Invest, Turnaround, Harvest: Private Equity Meets CSR

By Allen L. White
Senior Advisor, BSR

Prepared
October 2006

www.bsr.org
Note:
BSR publishes occasional papers as a contribution to the understanding of the role of business in society and the trends related to corporate social responsibility and responsible business practices. The views expressed in this publication are those of its author and do not necessarily represent the views of BSR or its member companies.

BSR maintains a policy of not acting as a representative of its membership, nor does it endorse specific policies or standards.

BSR is a not-for-profit membership organization that seeks to create a more just and sustainable global economy by working with the business community.
Invest, Turnaround, Harvest:

Private Equity Meets CSR

Allen L. White
Senior Advisor, BSR

Proposed mergers and acquisitions among U.S. and European stock exchanges … The rise of financial instruments such as hedge funds and private equity funds … The pace of change in global capital markets has rarely been more frenetic. Capital markets are nothing if not fluid in terms of their ownership, instruments and governance.

For some, rapid changes signal that the market is doing exactly what it is supposed to do: providing capital holders with a wide range of competitive products and services that, in the aggregate, will move capital toward its most efficient use. For the skeptics, this tumultuous environment is a reflection of the market’s march toward short-termism, where quarterly earnings-per-share trump all other indicators of financial performance. These skeptics see markets as a trading platform rather than an engine of wealth creation, where profits are more closely tied to the volume and timing of the trade than to the intrinsic value and the prospects of publicly traded companies. In the eyes of the skeptics, “stock-renting” (versus “stock-owning”) culture has come to dominate contemporary capital markets.

Whether a person stands on the side of the market believers or the market skeptics, contemporary trends in capital markets have profound implications for corporate social responsibility (CSR). Every day, every quarter and every year, stock offerings and buybacks, investments in R&D, human capital and new technologies, and a plethora of other capital-related decisions affect CSR priorities and programs. The ways in which CSR priorities and programs are affected may not be immediately obvious or measurable, even to those with CSR responsibilities within the firm, but they are real and increasingly significant to CSR performance.

One of the most notable trends that is remaking capital markets is the rise of private equity funds. This rise has been subject to abundant enthusiasm and equally abundant criticism. For enthusiasts, private equity funds are a mechanism for returning stockholding to a model of deeper connection between management and shareholders.  

---

1 A special thanks to Josh Lamstein for his invaluable insights into the working of private equity funds. Thanks also to Aron Cramer, Anna Fleder and Emma Stewart for comments on an earlier draft. Any remaining errors are the responsibility of the author.


3 Here I speak in relative terms. Mutual funds typically turn over within a year and hedge funds within months or even days. In contrast, stocks in many private equity funds are retained for three, four and five years, sometimes more.
Comparatively longer holding periods and intensive engagement with company management relative to (for example) most mutual funds are examples of factors that are more aligned with long-term value creation and compatible with fostering CSR practices with portfolio companies.

For the detractors, however, the picture of private equity is mixed. Private equity funds are protected from the scrutiny received by publicly traded securities and operate without the oversight and reporting requirements of public markets. Further, while many funds genuinely focus on the task of turning around underperforming companies by sharpening management, product and marketing discipline, others seek to move swiftly to acquire controlling interests in a firm and may impose severe cost-cutting measures that do not comport with long-term value creation measured against typical CSR goals, such as the enhancement of human and environmental capital.

From a CSR perspective, it is the details that matter, as absolutes are elusive in this rapidly changing segment of capital markets. Even in the case of the more patient private equity funds, some portfolio companies may be turned around through drastic reductions in labor forces or quick liquidation of assets if such actions promise to maximize returns to the limited and general partners of the fund. Drastic changes may occur regardless of an original strategy of gradual turnaround. Even the transparency dimension is ambiguous, since private equity fund managers report in detail to their investors — including large public pension funds — on a quarterly basis and at a level of detail that may exceed counterparts in publicly regulated securities.

This paper is the fourth in a series that explores the nexus of CSR and a number of critical themes in contemporary business — intangible assets, corporate boards, patient capital and, in this paper, new financial instruments. These papers are bound by a common theme: no aspect of business is wholly disconnected from CSR and, conversely, CSR cannot be detached from critical aspects of managing the modern corporation. If the majority of business leaders do not see these connections, they may miss opportunities and fail to manage real but controllable risks. The goal of this paper and its predecessors is to expose linkages, opportunities and risks that may not be obvious to managers, but are nonetheless essential to managing business amidst the complexities of a rapidly globalizing economy.

