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Human Capital Management: A Gateway into ESG

As private equity embraces the principles of responsible investment, many are looking to HCM initiatives to advance the social and governance components their ESG strategy.

By Laura Queen, CEO, 29Bison

When the Business Roundtable announced it had reconsidered the purpose of a corporation -- from a purely financial and investor-centric orientation to now consider *all* stakeholders -- it marked a significant milestone for the ESG movement. After decades of research, education, and shareholder activism, those who have been arguing for a more sustainable form of capitalism were rewarded by this acknowledgement that environmental, social and governance factors are indeed vital to a company's longer-term prospects. If there's a caveat, it's that investors and business leaders must now rethink their approach to growth and value creation as they adopt a more inclusive lens.

Private equity has always had a paradoxical relationship with ESG. A growing number of GPs, for instance, have signed the UN's Principles of Responsible Investment, including recent signatories L Catterton, Oak Hill Advisors and Paine Schwartz. And the American Investment Council, 10 years ago, published its own responsible investment guidelines for member firms to follow. The asset class, as private and patient capital also represents an ideal vehicle to enact ambitious ESG programs within their portfolio companies. The challenge is that if ESG efforts extend holding periods or divert attention away from other priorities – ostensibly projects more aligned to more-traditional investment theses – ESG will struggle to graduate beyond merely an aspirational component of PE's value-creation playbook.

If an exception exists, it's in the industry's burgeoning efforts to optimize the workforces of their portfolio companies. In fact, the Social and Governance factors of ESG are very closely aligned to many of the most pronounced opportunities and risks some GPs already pursue and manage through Human Capital Management (HCM). For sponsors that have yet to formalize HCM processes into their value-creation plans, doing so also represents an obvious starting point for an ESG strategy that pays dividends to all stakeholders, investors included.

ESG's Parallels to HCM

To be sure, most in private equity already appreciate the role of company management in driving returns. One GP, at their annual investor meeting, noted that without exception, they'd rather own a "C" business with an "A" management team than hold an investment in which the caliber of each was transposed. That said, the "people" factor has traditionally been difficult for investors to quantify.

More recently, a growing body of research is documenting and proving out how critical the workforce is to value creation. One study out of the London School of Business found that employee engagement and satisfaction directly correlate to company performance.

Ironically, the role of people is becoming even more pronounced amid technological change. McKinsey & Co. identified that the most important factors in effecting digital transformation are related to whether an organization either has or can develop the requisite talent and skillsets. Considering digital transformation represents one of PE's most important growth levers, it underscores the risks of overlooking HCM. Investors who perceive advances in AI and machine learning as a way to automate and cut their way to growth are doing it wrong.

Research is also proving out the benefits of cognitive diversity in the workforce – and it's not just emanating out of academia. Recent analysis from Morgan Stanley, for instance, found that the most gender-diverse companies outperformed their benchmarks by 170 basis points, on average, annually.

Still, the risk of ignoring ESG and HCM considerations often fails to hit home until it's too late. For instance, in testimony before Congress, Boeing's CEO had to explain why he ignored repeated warnings from employees concerned about the safety of the aircraft maker's Super Max plane. The CEO was confronted by one email, sent directly to him, that suggested fatigue and "schedule pressure" were contributing to worker mistakes and decisions to circumvent established processes. Yet, Boeing made no changes to its production schedule. For those keeping score, following the second crash involving the company's Super Max plane, its market cap had lost in excess of $54 billion as of October 30, the day of the hearings.

Private equity -- though usually outside the public glare -- is just as exposed. On the same day in October, the buyout of G/O Media (owner of *Deadspin*, *the Onion*, and other media titles) hit turbulence when the bulk of Deadspin's reporting staff quit en masse. The investment initially encountered bumps almost immediately, though, when Deadspin's journalists began reporting on the hiring practices of the sponsor, sketching a picture in which experienced women and people of color were overlooked for open management roles that instead went to predominantly white males from outside the company.

While these are certainly extreme cases, outside of public view, we would estimate that 70% to 90% of failed initiatives are in part attributable to similar cultural and personnel issues that are often ignored.

Beyond just mitigating risks, companies that overlook HCM and ESG factors also absorb opportunity costs. We see this every day in private equity. In one instance, the investment thesis of a deal that we worked on was premised on building out the company's business development capabilities. But the strategy overlooked the causes behind an existing 25% backlog. The GP instead adapted their approach to marry any marketing and sales initiatives to added IT resources and personnel. This allowed the company to keep pace as the sales funnel filled up. Available synergies, too, can be missed without understanding the hidden aptitudes within the organization. In another buyout, we uncovered lean six sigma capabilities that could be further leveraged to improve supply-chain planning and oversight and drive efficiencies in procurement and inventory management.

Every situation, of course, is unique, which makes it hard to deploy a standardized approach. There are a few principles, however, that apply to both HCM and ESG strategies.

Don't Boil the Ocean

As investors attempt to get their arms around everything that goes into Human Capital Management, it can seem overwhelming. To suddenly add ESG considerations on top of everything else is more likely create despair and a sense of hopelessness. We continually remind our clients to avoid the tendency to try to boil the ocean. The most successful GPs determine the issues that are most important to a given business and then prioritize the initiatives that are most material. It's often the case that what matters most can be determined by understanding how it impacts the end customer or market.

Measure What Matters

Almost all executives claim their people are the most important asset of their company. Some would argue that it has become a cliché. Yet, from a financial standpoint, employees are only recognized as an expense line on the balance sheet bundled in with "other" intangible items. This not only conceals the impact of people in driving company growth, but characterizes employees solely as a cost. One of the biggest advances in HCM and ESG, however, has been the development of new metrics that re-orient analysis to focus on the latent opportunity within the workforce.

In HCM, for instance, more sophisticated programs will measure the return on human capital investments or track the total cost of the workforce (TCOW) as a percentage of operating expenses. Investors, meanwhile, have begun looking at productivity of workers (versus profits alone) as a driver of value. In ESG, alternatively, relevant metrics might include days lost to illness per full-time employee or statistics around gender balance and diversity across the organization. Apax Partners, for instance, publishes an ESG report that also tracks at the portfolio company level the percentage of its companies with health and safety policies, anti-corruption guidelines, environmental and waste management protocols, and supply-chain transparency.

Follow Through

It’s one thing to know what’s material and what isn’t; it’s another to track and measure progress; but none of this will create the desired impact without following through. This goes without saying, but in our experience the impact is often far greater than most anticipate.

Employees, ultimately, want to be heard and empowered. Just by formalizing a process to gain 360-feedback demonstrates their voice matters. Other initiatives to foster this dialogue might include group sessions in which staff can help identify strengths, weaknesses, opportunities and threats. Just as sponsors want to align interests with management through shared ownership, compensation is equally important to incentivize the workforce. If stock is not available, other alternatives such as a phantom equity plan can fill the void. The importance of transparency also cannot be understated. In a vacuum, employees will let their imaginations get the best of them. Trust, however, translates into retention, productivity gains, and ultimately financial performance.

It was Adam Smith in Wealth of Nations who noted that “no society can surely be flourishing and happy of which the far greater part of the members are poor and miserable.” The same is true at most companies. And sponsors who are able drive improvements in ESG and HCM across their portfolio will help these businesses deliver a better competitive alternative, enhancing returns in the process. It’s not a compromise; it’s a win/win scenario in which the fortunes of all stakeholders can be enriched.