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ESG moving out of the Compliance Room and into the Heart of the Investment Process

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Executive Summary

Environmental, social, and governance (ESG) concerns are increasingly being factored into the valuation and management of financial assets. Issues such as climate change, sustainability, consumer protection, social responsibility and employee engagement are no longer viewed solely as components of risk management, but have also gained recognition in recent years as important drivers of firm value, particularly in the long term.

We present results from one of the first comprehensive surveys covering the role of ESG in the investment practices of the private equity industry. This is the first phase of a deeper academic investigation of the topic. Based on responses from 42 private equity firms, representing a broad geographic and sector focus and a cumulative total of over US$640 billion in assets under management, the findings indicate that ESG policy – far from being a peripheral consideration – emerges as a core value-creation strategy at private equity funds for portfolio companies.

We find that this trend appears to be led by LP demand, and that the integration of ESG permeates down from the highest board levels, throughout the organization and all the way through to the individual private equity fund level, with core investment professionals often tasked with ESG policy implementation. Moreover, ESG policy appears to be rather sophisticated in that consideration of such issues takes place at the origination stage as well as during the period of asset ownership, although adherence to ESG policies is not uniform and is often implemented through guidelines rather than investment rules. We also find that ESG policies encompass not only environmental, social, and governance matters but also ethical issues, with companies actively monitoring their activities, gathering data and reporting along these dimensions.

In our sample, the emphasis on ESG policy as a core private equity value creation strategy is particularly prominent in the largest of the private equity funds (i.e., AUM >US$10 billion), where investor pressure is reported to be most acute. However, despite this focus, some barriers are reported in quantifying and monitoring the implementation of ESG policy. Importantly, we also discover fascinating heterogeneity across firms, in terms of how ESG policies are implemented and the processes by which ESG is integrated in decision-making. We speculate that such heterogeneity will likely have important implications for the variation in capability across private equity firms to generate value through ESG.

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We are also grateful to the multiple GPs and LPs that generously provided their time and valuable input as we prepared our online questionnaire. Finally, we would like to thank Adam Frost and the private equity team at the UNPRI for distributing the survey through their website and private equity newsletter.

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Introduction

The implications of integrating environmental, social and governance (ESG) issues into a firm's strategy and business model have drawn considerable academic attention in recent years. Due to the growing availability and sufficient comparability of ESG data, this research has predominantly focused on examining the practices of publicly listed firms and also on understanding socially responsible investment (SRI) – an approach that considers ESG issues as part of the investment process. However, to date, there has been limited systematic examination of ESG-related issues in the context of the private equity industry; an industry that has been traditionally viewed as maximizing shareholder returns efficiently, while providing high-powered managerial incentives (e.g. Jensen, 1989; Kaplan and Stromberg, 2009).

As such, the integration of ESG issues in this industry may be viewed by some as inherently contradictory in the sense that ESG investments may be a type of agency cost that simply results in a transfer of investor wealth to other stakeholders and/or a generation of managerial utility at the expense of financial returns. Specifically, neoclassical economists would argue that undertaking ESG initiatives might unnecessarily raise a firm's costs, resulting in competitive disadvantage (e.g. Friedman, 1970; Jensen, 2002). And from an agency theory perspective, some studies suggest that utilizing strategic firm resources to generate positive ESG performance yields only significant managerial benefits rather than financial benefits to shareholders (Brammer & Millington, 2008).

On the other hand, ESG issues may represent opportunities for profitable business growth, as several academic studies have found (e.g. Bansal & Roth, 2000). In particular, scholars have shown that higher ESG performance may enable a firm to obtain better resources, hire more talented employees and achieve better marketing of products and services. It can also lead to the creation of unforeseen opportunities or function in similar ways to advertising, by increasing overall demand for products and services and/or reducing consumer price sensitivity. Superior ESG performance may also mitigate the likelihood of negative regulatory, legislative or fiscal pressure, mitigate reputational risk, win socially conscious consumers, attract financial resources from socially responsive investors, or even ease a firm's capital constraints.