What Is Private Equity?

Private equity is a general term given to a range of financial instruments that fall outside the boundaries of publicly traded securities. Private equity, of course, is at work everyday as the fuel for bringing innovations to market. In the venture capital world, private equity

---

1 The following section explains distinctions between various forms of private equity strategies and instruments.
investors pour billions each year into start-ups in biotechnology, internet technology, alternative energy and a host of other sectors. Among these sectors, alternative energy has become the darling of venture capital in the last year. This is the case not only among traditional venture capital funds, but also among hedge funds, investment banks, public pension funds, insurance companies and investment arms of high-wealth individuals such as Bill Gates, Warren Buffet and Richard Branson. Further, leading brand private equity funds such as the Carlyle Group, in partnership with Riverstone, are jumping in. The partnership between the latter has invested U.S. $685 million in a renewable energy fund covering solar, geothermal and ethanol technologies. An estimated overall of U.S. $17 billion was invested in renewable energy in the U.S. during 2005 by these investors and others. Little or none of this surge is driven by CSR considerations, though if it is sustained (by rising oil prices and volatile global oil markets), the outcome will advance the sustainability goal of shifting toward a less carbon-intensive future.

While venture capital has long been a magnet for private equity investors, the more recent manifestation is the billions of dollars flowing into existing companies that, in the eyes of investors, are underperforming by virtue of a stagnant share price or deficient top management. In this segment of the market, private equity investors see opportunities for either asset “stripping” or gradual turnaround through refocusing and re-energizing core business activity. In the former case, private equity investors “buy it, strip it, then flip it” in an effort to produce outsized returns for the limited and general partners. In one recent, extreme case, three private equity firms purchased Hertz Rent A Car from Ford Motor Co. for U.S. $14 billion and, in less than a year, paid out a U.S. $1 billion “special dividend” to the partners even before a new CEO was hired. At about the same time, the private equity group filed for an IPO in hopes of achieving quick financial success for themselves and their investors. In circumstances such as this, with quick turnover and exorbitant payouts drawn from the debt incurred by the newly acquired company, one would be hard pressed to find the smallest indication of CSR as either a motivator or an outcome.

Distinct from the “strip and flip” strategy of the short-term profit seekers are the more measured — and from a CSR standpoint, more promising — private equity funds that are seriously engaged in strategic turnaround of acquired companies. In these cases, private investors (e.g. pension funds, insurance companies, investment banks) acting as limited partners entrust financial assets to a general partner for purposes of identifying and purchasing controlling interests in a portfolio of companies. The duration of the partnership is typically in the five- to seven-year range and considered mid-term by standards of today’s portfolios, which average a year or less for mutual funds and months, weeks or even days for many hedge fund holdings. Funds of this duration fall

---


8 Hedge funds, a $1.3 trillion industry, are another variety of private equity investments not explored in depth in this paper. Suffice it to say that the character of hedge funds, which derive returns as much from weak performance as from high performance, are more closely situated to the “buy-out” firms associated with the aforementioned Hertz deal than the “stewardship” funds on which this paper focuses.
into the category of what may be called stewardship holdings, with the limited partner seeking companies from the outset that fit a particular sectoral or market cap type. In these private equity funds, the expectation (though not necessarily the result for all portfolio companies) is for the limited partner to acquire, turnaround and eventually harvest the returns through deep intervention in the structure and operations of the fund’s companies. It is this stewardship segment of the private equity world that offers the most nuanced interaction with CSR.

Diversity

While relatively large private equity firms (measured by the average size of the funds they manage or total assets under management) such as Carlyle, Blackstone and Apollo are among the best known, hundreds of others have emerged in recent years. In the first half of 2006 alone, 517 new funds were launched in the U.S. with assets totaling an estimated U.S. $117 billion. This compares with U.S. $133 billion during all of 2005.9 Worldwide, an estimated U.S. $174 billion flowed into private equity funds in 2005.10

Expansion in numbers has occasioned greater diversity. Like the thousands of mutual funds in the market — large cap and small cap, technology and extractives, growth and value — each private equity fund has a particular investment focus designed to appeal to various segments of the investor community with widely varying economic and non-economic objectives.

