

RCP|Advisors

Your Private Equity Partner in the Lower Middle Market

Concerns vs. Benefits: ESG Within Middle Market PE

Q4 2019



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ESG Investment Considerations

Introduction & Methodology

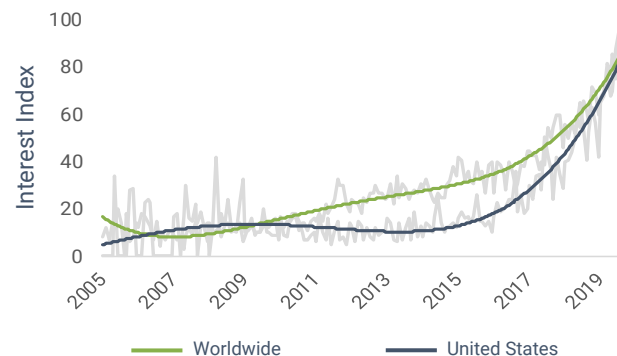
Do ESG “Benefit” Investments Differ Meaningfully From ESG “Concerns?”

INTRODUCTION

- » “ESG” (Environmental, Social, and Governance) refers to three widely-recognized criteria for evaluating investments’ non-financial impacts
- » Google Trends search reveals heightened interest: the term “ESG” in Finance has grown immensely since it was coined in 2005, with US searches quickly catching up to worldwide interest

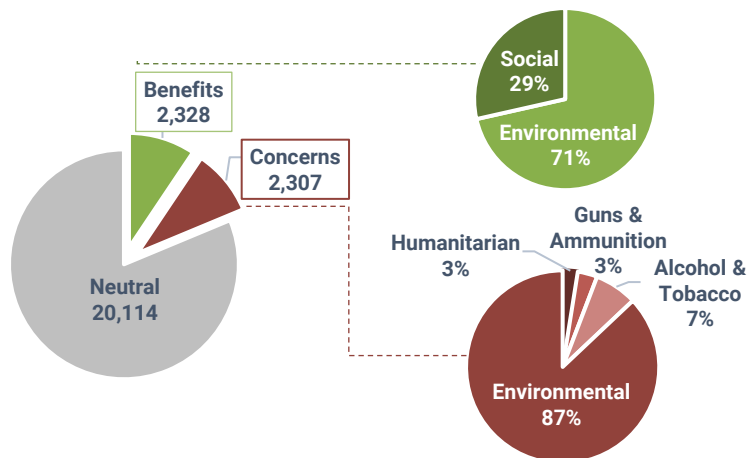
Leveraging its proprietary database of 34,700+ transactions by 3,300+ Private Equity managers, RCP Advisors seeks to measure the trends and outcomes associated with ESG investing in Middle Market Private Equity

Google Trends: “ESG” in Finance



METHOD

- » Each operating company in RCP’s database is labeled as an “ESG Benefit,” “ESG Concern,” or “Neutral”:
- » RCP Advisors analyzes the impact of having a certain ESG label on various investment metrics:



Deal Flow

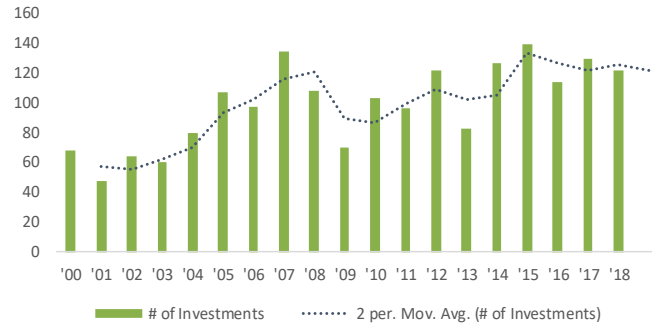
Moving Towards Good: “Benefit” Deals Rising While “Concern” Deals Shrink

ESG BENEFIT

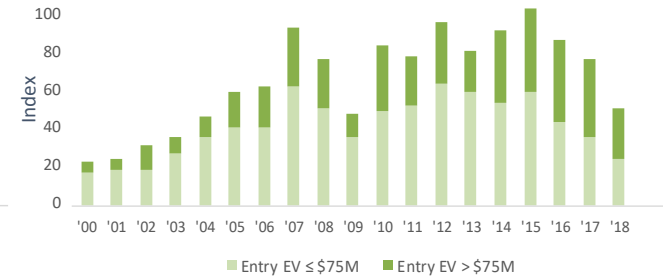
- » Volume of investments into ESG “Benefit” companies has steadily increased since 2000
- » Since 2013, large* companies make up an increasingly higher proportion of ESG “Benefit” investments