Certainly, the question of whether ESG integration generates shareholder value in the long run has implications not only for the firms themselves but also for capital allocation decisions made by markets, and by investors more specifically, whether we refer to public or private equity. Although scholarly work that explores value creation through ESG in private equity is practically non-existent, in the public equity space, much has been written over the last couple of decades. In particular, numerous academic articles have sought to uncover the link between ESG and financial performance. A comprehensive meta-analysis of this stream of work by Margolis et al. (2007) finds a small positive, yet statistically significant, impact of ESG on profitability. Importantly, the most recent study by Eccles, Ioannou and Serafeim (2014) uses a matched sample methodology and finds that sustainable organizations – defined as those organizations that voluntarily integrate ESG issues into their strategy and business models – outperform their lower sustainability peers over an 18-year horizon, both in stock market as well as operational performance.

In parallel, in the finance literature, numerous studies have investigated the investment returns of Socially Responsible Investment (SRI) funds and the results have been rather mixed. On the one hand, it is argued that integration of ESG issues may result in a portfolio composition based on a restricted investment universe (e.g. due to exclusion criteria). Therefore, such a portfolio may be less efficient and generate lower expected risk-adjusted returns vis-à-vis a portfolio that is constructed without such restrictions. On the other hand, some argue that integration of ESG considerations in portfolio management enables the identification of firms that are more likely to generate sustainable superior returns in the long run and, therefore, the loss in efficiency is compensated for through superior selection.

Empirically, scholars have explored the performance of SRI indices compared with more traditional indices, the performance of SRI mutual funds compared with traditional mutual funds, and the performance of constructed SRI portfolios compared with market indices or other conventional portfolios. On average, it appears that SRI funds do not generate lower returns compared with their traditional/market counterparts, although the very definition of what does and what does not constitute an SRI fund in the literature is not always clear.

Arguably one of the private equity industry's first major acts of acknowledgement and initial integration of ESG considerations was the launch of the Private Equity United Nations Principles for Responsible Investing (UN PRI) in 2009. By the end of 2014, a number of major private equity firms had become UN PRI signatories, suggesting that they recognized, at least symbolically, that ESG issues can affect the performance of investment portfolios and, therefore, that ESG considerations should be integrated into investment decisions.

In addition to the broader question of whether ESG integration may be linked to value creation at portfolio companies, more recently the UN PRI acknowledged a momentum in responsible investment within the private equity industry and suggested that it is LPs that are asking GPs to integrate ESG issues. Interestingly, it is also argued that, because of "the economic downturn and public scrutiny, the industry is under pressure to demonstrate that it is a responsible member of society in order to gain access to capital markets". However, to date, we have limited quantitative data that could provide an insightful understanding of the current state of affairs with regards to ESG integration in the industry. This is precisely the reason why we conducted this survey: to carefully scan the landscape and provide a sophisticated and robust understanding of the key current issues surrounding ESG integration.

To be more precise, in this survey we sought to explore crucial aspects of the ESG integration process in the private equity industry:

a. To what extent is the private equity industry facing current (or expecting future) pressures to integrate ESG factors, and where do such pressures come from?

b. What are the most important barriers to the integration of ESG factors and what are the reasons why some firms do not integrate ESG at all?

c. How is the integration of ESG factors structurally embedded across private equity firms in terms of the level of authority, responsibility, monitoring and accountability?

d. How sophisticated is the current state of ESG integration and implementation in terms of the array of existing policies, the stage of investment cycle at which ESG issues are considered, and the extent to which ESG data is being monitored, gathered and reported?

We begin by providing more information on the background to the survey as well as the profile of the respondents in the final sample. We then present and discuss the findings of the survey in detail, followed by our concluding remarks.