Interestingly, public sector funds are the largest single investor in private equity, with public pensions representing about 40 percent of assets invested in private equity funds. Such institutional investors might be attracted to a fund focusing on under-performing companies in growth sectors (e.g. health care technology and services) in which jobs are at risk due to poor management of the company but are difficult to outsource overseas. This scenario also appeals to the union constituencies whose pension savings form the basis of the institutional investor customer.

A different class of investor — one with an appetite for technology stocks and greater risks — may seek out a private equity fund that scouts for underperforming technology companies with promising but unrealized products and services. Elevation, a Silicon Valley private equity fund and venture capitalist firm, is such a case.11 Elevation has focused on supporting new technology firms, along with old-line media companies seeking to navigate the new world of internet technology. The fund’s experience ranges from leveraged buy-outs of single companies to minority but significant investments in family businesses like Forbes, to more standard sector-oriented collections of multiple underperforming firms.

---

Lifecycle

Regardless of size and strategy, the lifecycles of stewardship private equity funds share certain attributes. At the outset, the general partner defines a specific investment goal and strategy for the new fund. The general partner then works to secure commitments from potential investors prior to the formal launch. Once a significant fraction is secure, the fund is launched. For example, a fund with a U.S. $250 million goal may be declared “active” upon reaching a commitment level of U.S. $150 million. The clock (i.e. the fund’s life) of up to, say, 10 years begins with the declaration of “active.” The general partner commits through formal documentation to the limited partners that the remaining $100 million will be raised within a year. The general partner may also contribute a modest sum to the partnership, but by and large, funds are capitalized through the investments of limited partners plus debt secured from lending institutions to support the fund’s overall investment strategy.

In the first three to four years of the fund, the work of the general partners is to begin building the fund’s portfolio consistent with its investment objectives. Investors, who are already committed to transferring funds to the general partner, may impose certain constraints on how their funds are spent. A public pension fund, for example, may prohibit use of its assets for acquiring shares of weapons or tobacco manufacturers, with the right to opt out of the fund should such agreements be violated.

The task of scouting for firms that fit the fund’s investment strategy requires intensive research by teams comprising business strategists, lawyers, accountants, technologists, marketing experts and others. The typical screening process, overseen by the general partner, includes all or most of the following criteria:

- Quality of management
- Capacity to take on debt
- Revenue prospects
- Quality of historical earnings
- Competitive advantage and disadvantage
- Hidden liabilities

During the portfolio building phase, strategic goals are set for each company at the time of the investment. Phase 2 implementation begins as soon as practicable. As companies are added to a portfolio, changes begin — in top management, in strategic direction, in product focus and in other areas critical to a successful turnaround. New managers may be brought on board with very modest salaries but with powerful incentives in the form of stock options that may increase dramatically in value as the turnaround begins.

---

Here I focus on private equity funds with multiple companies in their portfolios that fall within a definable asset class, such as mid-cap media, health care, life sciences, extractives or alternative energy technology, that have as their overall objective (in the words of Lou Gerstner, Chairman of Carlyle Group) the re-financing, re-energizing and re-focusing of portfolio companies (Thornton 55).
The time horizon of up to 10 years allows for periodic evaluation of strategy and implementation. Mid-course corrections may be put in place, or a decision to either sell or issue an IPO for the company may occur well before the 10 years have elapsed. The challenge of the general partner is to demonstrate that the company is on track to meet its turnaround goals and reward investors, both existing and potential, with competitive returns. By doing so, the stage is set to hold the company for further strengthening, to attract additional private investors with fresh capital and to begin stimulating interest in public markets for the moment when the company goes public.

Meanwhile, to supplement funds from private equity investors, substantial bank debt may be brought in with loans (often seven-year loans) to allow ample time and resources for strategic changes to be fully implemented before the loan comes due. The general partner itself may also invest at any time, though this normally represents a small fraction of the total investment package.

