

KEYNOTE INTERVIEW

Value creation via ESG



*The focus on ESG is growing, yet few lower middle-market private equity fund managers have made it a priority, say **John Poff**, **David Walden** and **Bonnie Howard** of MiddleGround Capital*

While sustainable investing has risen to the top of the list among the world's largest institutional investors, a small North American-based private equity firm called MiddleGround Capital has a different idea of how to implement ESG. One of its founding partners, John Stewart, often says, "The way to drive real change is to not wait for legislation, but for everyone to take the initiative and do their part." That is what they aim to do, say John Poff, David Walden and Bonnie Howard of MiddleGround Capital.

Q MiddleGround is a new and relatively small firm. How did you get started on ESG?

John Poff: The first thing you have to do is commit resources to drive real change. Our partners are passionate about ESG and realized that for the firm to take ESG

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seriously, we needed dedicated resources.

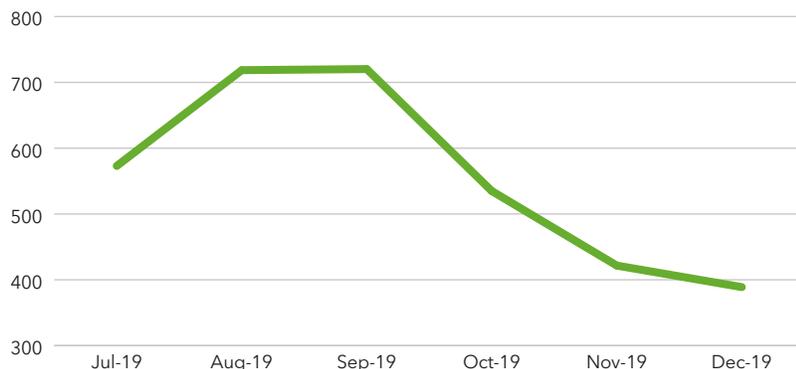
Q Why is ESG important to lower mid-market private equity investing, and what is the opportunity?

David Walden: ESG is vital for everyone. We all share this planet, and fundamentally our goal is to leave things better off than before we became involved. That is how you measure your impact. Private equity gets a bad rap as corporate raiders and greed often makes the headlines, which presents a massive opportunity for us to be a leader on ESG. Further, ESG hasn't historically been a focus for middle-market

businesses, as addressing these issues is inherently a long-term process. Often there are more urgent business issues faced by a management team or ownership group that has limited time and resources. We believe there is a lot we can do to transform our businesses and make them world-class on ESG.

JP: ESG is important to me because I believe people expect to be treated fairly and have the opportunity to make an impact. My role as ESG leader at MiddleGround allows me to influence the outcome for thousands of people directly and foster a culture where ESG is foundational. Many management teams in lower middle-market manufacturing don't value ESG as an opportunity, let alone a priority. This is a great chance for private equity investors to provide much-needed resources for

Energy usage at a MiddleGround-owned factory before and after acquisition, July through December 2019 (megawatt-hours)



Source: MiddleGround Capital Partners

Q To what extent is managing ESG issues a risk mitigation exercise? Can it create equity value?

DW: Proactively managing ESG matters allows us to understand the necessary investment before putting any money to work, so yes, it helps with risk mitigation. However, over time, we believe buyers will pay higher multiples for companies that don't have unresolved ESG issues, so in that sense, we believe managing ESG issues will create equity value.

Our world is changing. Paying employees a living wage, being conscious of your carbon footprint, being inclusive with diverse workforces and management teams, etc, is the minimum that needs to get done to attract talented and capable workers. Eventually, working with a business that is in line with your personal views will be a focus of decision-making for all stakeholders.

JP: ESG items often make common sense. For example, we install LED lighting to improve visibility at our facilities and improve airflow and air quality by installing high-volume air exchangers. These changes enhance the working conditions for the employees, making the factory more efficient, and at the same time, lower our operating costs by reducing energy consumption. As an example, one factory has seen monthly kilowatt-hours drop from nearly 720,000 to less than 390,000 within three months – that's pretty significant and is a win-win.

identifying, implementing and tracking ESG initiatives. ESG is an expected priority for our management teams.

Q Why is ESG important for you as a firm?