- » Demonstrates market-wide shift in demand towards socially- and environmentally-responsible investing

Initial Investments Since 2000



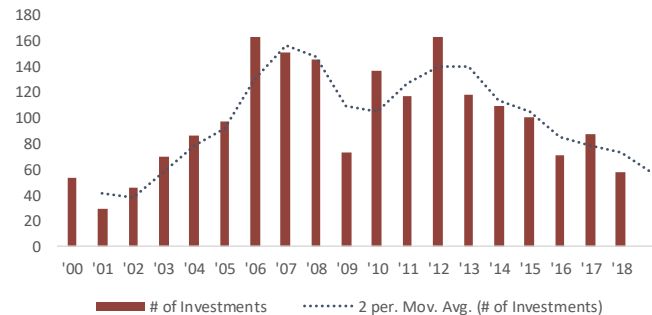
Initial Investments by Company Size



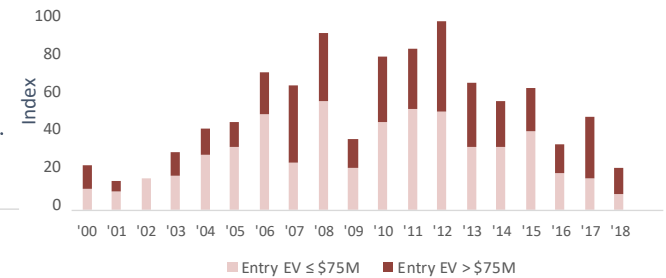
ESG CONCERN

- » Investment volume has been markedly decreasing since 2012 peak
- » Evident for both large and small companies
- » Signals heightened awareness of risk factors associated with ESG “Concern” sectors

Initial Investments Since 2000



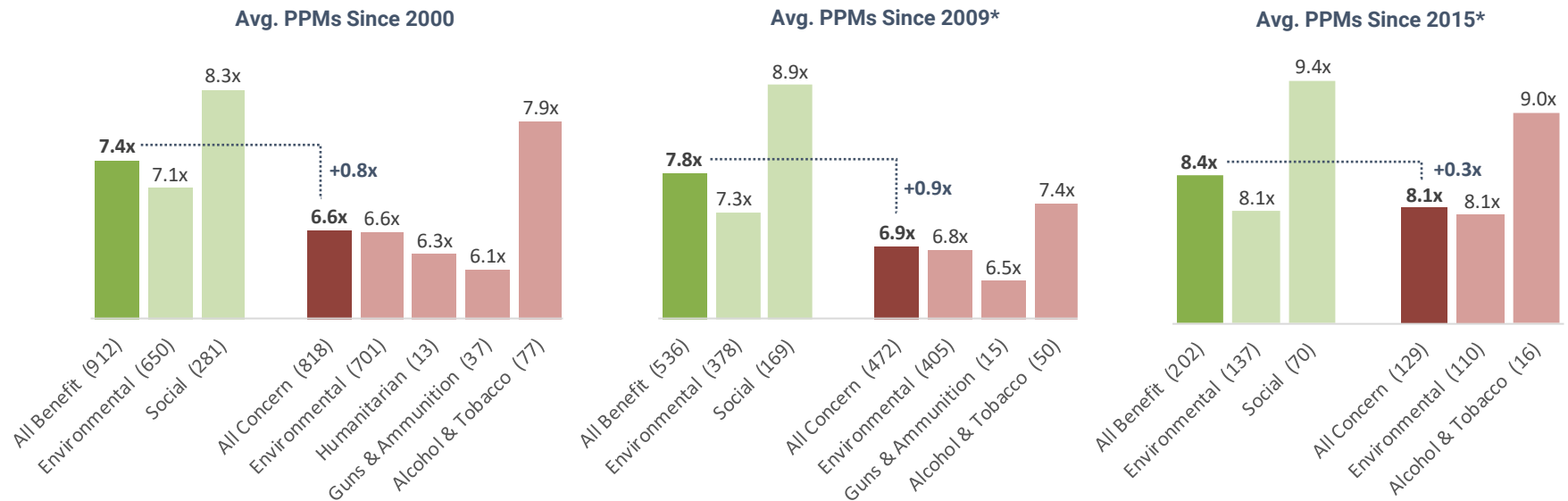
Initial Investments by Company Size



*Companies with Entry EV ≤ \$75M labeled “small”; companies with Entry EV > \$75M labeled “large.”