As the full portfolio of companies is implemented in Phase 2, regular communication with investors is the norm. The quality of reporting is one feature that private equity firms use to distinguish themselves from the competition. Typically, upon closing a transaction the general partner sends investors a detailed memo explaining the rationale for the investment and its anticipated return. While quarterly reports on earnings of the entire portfolio and individual constituent companies are commonplace, quarterly earnings expectations are not. In a conversation with a large institutional investor such as a public pension fund, the discussion is likely to focus on progress toward strategic objectives of the portfolio and expected versus actual prospects for enhancing sectoral competitiveness. This is a different conversation than typical CEO-analyst or CFO-analyst discussions that are largely focused on expected versus actual earnings. The protection from Wall Street quarterly pressure draws many to private equity funds. “In a private setting, you eliminate the dysfunctional short-term focus on quarterly results,” notes Lou Gerstner, chairman of the Carlyle Group, who as the former CEO of IBM is well-versed in public equity markets. The inducement to manipulate earnings to meet analysts’ expectations at a level of precision of cents-per-share is heavily muted, if not outright absent.

As portfolio companies move through the rebuilding process, the general partner begins the Phase 3 harvesting process. Options vary widely at this final stage of the lifecycle. Companies that equal or exceed expectations are ready for sale through public offerings. In other successful cases, a general partner may approach a larger firm in the same sector to interest them in acquiring the now refocused firm. In instances where a company has failed to meet turnaround expectations but still holds promise, the general partner may opt to retain the company, implement a second round of changes in management or strategy and re-track the company for later disposition after, say, another two to three years. Where companies fail to meet and have no prospects for meeting financial performance expectations, the general partner may opt to liquidate its assets and absorb

---

13 Thornton, 54.
the loss. If the overall portfolio performance is healthy, liquidation will have a minor impact on overall returns enjoyed by investors.

Through a CSR Lens

This cursory exploration of some private equity fundamentals raises a number of issues relevant to CSR. With the exception of transparency, it is challenging to find even a minor reference to CSR matters among fund managers or those who spend time assessing trends in private equity funds. Issues of human rights, labor standards, environment and even corporate governance are seldom discussed as pros and cons of private equity.

This silence is hardly surprising. For private equity fund managers, escaping the scrutiny applied to publicly traded companies and mutual funds is a key motive for migrating into the field, as this can enable the rebuilding of fledgling companies with a single-minded attention to the mid-term, financial bottom line. Private equity is still a relatively new asset class and is unfamiliar territory to constituents such as environmentalists, human rights activists and many social investors accustomed to monitoring and campaigning against high-profile, publicly traded companies. For these constituent groups, the fact that private equity funds closely guard their information represents a substantial impediment to actively analyzing the CSR performance of companies they hold.

If private equity funds continue to expand at the rate demonstrated during the last few years, it is inevitable that they will be subject to greater scrutiny not only by activists but also by government. Already, the Financial Services Authority (FSA) of the UK has launched a probe into the transparency, debt funding levels and general risks to the stability of financial markets that are represented by private equity.

What can we say at this juncture about the nexus of private equity funds and CSR? At least four issues come to mind: transparency, human capital, stakeholder governance and program vulnerability.

Transparency

Already questions are being raised about the obscenity surrounding private equity fund holdings, returns and reporting. Fund managers argue that the absence of regulated

---

CalPERS, the giant California public employee pension fund, classifies private equity as “alternative funds,” in the same class as hedge funds.

From a cottage industry in the early 1980s with the largest fund managing $135 million, today scores of funds manage $1 billion, with at least five managing $5 billion or more. “The New Kings of Capitalism,” The Economist, November 25, 2004.

disclosure provides the agility and flexibility to identify, invest, refinance and refocus firms that might otherwise fail for lack of management expertise and capital infusion. Reporting does occur on a regular and fairly rigorous basis, generally to portfolio investors at the moment of each new transaction and on a quarterly basis once the fund is fully active. The level of scrutiny falls well short of the spotlight in which publicly traded securities operate. Even for fund investors, the complexity of companies in a single fund may obscure the potential CSR risk, as Yale University discovered in 2002 when it found itself invested in a firm accused of a questionable water development project in an environmentally sensitive area. Few would challenge the notion that transparency is a key pillar of CSR. How can — and how should — private equity funds be held accountable while preserving the aspects of these funds that enable mid-term, strategic investments, which bring new vitality to stagnant companies?

Human Capital

Building human capital is integral to a strong CSR program. It occurs through various mechanisms: in-house training, opportunities for external continuing education, participation in decision-making, incentives, recognition and rewards for innovation. Firms may underperform in part because human capital is either inadequate or poorly deployed. When a private equity fund acquires a firm, the clock starts ticking. While timelines extend well beyond the month or year of typical hedge funds or mutual funds, rebuilding or redeploying human capital takes time, often more than the three to four years during Phase 2 implementation. For the general partner, the lure of severe cost-cutting through staff reductions and termination of human capital development activities is strong, particularly when investor expectations of 25%-30% returns, not uncommon in the private equity world, are driving the decisions of the general partner. What is the actual performance of private equity funds in preserving and enlarging human capital, and are there ways to improve it?