DW: We try to make every business better in every way possible. We believe in the mission of ESG. It isn't a marketing gimmick or surface-level issue – it's the core of who we are as individuals. Before our partners made ESG a priority in our strategic plan, we discussed it as a group and collectively decided that this was the right direction for the firm. We care

about the environment; we see the value in diversity and best-in-class governance. We believe transparency on these issues is critical. We have dedicated resources in the firm working on ESG every day, established ESG coordinators at each of our portfolio companies and every portfolio company board of directors has an ESG committee. To demonstrate our commitment, MiddleGround became a signatory to the UN Principles for Responsible Investment PRI. We are proud to be the first sub-\$1 billion AUM industrials-focused buyout firm globally to become a signatory. It's a statement to ourselves, our

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DAVID WALDEN

families, our employees, our management teams and our limited partners – we want to be a leader on these issues and be held accountable to the highest standards.

JP: We have a unique perspective on ESG, given our team's collective experience working on the shop floor in manufacturing businesses. Our founding partner, John Stewart, started his career putting bumpers on Toyota Camrys for Toyota Motor Corporation. Our blue-collar mentality helps to elevate ESG as a critical part of the operational model. It all begins with our diligence process which was designed to identify opportunity and create an investment thesis that benefits all stakeholders. We identify ESG issues along with value creation initiatives in order to evaluate current performance, find ways to improve the business and ensure our goals are clear.

Q Why do you think lower mid-market private equity firms have been slower to adopt ESG principles?

DW: Committing to ESG improvement can be intimidating. Many firms don't know where to start. A lot of the DNA of our firm comes from the experience many of our operating team members have working at Toyota Motor Corporation. Implementing ESG is something that they helped Toyota do 20 years ago. That certainly gives us an advantage and helps to remove some of the uncertainty.

Also, GPs will focus on what their LPs are focused on during diligence. If LPs aren't demanding that GPs address and track ESG issues within their portfolios, GPs might not see ESG as a priority. We have an active dialogue with our LPs about what ESG issues matter to them.

Q ESG is a big universe. Where are you focusing your efforts?

Bonnie Howard: We see all three elements – the E, S and G – as necessary, although currently, we're spending a lot of time with our portfolio companies ensuring employees receive a living wage. We've also engaged Natural Capital Partners to measure each portfolio company's carbon

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JOHN POFF

footprint so that we understand our starting point.

JP: We are actively tracking and addressing situations in which employees are being paid less than \$15 per hour at our portfolio companies. Our goal is for all employees to receive at least that rate. We also track our CEOs' pay as a multiple of the lowest wage earner in the company.

Health and safety are other key areas. One of our portfolio companies had 18 reportable incidents in the year before we invested. Since then, there have only been two occurrences. When you start your career on the factory floor you understand that there is nothing more important than the people doing the work on the shop floor – if you take good care of them, they will take good care of you.

Q How have you managed through the pandemic?

JP: Back in January, we established a covid-19 task force to identify risks and develop contingency plans to support our portfolio companies. Our first priority was to keep our employees safe, so we developed protocols that included cleaning all common areas and equipment, social distancing, taking temperatures,

providing personal protective equipment and identifying what employees should do if they felt ill. We also had each shift at every facility report daily adherence to the protocols and absenteeism related to covid-19.

When the virus began to circulate more broadly, we informed all of our employees that they would still be paid if they contracted covid-19 and were forced to self-quarantine. Hourly workers making \$15-20 an hour generally will come into work when they are sick because they need the money. We wanted to remove this concern and made this decision well before any covid-related government assistance was passed. Throughout the pandemic, we've tried to make sure employees don't feel like they have to choose between their paycheck and their health.

Q How do you see ESG in private equity developing over the coming years?

DW: As the workforce continues to evolve over the next five to 10 years and millennials begin to replace the baby boomers in positions of authority, ESG will only become more critical. As people care more about the “how and why” of business versus simple economic returns, ESG will become more of a decision point. This will lead to a world where ESG is a minimum gateway for entry, irrespective of returns. A great example of how this has changed, even over just the last three to five years, is that investment bankers are starting to include dedicated sections in sell-side marketing materials touting a company's ESG characteristics. It's a new phenomenon, and I think you'll see more and more new ESG-oriented practices like it develop over the coming years.

At MiddleGround, we certainly don't have all the answers, so it's essential to continue to challenge ourselves and grow every year. At the end of each day, we are just trying to leave our piece of the world better than before we touched it. ■

John Poff, David Walden and Bonnie Howard represent the operations team, investment team and back office, respectively as leaders of MiddleGround's ESG effort