Valuations at Entry

No Meaningful Price Difference Between “Benefits” and “Concerns” Since 2015



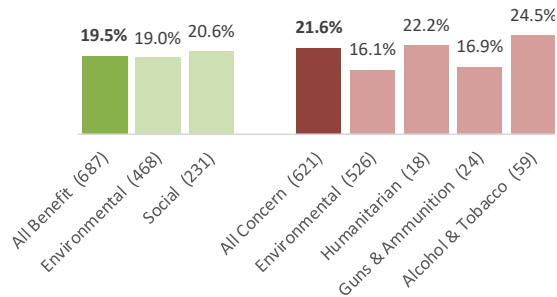
- » Companies labeled ESG “Benefit” command higher valuations on average than ESG “Concerns”
 - Driven mainly by high purchase price multiples (PPMs) within the “Social Benefits” category
 - “Alcohol & Tobacco” consistently the most expensive category within “Concerns”
- » However, purchase price discrepancy between “Benefits” and “Concerns” has shrunk significantly in the past five years
 - Especially apparent in the “Environmental” category: since 2015, Environmental “Benefit” deals are no longer more expensive on average than Environmental “Concerns”
 - Continued rise in “Social Benefit” valuations balanced by rising “Alcohol & Tobacco” valuations

*Any category with fewer than 10 observations is excluded from the analysis.

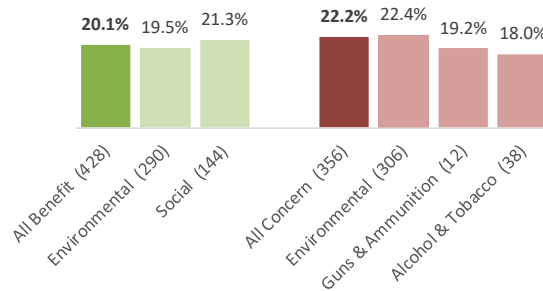
EBITDA Margin & Growth

“Benefits” Outperform “Concerns” in EBITDA Growth

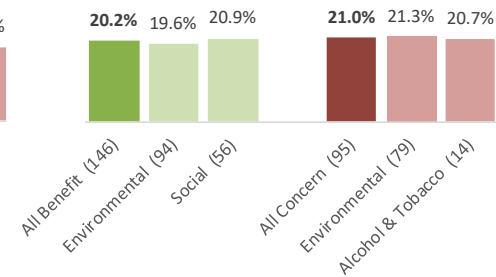
Avg. Entry EBITDA Margin Since 2000



Avg. Entry EBITDA Margin Since 2009*

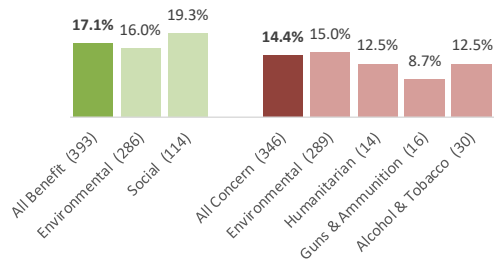


Avg. Entry EBITDA Margin Since 2015*

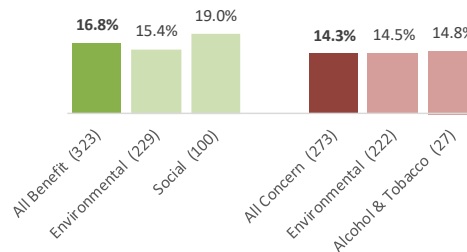


- » ESG “Benefit” companies tend to have lower entry margins on average, although the gap has shrunk over time and has not been statistically significant since 2015
- » Decreasing difference may be due to heightened pressure to invest in mitigating ESG-related risks

