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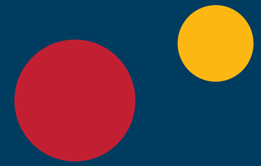


External Research Report

Impact Term Sheet Resources
October 2022

Sustaining strong ESG and sustainability risk and impact management in the context of exit: Considerations for investors and portfolio companies

This research report has been prepared for LISI by one of the law firms in our community.

Mini-summary

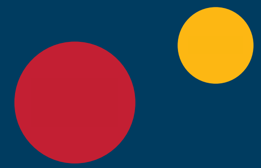
When seeking to sustain momentum on robust sustainability risk or impact management, there isn't a single approach to achieving an exit from an investment that (i) does not undermine the sustainability and/or impact efforts made during an investment holding period and, (ii) instead actually aims to leave a company with the greatest chance of ensuring the sustainability trajectory can continue.

How best to prepare for an effective exit

- Plan ahead: best market practice is to build exit considerations into an investment strategy from the outset. Yes, that early: targeting investments where sustainability and/or impact is central to a business model and/or is management's focus can help during the investment holding period and when approaching exit, to ensure sustainability concerns remain central to the company's strategy. Although investments and projects will change during their lifecycle, early establishment by an investor of their priorities for exit (including sustainability and/or impact) is advantageous.

- Communicate: regular communication with portfolio companies ahead of and on an exit strategy helps ensure alignment and understanding, and avoiding a vacuum post-exit where progress made over the holding period is quickly lost. The management team of portfolio companies should outline their perspectives on how to ensure a smooth transition and ensure, where possible, continuity of management and key personnel. Portfolio company management will also be key to identifying areas of value creation and impact built up during the hold period.

- Who to sell to? When exit approaches, balancing sustainability concerns with financial performance requires careful thought. Identifying an appropriate purchaser requires considerable attention, and where flexibility on exit timing can be built in this is useful to alleviate pressure on selling to a buyer who does not grasp strong ESG risk/opportunity management or is not pursuing impact outcomes.



Practical examples

Recognise the opportunity to create financial value and manage risks as well as promoting broader values:

Increasingly common market practice includes private equity ("PE") or venture capital ("VC") firms establishing and pursuing a sustainability agenda throughout the PE/VC firm's holding period and incorporating this into exit strategy from the outset to demonstrate effective risk management and value creation. Here are some different approaches they might take:

- **Enhanced risk management:** Measuring and monitoring ESG performance or impact throughout the holding period without necessarily achieving an impact 'goal' or assessment of performance at exit but where the ESG credentials form part of the value offering to potential buyers (either from the perspective of improved risk management or greater potential for value creation);

- **Impact and value creation potential:** Measuring and monitoring impact throughout the holding period of the investment with a clear time-bound target or 'goal' and showing progress towards this on exit. This does not only have to focus on purpose-driven or "green" companies, but significant impact can be achieved by working with companies to move them from "brown" to "green". Sometimes the outliers will show the biggest turn around; or

- **Achieving impact and values-alignment as part of value creation:** Measuring and monitoring impact throughout the holding period of the investment with a clear time-bound target or 'goal', and linking this to a financial incentive for realising that target or goal or alignment with purpose or values - incentivising sellers to enhance and substantiate ESG credentials and achieve targets and goals. Win-win.

The length of a holding period can affect the relative success of pursuing sustainability goals. ESG initiatives often take time to be embedded and realise results, and these may not always necessarily align well with PE and especially VC firms operating on a shorter time horizon (and for whom the primary aim often remains maximising pure financial returns).

Industry commentators such as the Global Impact Investing Network ("GIIN") also refer to examples of fund managers' exiting from microfinance businesses (see links below).

Similar principles are also adopted by non-governmental organisations and aid agencies on their exit of a particular geography or project, and its handover to local partners.

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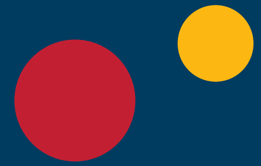


Examples that frame a possible new approach to this topic

A framework for categorising new approaches and methods is described in the question: "What are some specific practical examples relevant to this research area, and how might you categorise them?" above. In addition, the following approaches are drawn from market practice:

How impact increases sale value

Documenting success on sustainability and ESG-related initiatives and goals can attract potential buyers that hold sustainability and impact management as priorities and help enhance a company's potential sale value. This can be aligned with company purpose and values, which may attract potential buyers who give such principles similar or equivalent importance. However, documenting this requires having the systems and processes in place during a holding period to ensure this data can be captured and then reported.

