bad governance news	-7.51 ***	1.04	-7.73 ***	1.18
case study order	0.24		-0.16	0.72
internet session	-0.65			
investor age	0.07 *			
investor gender	1.04			
venture capital	-1.55			
buyout	-1.10			
expansion capital	-2.49 **			
SRI	-3.43			
ESG training	-0.00			
risk aversion	0.35			
nb. of observations	310		330	
nb. of participants	31		33	
R-sq (within)	35.9		32.4	
Wald chi2	164.6***			
F-test			19.9***	

* 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

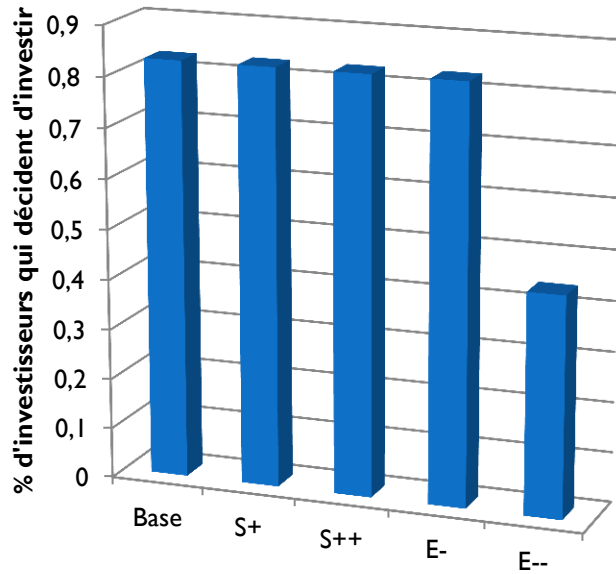


Sustainable and unsustainable practices asymmetrically affect firm valuation by private equity investors

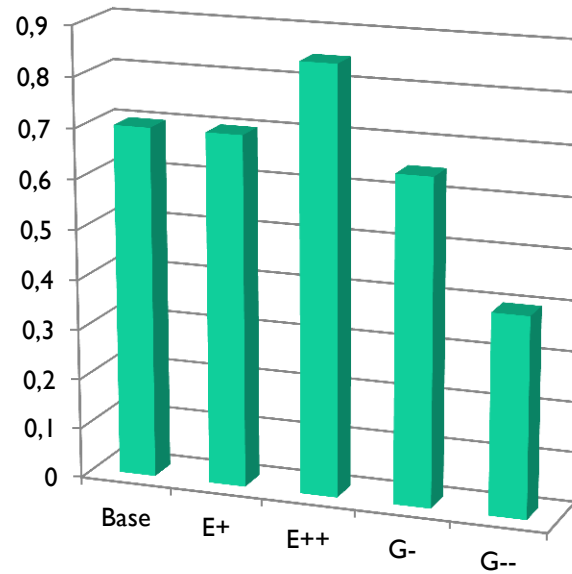
3.5 Results (6/8)

- Results on investment decision

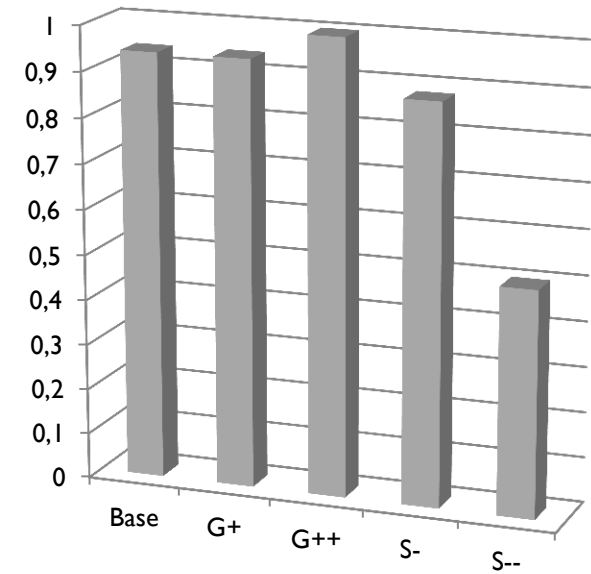
Cas A



Cas B



Cas C



3.5 Results (7/8)

- Results on investment decision

Estimation of the impact of extra-financial information on the investment decision

variable	random effects logistic model		Fixed-effects logistic model	
	Estimate	Std. Er	Estimate	Std. Er
good environmental news	-0.49	0.63	-0.25	0.61
bad environmental news	-1.12 *	0.60	-0.91	0.59
good social news	0.22	0.64	-0.03	0.62
bad social news	-0.82	0.69	-0.95	0.65
good governance news	2.77 **	1.23	2.54 **	1.17
bad governance news	-2.36 ***	0.62	-1.85 ***	0.57
case study order	0.59	0.38	0.36	0.36
internet session	-2.72 **	1.27		
investor age	-0.00	0.05		
investor gender	-1.26	1.02		
venture capital	-1.10	1.54		
buyout	-2.46 *	1.39		
expansion capital	-1.58	1.55		
SRI	-4.28	2.95		
ESG training	0.50	0.85		
risk aversion	-0.19	0.38		
nb. of observations	310		240	
nb. of participants	31		24	
Wald chi2	34.3***			
F-test				
LR chi2	57.4***		31.8***	
log_likelihood	-125.2		-73.7	
rho				

* p-value < 10%; ** p-value < 5%; *** p-value < 1%.

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

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