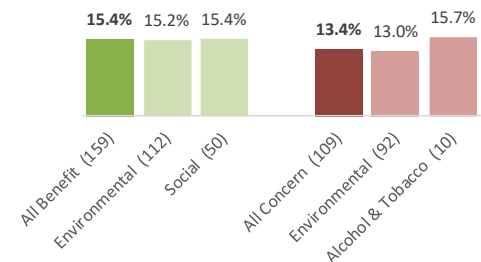
EBITDA CAGR Since 2000**



EBITDA CAGR Since 2009***



EBITDA CAGR Since 2015***

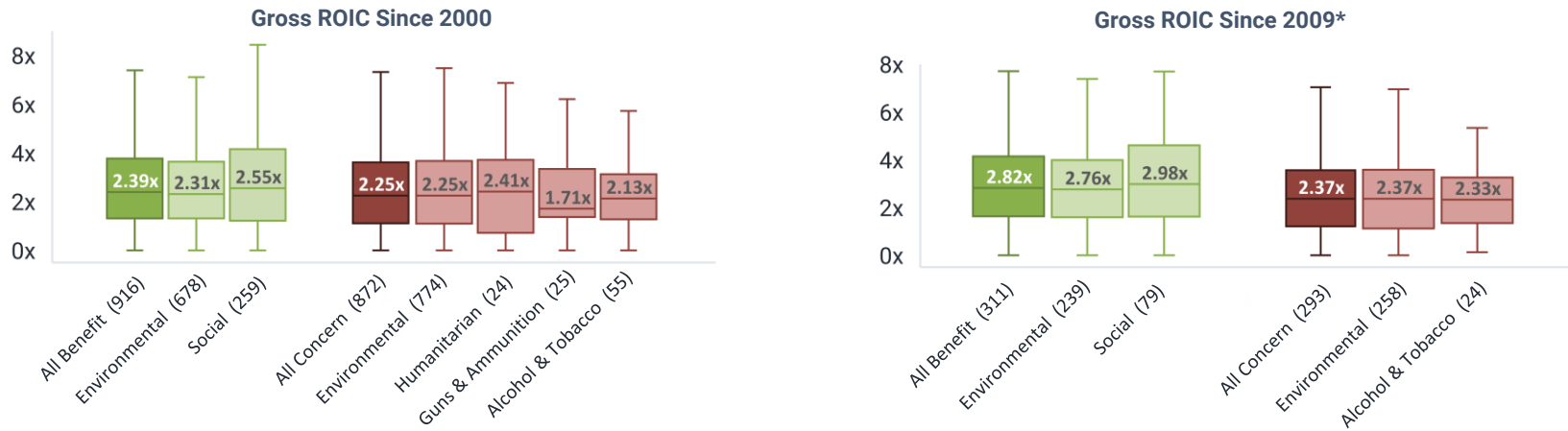


- » ESG “Benefits” outperform the “Concerns” category in EBITDA growth, with 270bps overall outperformance in CAGR since 2000
- » EBITDA CAGRs have been gradually decreasing over time for both categories, in line with overall market conditions

*Any category with fewer than 10 observations is excluded from the analysis. **EBITDA CAGRs are calculated for each investment at year of exit.

Investment Performance

ESG “Benefits” Returns Outperform “Concerns” in both Risk and Reward



- » ESG “Benefits” increasingly outperform deals labeled ESG “Concern,” with confirmed statistical significance
 - Benefits show higher average, median, and top quartile performance
 - A visibly muted downside validates use of ESG “Benefit” investing as a risk-mitigating tool
- » “Benefit” outperformance has strengthened in past ten years
 - Difference in average ROIC between all ESG “Benefits” and “Concerns” has increased from 0.09x since 2000 to 0.56x since 2009
 - Not due to poorer performance in “Concerns” category, but rather to significant improvements in “Benefits” category

*Any category with fewer than 10 observations is excluded from the analysis. **Past performance is not indicative of future results, which may vary.** Future returns are not guaranteed, and a loss of principal may occur. No investment or investment strategy implies a complete lack of risk. A private fund investment involves a high degree of risk as such investments are speculative, subject to high return volatility and will be illiquid on a long-term basis. Investors may lose their entire investment.



Conclusion



ESG Focus Has Yielded Benefits In Returns

Relationship between ESG Benefit and Concern investing parallels “Tortoise and the Hare” narrative

- » While ESG-beneficial investments are more expensive and have worse margins on average at the outset, “Benefits” show higher growth prospects, materializing in significant return outperformance compared to “Concerns”

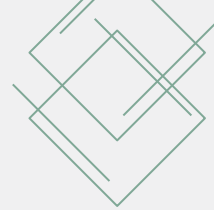
Increasing risk profile associated with “Concern” investments...