Methods and Background

We conducted several informal interviews with GPs and LPs to confirm the relevance and timeliness of the survey questions and also to ensure that the survey covered all the key current considerations with regards to the process of ESG integration in the private equity industry. Subsequently, we prepared a brief anonymized online survey, which focused on the above issues, and distributed it to multiple private equity funds, soliciting their participation. We actively engaged with several of them, in the form of short phone conversations, to explain the broader project scope and its objectives, to provide clarifications and to answer any other questions regarding the survey itself. In addition, participation to the survey was solicited through the UN PRI – Private Equity website and the UN PRI – Private Equity-focussed newsletter. In total, forty-two (42) private equity firms participated through the online link, of which thirty-three (33) firms provided data on assets under management. Combined, all the survey respondents represent a cumulative total of over US$640 billion in assets under management.

The High-Level Sample Profile

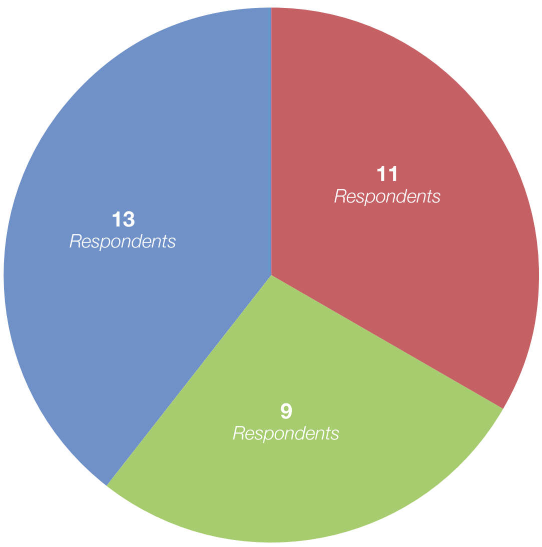
We categorize respondents by size, based on the reported assets under management and note that our final sample consists of eleven (11) small, nine (9) medium and thirteen (13) large private equity firms, suggesting a good representation of the range of private equity firms in the industry (see Figure 1).

Moreover, the survey included questions about each firm's investment focus, in terms of both geography and sector focus. We find that the sample firms represent a broad geographic and sector-focus spread, with most indicating a strong European presence. Specifically, 74% of the respondents reported an investment focus on Europe, while 31% reported a presence in North America, and about 29% a presence in the Asia-Pacific region. Figure 2 presents the distribution of investment focus across regions and by firm size. Note that each firm was allowed to indicate more than one area of geographic focus.

In terms of sector focus, we note a wide distribution across our sample, with the technology, retail, and manufacturing sectors being the areas in which the majority of the respondents invest. Also included in the sample are private equity firms that invest in the financial sector and a few that invest in the agriculture sector. Again, we note that each firm could indicate more than one area of sector focus (see Table 1).

In sum, we maintain that the final sample comprises a representative cross-section of the private equity industry, in terms of size, geographic and sector focus. We acknowledge, however, that it may be biased in that firms self-selected by responding to the online survey. We thus caution the reader that the findings and inferences that we draw in this report are conditional on a firm engaging with ESG and volunteering to respond to the anonymous online questionnaire. Nevertheless, as we explain in detail in the sections that follow, the results of this survey provide an insightful view into the current state of affairs with regards to ESG integration in the private equity industry and a comprehensive exposition of how such integration may be implemented by the ESG leaders of the industry. Importantly, our findings raise a number of fundamental questions regarding value creation for, and by, the sector, which we briefly discuss throughout the report and we hope to address through follow-up academic research.

