Rebuilding a Tainted Brand

By Bowen White , Research Associate, INSEAD Global Private Equity Initiative

Private equity fund investors have the ownership leverage to turn around companies via social and governance reform.

The 2008 infant formula scandal in China has been etched into Chinese memory. With an estimated 300,000 infant victims, 54,000 of whom were hospitalised and six killed by milk formula laced with melamine to enhance the appearance of protein, trust was destroyed in Chinese-produced baby formula. After initially focusing on Sanlu Group (Sanlu), government inspectors revealed that the problem also existed in products from 21 other companies, one of which was Guangdong Yashili Group (Yashili).

The scandal's impact was swift and brutal, as Sanlu was tipped into bankruptcy and two managers of the company's raw milk suppliers were sentenced to death only months after the scandal broke.[1] Beyond the criminal charges, investigation into the incident exposed outright fraud across the industry supply chain as well as corporate governance failures and a lack of government oversight.

As the industry limped forward, private equity firm Carlyle identified an opportunity to take a stake in Yashili and to create value via ESG (environmental, social and governance) levers. A year after the initial scandal, Carlyle acquired the first of two tranches in Yashili. With a strong determination to restore consumer confidence in the industry, Yashili's management worked closely with Carlyle to rebuild its safety record and brand image.

Cleansing Yashili

It was a timely move. The same year, Carlyle made its move on Yashili, it had also begun developing a top-down, systematic approach to managing ESG considerations. As I pointed out in my **last post**, ESG considerations are becoming a priority for private equity general partners (GPs), led by the changing investment objectives of their predominantly institutional investor base. An in-depth examination of leading GPs' approach to ESG can be found in our recent report, **ESG in Private Equity: A Fast-Evolving Standard**.

To address the melamine issue directly, the company made a major strategic decision to procure 100 percent of its raw milk powder from high-quality overseas dairy producers. It also established product testing collaborations with top-tier international laboratories to strengthen product quality and safety control.

The Carlyle-Yashili partnership also set an example for the industry to transform itself and elevate its product quality to international standards. With Carlyle's assistance, Yashili established the Food Quality and Safety Advisory Committee (FQSAC), the first of its kind in the Chinese dairy industry. This served as a catalyst to further enhance its product quality control protocols, via checks by certified auditors from an American auditing company and product testing in certified labs in the U.S., New Zealand and Hong Kong.

In addition to the improvements in product safety, Carlyle helped Yashili recruit a Chief Quality Advisor, a Chief R&D officer and a CFO in order to strengthen and control reporting practices. The combination of best practices and talented management led to a successful listing on the Hong Kong Stock Exchange in November 2010, which further strengthened corporate governance.

Corporate governance, Carlyle style

In 2010, as it took a second tranche in Yashili, Carlyle established a set of responsible investment guidelines, drawing on internationally recognised standards such as the **UNPRI** and the **UN Global Compact**. These guidelines provided a comprehensive framework to consider ESG risks and opportunities throughout the investment process. From 2011, the firm began encouraging its portfolio companies to review their operations in accordance with the guidelines. Now more than 90 percent do so.

Carlyle's ESG policy is defined by its Global External Affairs Group, with staff and resources located in the U.S. driving global policy implementation. External Affairs stays in constant contact with the firm's investment teams and limited partners, ensuring that both general and limited partner's priorities are incorporated into the policy.

Executing the firm's policy falls to deal teams, Carlyle board representatives and portfolio companies during the investment process. During the pre-investment phase, a process-lite framework provides deal teams with the resources to assess both ESG risks and opportunities; when an ESG factor comes to the fore, deal teams work with External Affairs personnel to gauge Carlyle's appetite for a specific risk. The firm's management committee and External Affairs must review and sign off on all ESG considerations prior to investment.

Post-investment, portfolio companies often undergo the firm's EcoValuScreen tool, a due diligence framework that identifies operational enhancements that often lead to better environmental and financial performance.To strengthen its internal capabilities, Carlyle recently hired a Chief Sustainability Officer, who brings specific knowledge and capability to execute ESG initiatives.

While GPs often focus on the tangible impact of eco-efficiencies and cost-savings related to ESG, Carlyle demonstrates the value of addressing complex social issues via product safety and governance reform through governance frameworks and policies that can enhance reputation. These improvements can drive value in companies suffering from an industry discount and strengthen internal processes on a path to turnaround.

Bowen White is a Research Associate at the ***INSEAD Global Private Equity Initiative***

Follow INSEAD Knowledge on ***Twitter*** *and* ***Facebook***

[1] Sun, F. (2008). *Sanlu Group and the Tainted Milk Crisis.* London, Ontario: Ivey Publishing.

Find article at

https://knowledge.insead.edu/leadership-organisations/rebuilding-tainted-brand

About the author(s)

Bowen White Bowen White is the Associate Director of INSEAD's Global Private Equity Initiative (GPEI).