- » Shifting consumer preferences
- » Fluctuating availability/cost of materials
- » Increasingly stringent regulations around “Concern” sectors

...encourages asset managers to protect their investments by incorporating ESG considerations



Implementing an ESG Policy



Implementing an ESG Policy

RCP Advisors Offers ESG Policy Templates to Promote ESG Compliance

- » In order to ensure industry-wide progress toward responsible, forward-thinking, and diligent investing, RCP Advisors has created three fully-written ESG policy templates for managers wishing to implement (or improve) an ESG policy framework:
 - The “**Baseline**” policy encourages beginners to learn about and implement basic ESG considerations
 - The “**Comprehensive**” policy encourages managers to conduct ongoing ESG diligence
 - The “**Reach**” policy encourages managers to become industry leaders in ESG through intensive tracking and reporting of ESG considerations
- » The policies cover three major categories:
 - The “**Pre-Investment**” stage delineates what to consider when evaluating investment opportunities
 - The “**Operating**” stage delineates how to improve, measure, and report investment performance
 - “**Firmwide**” delineates corporate best practices for managers to incorporate into day-to-day processes
- » Use the following checklist to determine which policy template fits your firm’s goals and capabilities

We encourage you to use one of the following RCP ESG Templates.

Request your complimentary, fully-editable template [here](#).

ESG Policy Checklist: Pre-Investment Stage

Baseline:

- Assign an ESG champion at the Partner level OR engage outside ESG experts to guide ESG considerations
- Discuss the possibility of excluding sectors that may cause ESG concerns
- Evaluate company willingness to engage in ESG reporting and initiatives in a transparent fashion
- Make decisions in accordance with the UN's 6 Principles of Responsible Investing

Comprehensive:

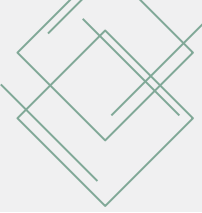
- Assign an ESG champion at the Partner level OR engage outside ESG experts to guide ESG considerations
- Discuss the possibility of excluding sectors that may cause ESG concerns
- Evaluate company willingness to engage in ESG reporting and initiatives in a transparent fashion
- Make decisions in accordance with the UN's 6 Principles of Responsible Investing
- Include a detailed ESG Risks and Opportunities section within the investment memorandum

Reach:

- Assign an ESG champion at the Partner level AND engage ESG experts to guide ESG considerations
- Train all investment professionals on ESG procedures
- Exclude sectors that may cause ESG concerns from investible universe
- Evaluate company willingness to engage in ESG reporting and initiatives in a transparent fashion
- Make decisions in accordance with the UN's 6 Principles of Responsible Investing
- Include an ESG Risks and Opportunities section within the investment memorandum detailing:
 - Potential ESG concerns and mitigants
 - Plans for monitoring progress at pre-determined intervals
 - All identifiable stakeholders (LPs, company employees, vendors, etc.)
 - Possible violations of sectoral exclusion policies

We encourage you to use one of the following RCP ESG Templates.

Request your complimentary, fully-editable template [here](#).



ESG Policy Checklist: Operating Stage

Baseline:

- Identify ESG concerns and enact mitigants on a regular basis
- Identify stakeholders along the value chain (LPs, company employees, vendors, etc.)
- Discuss potential impacts to stakeholder well-being as part of each decision
- Honor local labor laws, along with health and safety ordinances and regulations
- Identify and report any material ESG events/violations to LPs

Comprehensive:

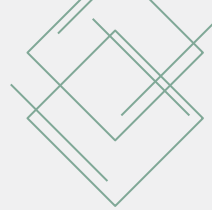
- Identify ESG concerns and enact mitigants on a regular basis
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- Discuss potential impacts to stakeholder well-being as part of each decision
- Honor local labor laws, along with health and safety ordinances and regulations
- Identify and report any material ESG events/violations to LPs
- Measure and communicate progress within ESG considerations at investment exit

Reach:

- Identify ESG concerns and enact mitigants on a regular basis
- Identify stakeholders along the value chain (LPs, company employees, vendors, etc.)
- Discuss potential impacts to stakeholder well-being as part of each decision
- Hold a seat on each underlying company's board of directors to directly identify and implement ESG practices
- Provide an ESG performance rating for each underlying company during quarterly and annual communications, with related measurable justifications
- Honor local labor laws, along with health and safety ordinances and regulations
- Identify and report any material ESG events/violations to LPs
- Measure and communicate progress within ESG considerations at investment exit
- Implement an investment exit strategy that ensures continuity of ESG practices post-investment

We encourage you to use one of the following RCP ESG Templates.