Figure 1: Sample Firms by Size



Size of Firm	Total AUM (US$ mn)	Average AUM (US$ mn)
Small	6,480	589
Medium	44,030	4,892
Large	591,000	45,462

Total number of responses: 42; 9 did not provide AUM data

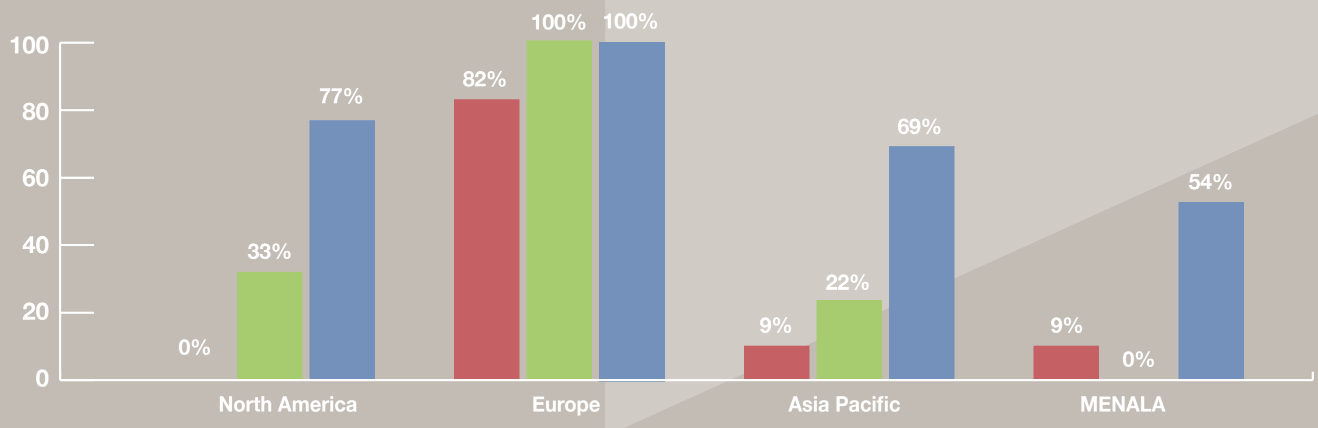
Small (<US$ 1 billion)
Medium (Between US$ 1 billion and US$ 10 billion)
Large (>US$ 10 billion)

Table 1: Sample Firms by Industrial Investment Focus

Size of Firm	Technology	Retail	Manufacturing	Financial	Agriculture	Other
Small	6	4	4	2	2	4
Medium	7	6	6	6	1	7
Large	10	12	11	11	4	8
All	23	22	21	19	7	19
% of Sample (including those without size response)	55%	52%	50%	45%	17%	45%

This question allows multiple selections by respondents, so answer categories are not mutually exclusive.

Figure 2: Sample Firms by Regional Investment Focus



** MENALA includes Middle East and North Africa, and Latin America regions*
This question allows multiple selections by respondents, so answer categories are not mutually exclusive.

Sources of ESG Integration Pressures

To what extent do private equity firms face pressures to integrate ESG factors, and where do such pressures come from? In recent years, the industry as a whole has been under intense public scrutiny as well as media criticism due to its relative lack of transparency and particularly with regards to its social responsibility. There are also some who argue that the industry has been slower to integrate ESG issues compared with public equity, and some allege that the industry focuses on short-term profits at the expense of long-term value creation. More generally, there has been increased scrutiny of corporate and financial firms' behavior as a result of the numerous corporate scandals of late, the global crisis of the financial system in 2008 and multiple environmental disasters directly attributed to some companies' operational failures. There have even been cases resulting in the regrettable loss of human life because of compromised health and safety standards. This has severely undermined the public's trust in the modern business organization and, to a significant extent, in the modern capital allocation system. Thus, demands by governments, regulators, investors and society at large for increased transparency and accountability have begun to surface.

In fact, it is often suggested (but has not been systematically measured) that in the context of the private equity industry, an increasing number of LPs insist that GPs manage any potential risks and opportunities that are associated with ESG issues more proactively, and that they provide more detailed disclosures regarding the process of ESG integration as well as more information regarding ESG concerns at portfolio companies.