Stakeholder Governance

Empowering a broad range of stakeholders to participate in corporate decision making through board composition, advisory groups, community engagement and other mechanisms is widely viewed as key to effective CSR practice. For private equity funds, such governance is viewed as constraining rather than supporting management and strategic innovation. At their core, private equity funds are financial instruments with a single, overarching purpose of competitive returns to their limited partners. Because the fund’s involvement with its portfolio companies is time-limited to three to five years, little incentive exists to build the stakeholder relationships that CSR leaders at both publicly traded and family-controlled firms seek to cultivate. The result is that decisions of portfolio company managers, with support from the general partner, are skewed toward preparing the firm for disposition at maximum returns within the lifespan of the
The alignment of this goal with the objective and arduous process of stakeholder governance is weak at best.

Program Vulnerability

CSR programs reflect the efforts of multiple parties over many years. Conceptualization, business justification, internal marketing, execution and assessment are costly in terms of direct dollar outlays and indirect costs via staff time. Labor audits in contract factories, electronic product take-back programs, anti-corruption measures in overseas operations and other measures all take money and time with the attendant opportunity costs to the company and its employees. From the vantage point of a private equity fund manager, CSR activities must compete head-to-head with other demands on the company during the years it is actively managed by the partnership. Private equity investors are best viewed as agnostic on CSR matters. They are by definition newcomers with neither the institutional memory nor commitments to bring CSR activities to life. If CSR activities add mid-term shareholder value, they are likely to survive at the firm. If they do not, they probably will not. Of course, many CSR investments are long term by nature. For the general partner of a private equity fund, intangible benefits such as reputation gains and attraction of top talent will likely fall into the category of “nice to have, but will not materialize within the lifespan of the fund.” The pressure to achieve cost reductions to build toward 25% rates of return in the mid-term will place all CSR programs under a magnifying glass. With new management at the helm and incentive structures aligned towards mid-term performance before sell-off, even a strong CSR culture will likely not survive.

The Long View

Transparency, human capital, stakeholder governance and general CSR program vulnerability illustrate the complex interactions of private equity capital and CSR. Part of the complexity stems from the diversity of private equity financing, which ranges from the “strip and flip” profit-taking model applied to single companies to the stewardship funds with 10-year lifecycles containing multiple companies that share a common sectoral identification, such as internet technology, life sciences or extractives. I have focused on the latter, but this does not imply that private equity activity focused on single company acquisitions is any less consequential for CSR.

The story of the private equity-CSR relationship will continue to unfold. Many questions remain unanswered because the nexus of private equity and CSR is uncharted territory, with scant empirical research upon which to make judgments. We do not know, for example, what the actual consequences for human capital and CSR programs have been among companies acquired by stewardship private equity funds. Do the general partners perceive hidden shareholder value in CSR activities that justify their
continuation, even in the face of pressures to deliver 25% percent returns to limited partners? On the side of transparency, public access to information on portfolio companies is highly restricted and unregulated in contrast to publicly traded securities. While institutional and other investors may have access to detailed information that exceeds the disclosures for publicly traded companies, such information is not available to a broader range of stakeholders — including employees, communities, activists and consumers — with legitimate interests in the conduct and operations of companies.

The pathway forward points to a systematic and ongoing monitoring, analysis and communication into how CSR interacts with the full array of financial instruments in the market. A burgeoning number of analyses, principles and initiatives linking financial instruments to environmental, social and governance issues have emerged in the last five years, but virtually all pertain to publicly traded companies. The rapid growth of private equity funds in all their variants indicates a pressing need to look beyond the traditional boundaries of large, public firms into the realm of new financial mechanisms that are ascending rapidly in global capital markets.

---

About Allen White
Allen White in his Senior Advisor capacity with Business for Social Responsibility (BSR) has been charged with challenging both BSR and businesses engaged in the work of corporate social responsibility to think in new and different ways. In practice this has meant drafting a series of thought-provoking public reports designed to serve as the catalyst for dialogue among the many stakeholders that affect and are affected by the nature of business and society relations.