Request your complimentary, fully-editable template [here](#).



ESG Policy Checklist: Firmwide

Baseline:

- Maintain a Code of Ethics and related policies that address:
 - Corruption and bribery
 - Anti-harassment
 - Equal Opportunity
 - Cybersecurity
- Conduct firmwide Ethics training annually
- Practice resource efficiency:
 - Double-sided printing
 - Recycling and/or composting program
 - Conserve food and energy
 - Source products locally
 - Encourage use of public transportation/ride share
- Ensure fair employment strategies:
 - Equal opportunity employment process
 - Provide employees with fair wages and basic benefits
- Encourage employees to take part in philanthropic firm-wide events
- Discuss ESG progress during annual meetings

Comprehensive:

- Be a UN PRI Signatory
- Maintain a Code of Ethics and related policies that address:
 - Corruption and bribery
 - Anti-harassment
 - Equal Opportunity
 - Cybersecurity
- Conduct firmwide Ethics training annually
- Practice resource efficiency:
 - Double-sided printing
 - Recycling and/or composting program
 - Conserve food and energy
 - Source products locally
 - Encourage use of public transportation/ride share
 - Limit use of non-recyclable materials
- Ensure fair employment strategies:
 - Equal opportunity employment process
 - Provide employees with fair wages and basic benefits
- Engage in regular firmwide social and philanthropic events
- Discuss ESG progress regularly with limited partners, including during annual meetings

Reach:

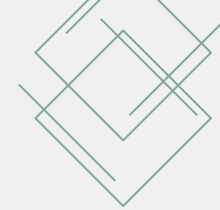
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 - Limit use of non-recyclable materials
- Ensure fair employment strategies:
 - Equal opportunity employment process
 - Provide employees with fair wages and basic benefits
- Engage in regular firmwide social and philanthropic events
- Discuss ESG progress regularly with limited partners, including during annual meetings
- Report firm ESG progress annually

We encourage you to use one of the following RCP ESG Templates.

Request your complimentary, fully-editable template [here](#).



Appendix



Important Disclosures and Notes

This Presentation is based on analysis of financial information available or provided to RCP Advisors (together with its affiliates, "RCP") by third parties. RCP has not independently verified any such information provided or available to RCP. Performance information provided herein was not prepared, reviewed or approved by the underlying funds or their general partners. Information obtained from third parties is believed to be reliable, but no representation, warranty or undertaking, express or implied, is given as to the accuracy or completeness of such information. Projected market and financial information, analyses and conclusions contained herein are based on the information described above and on RCP's judgment, and should not be construed as definitive forecasts or guarantees of future performance or results. The information, data, analyses, and opinions presented herein do not constitute investment advice, are provided solely for informational purposes and therefore are not an offer to buy or sell a security. Please note that references to specific securities or other investment options within this Report should not be considered an offer (as defined by the Securities and Exchange Act) to purchase or sell that specific investment. The performance data shown represents past performance. Past performance does not guarantee future results.

Description of Performance Measurement Methodology

ROIC: Represents the return on invested capital. ROIC is calculated by dividing the sum of distributions plus total partners' capital by capital contributed. Total partners' capital balance is the book assets (fair value of unrealized investments plus cash on hand and miscellaneous assets) less the liabilities at the measurement date.

Gross ROIC: Represents the return on invested capital for an individual deal. Gross ROIC is calculated by dividing the sum of distributions and unrealized NAV as of the most recent available valuation date by invested capital. Gross performance returns do not reflect management fees, carried interest, and expenses. Actual returns will be reduced by management fees and other expenses that will be incurred in the management of a fund. Actual account performance will vary depending on each fund's applicable fee schedule.

Exhibits detailing data for portfolio companies are grouped by year of the fund's initial investment in a company, as opposed to vintage year. Returns are gross returns.