Screening purchasers for alignment

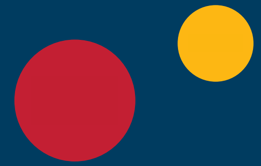
It is possible to look to identify appropriate prospective purchasers at an early stage in the exit process - identifying alignment with sustainability objectives and ambition. The GIIN suggest first screening potential purchasers based on their reputation, demonstrable commitment to sustainability and furthering the impact of an investment. A seller can then evaluate bids both on the basis of financial return and sustainability. Portfolio company management could also be involved in this process to identify the extent of their alignment with a potential purchaser.

Creating financial incentives

Typical PE or VC models and investment timeframes may generate greater pressure for a hastier exit where ESG and sustainability considerations are given lesser importance. The GIIN advocate using creative financing models which offer flexible repayment options, such as structuring loan repayments as a percentage of revenues. Such structures mean companies can adapt their repayments to variable cash flows and can assist a selling firm in alleviating the pressure to sell quickly. Instead, they have time to find a buyer with a greater degree of alignment to the portfolio company's sustainability agenda and trajectory.

Values alignment

Of course, companies may be able to emphasise broader values-alignment driven from a belief or purpose that improving sustainability performance is "the right thing to do" for people and planet or to promote company culture and attract or retain staff with similar principles.



Drivers of the effect impact has on exit strategies?

The approaches to how impact may affect exit strategies is largely based on market and commercial considerations, rather than necessarily legal or regulatory drivers - which are still emerging to develop consistent market practice - (although legal and regulatory factors should of course be accounted for).

Legal approaches may include:

- Assigning, at exit, a measure of ownership or control to the former investor. The GIIN suggest a golden share with special voting rights to an entity related to the investor or, alternatively, allowing an investor to exit by selling shares to an entity that issues participation certificates. In a similar vein, Grassroots Capital advocate 'hardwiring social mission in shareholders' agreements (SHA) to help give founders and investors confidence that the mission of the company will be preserved in the face of investor turnover or dilution'. The GIIN note that anti-dilution SHAs can also help ensure some continuity of management across changes in company ownership. Such measures are intended to ensure the founder(s) can safeguard the company's culture, as well as encouraging managers to forgo short-termism in preference for building longer-term value. Non-standard clauses in an SHA can include provisions stating a company's ESG priority (subject to a financial sustainability floor).

- Committing to measure ESG or impact-related KPIs, and reporting on these at regular intervals to investors. This generates increased accountability to investors and, as a result, compels funds to drive portfolio companies' performance against impact-related KPIs.

- A 'carrot': linking performance against impact-related KPIs to a financial incentive (for example, to carry payable to a general partner in a partnership structure). This incentive can take various forms:

  - 'step-up': award of carry payable depending on achieving certain ESG or impact thresholds;
  - 'proportional': award of a proportion of carry in the event that the impact is partially achieved;
  - 'all or nothing': award of carry payable if the impact-related KPIs are fully achieved.

- A 'stick': alternatively, non-achievement of ESG impact-related KPIs could result in a penalty or sacrifice of a percentage of carry.

- Inserting an ESG-related covenant into sale and purchase documentation, as was the case in KKR's acquisition of Upfield, the spreads business of Unilever in 2017.

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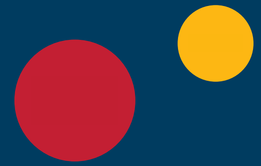

Case Studies

Initially applied to its investments in the education sector, TPG actively undertakes impact exit assessments of investments in order to obtain learnings of key impact drivers. TPG have noted that a key takeaway is that the quality of implementation during the holding period is central to realising impact. In other words, successful outcomes result from effective implementation of processes and procedures.

The GIIN refer to a number of case studies, including fund managers Adobe Capital and Lok Capital, and their respective exits from microfinance companies. Adobe Capital reportedly adopt novel repayment approaches including royalty-based repayment structures, which alleviate pressures on sale and give a seller greater time to identify a purchaser aligned with their sustainability and impact agenda.

In a different context, lessons from INGOs operating in the sphere of international development provide potentially useful insights. EveryChild have been heralded as an INGO which has achieved a number of successful exits from countries in which it had operations. Principles EveryChild consistently adopted included: (1) involving local partners throughout the exit process (and, where appropriate, letting them lead the process), (2) communicating with them the plan and stages for exit, (3) giving sufficient time and capital to ensuring a smooth transition to local partners, (4) building capacity, knowledge, experience and relationships between local partners and other stakeholders pre-exit, (5) engaging wider stakeholders in the community and state apparatus, and (6) documenting the successes and failures in an exit to learn lessons for the next exit.