Biases within the Report for consideration include:

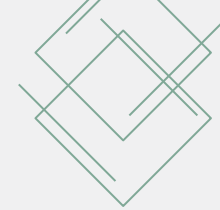
- Survivorship bias: Information flow will be biased towards managers successful enough to raise subsequent funds; given updated return information is primarily gathered during fundraising diligence, data reflects deals transacted by relatively more successful managers
- Availability bias: Due to RCP's lower middle market focus, more data is available on smaller companies vs. larger
- Realized deal bias: Because unrealized deals are excluded from the sample set, certain underperformers are likely underrepresented given the general tendency of PE firms to delay exits for struggling companies (mitigated by exclusion of unrealized deals held for less than five years)
- ESG labeling bias: Because RCP Advisors relies on third-party business descriptions to guide the ESG labeling process, labels may not capture the full extent of ESG-related practices at the operating company level

RCP Database: Provides private fund and investment-level performance data drawn from fundraising and diligence documents produced by general partners and publicly available information, as well as quarterly unaudited and audited annual financial statements produced by RCP's underlying fund managers. As of September 1, 2019, RCP's database contains information on more than 3,300 fund managers and more than 8,100 funds. These documents are provided to RCP by the fund managers themselves. Full discussion on the database appears on "Notes on the Data".

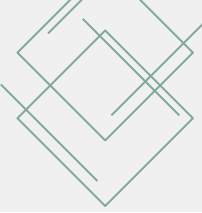
S&P Global Market Intelligence: Industry classifications and descriptions for fund holdings in RCP's database are based on categories provided by CapitalIQ. Capital IQ is a multinational financial information provider headquartered in New York City, United States, and a division of S&P Global. S&P Capital IQ was formed in 2010 from offerings previously provided by Capital IQ, elements of S&P including Global Credit Portal and MarketScope Advisor, enterprise solutions such as S&P Securities Evaluations and Compustat, research offerings including Leveraged Commentary & Data, Global Markets Intelligence, and company and fund research.



Notes on Data



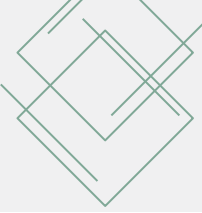
- » RCP collected information from PE Firms, third party data providers (e.g., S&P Global Market Intelligence, etc.), and public data sources for inclusion in the dataset. RCP's strategy is focused primarily on North American lower-middle market buyouts, so a majority of managers analyzed operate in this segment of the market.
- » In total, RCP tracks information on more than 3,300 fund managers whose funds' vintage years range from 1969 – Present, as of 11/21/2019. Manager strategies include Buyout, Growth, Buyout & Growth, Distressed, and Multi-Strategy; Mezzanine and other credit strategies are largely excluded from analysis, but can be added if relevant. Venture, Real Estate, and other unrelated strategies are completely excluded. Fund strategy classifications are determined based on internal RCP assessment.
- » The dataset contains Gross ROIC information for over 8,800 realized deals.
- » Gross ROIC is controlled for outliers that can meaningfully skew average calculations. Any instance of an ROIC >20x is replaced with a value of 20x ROIC to account for the outsized return without removing the data point.
- » Fund sizes of included managers range from less than \$50M to \$20B with an average fund size of ~\$880M and a median fund size of \$400M.
- » Deals analyzed have enterprise values of up to \$1B with an average of \$111M.
- » Companies are assigned various levels of industry classification based on a combination of RCP internal assessment and classifications provided by S&P Global Market Intelligence.
- » Because analysis includes disaggregation by ESG label, certain analyses may be performed on smaller sample sizes and may be biased by one or several data points. Any aggregation that includes less than ten data points has been excluded from the analysis.
- » Past performance is not an indication of future performance, provides no guarantee for the future, and is not constant over time.



Additional Disclosures

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RCP VALUES



INTEGRITY - We acknowledge a duty and responsibility to act in the best interests of our partnerships.



PERFORMANCE - We strive to be the best at everything we do as a firm, with a particular emphasis on maximizing return on investment while remaining focused on capital preservation.



CLIENT CENTERED - We place the interests and needs of our clients first, as we focus on exceeding their expectations.



INNOVATION & LEADERSHIP - We aim to be an industry leader and innovator by encouraging an entrepreneurial spirit that empowers our professionals to create research driven, strategic growth opportunities for RCP and our investors alike.



PARTNERSHIP, COMMUNITY & INCLUSION - We strive to have a culture of partnership, seeking to build strong, collaborative relationships with all stakeholders, while also cultivating a culture of diversity and inclusion. We have a fundamental ethical and investment belief in responsible behavior, including ESG practices, across our internal culture, general business practices, and investment considerations.