In preparation for exit, CVC note they are increasingly disclosing relevant ESG information to potential buyers. Disclosing such ESG information and demonstrating performance and impact can, as discussed above, increase sale value. The nature and extent of such disclosure depends on the form of exit (e.g. if a portfolio company is undertaking an IPO, CVC supports the company in preparing the relevant exchange ESG disclosures).

See CVC's 2022 ESG Report: https://www.cvc.com/media/twedkg2x/cvc-esg-report-2022_final.pdf.

Similarly, Lok embed a number of the principles described above into exit strategies, including making early consideration of exit (whilst allowing room to adapt such a plan during the holding period), and screening potential acquirers for their alignment with Lok's own sustainability policies and those of the portfolio company and its management.

It should also be noted that the ESG principles and strategies outlined above are not restricted to companies operating only in "green" industries or sectors. Rather, ESG factors may be applied to improve companies which have traditionally operated in "brown" industries (for example, companies operating in the fossil fuels industry), or which may be excluded from the investment strategies of asset managers (including defence or tobacco companies). On a case-by-case basis companies and their investors may consider specific ESG initiatives relevant to that entity, and seek to encourage the adoption of these.

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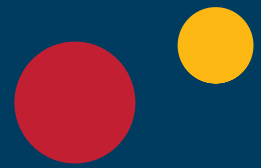

Further Reading

Schiff, H and Dithrich, H (Global Impact Investing Network) (2018), "Lasting impact: the need for responsible exits", available at https://thegiin.org/assets/GIIN_Responsible%20Exits_2018.pdf (first accessed 17 June 2022);

This report offers insights into how investors might enable organisations and projects in which they invest to deepen their impact beyond the duration of the investment. GIIN acknowledge that a responsible exit can be planned for early in the investment lifecycle and continuously re-evaluated during the holding period, stress the importance of evaluating prospective buyers for their alignment and sustainability priorities (and mechanisms to ensure sufficient time can be given to identifying the appropriate purchaser), and highlight potential legal approaches to ensuring impact beyond exit.

Gray, J, Ashburn, N, Douglas, H and Jeffers, J, (Wharton Social Impact Initiative) (2015), "Great Expectations: Mission Preservation and Financial Performance in Impact Investing" (first accessed 20 June 2022);

This article encourages managers to seek out acquirers aligned on sustainability priorities, and considers the 'tension' between preserving a company's impact 'mission' and economic factors. The authors also discuss using clauses in shareholder agreements to preserve ESG performance.

Grassroots Capital Management, (2014) "'Hardwiring' Social Mission in MFIs" (Concept note, Grassroots Capital Management, available at https://www.grassrootscap.com/wp-content/uploads/2014/02/Hardwire_Jan2014.pdf (first accessed 20 June 2022);

Raising concerns for potential mission drift, stakeholder incoherence and investor disillusionment, this article advocates explicit integration of social mission into legal documentation in order to safeguard a company's culture and prioritise longer-term objectives.

INTRAC (2016), "Exit strategies and sustainability: lessons for practitioners", available at https://www.intrac.org/wpcms/wp-content/uploads/2016/11/Exit-strategies-and-sustainability.-Lessons-for-practitioners.-November-2016.pdf (first accessed 16 June 2022);

This paper considers sustainable exits in the context of international development. Many of the principles highlighted in this paper are equally applicable to exiting investments in a commercial context.

Boiardi, P and Hehenberger, L, (European Venture Philanthropy Association) (2014), "A practical guide to planning and executing an impactful exit", available at https://evpa.eu.com/uploads/documents/EVPA_EXIT_STRATEGIES.pdf (first accessed 17 June 2022);

British International Investment, "ESG Toolkit: investment cycle, exit" (available at https://toolkit.bii.co.uk/investment-cycle/exit/) (first accessed 20 June 2022);

INTRAC (2015), "Working at the Sharp End of Programme Closure: EveryChild's Responsible Exit Principles", available at https://www.intrac.org/wpcms/wp-content/uploads/2016/09/Praxis-Note-70-EveryChilds-Responsible-Exit-Principles-Final-Lucy-Morris-Head-of-Programmes.pdf (first accessed 20 June 2022).