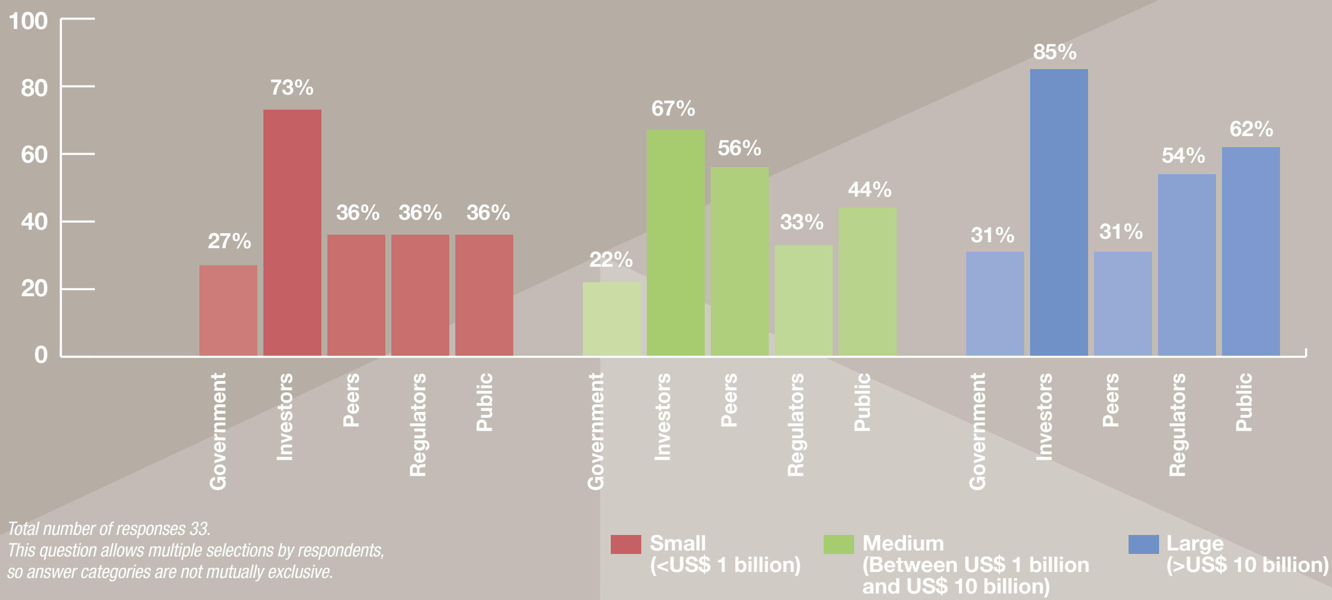
In this survey, we asked our respondents to identify where the current and future pressures for integrating ESG in private equity are predominantly coming from. Across private equity firm size categories, the message was loud and clear: currently, investors are leading the push for ESG integration (see Figure 3). The large firms in the sample appear to face particular pressure, given that 11 of the 13 indicated investors as a source of current pressures. Public and regulatory authorities follow as secondary sources for 8 and 7 of these large firms, respectively.

Moreover, 8 of the 11 small firms, and 6 of the 9 medium-sized firms identified investors as being behind the push for ESG integration.

The results also show that investor, as well as public, pressure towards ESG integration seem to be more acute for firms with a European investment focus, quite possibly reflecting the fact that European countries and capital markets are more broadly at the forefront of socially responsible investment practices (see Figure 4). Ten of the 13 firms with a North American and 9 of the 12 firms with an Asia-Pacific focus also reported current pressures coming from investors, whereas 6 and 5, respectively, reported that the public is exercising pressure. Interestingly, we note that the MENALA (Middle East, Northern Africa, Latin America) regions appear to be more muted in terms of exerting such pressures, possibly reflecting the low penetration of socially responsible investment, as well as the rather limited undertaking of socially responsible initiatives by corporates in those regions.

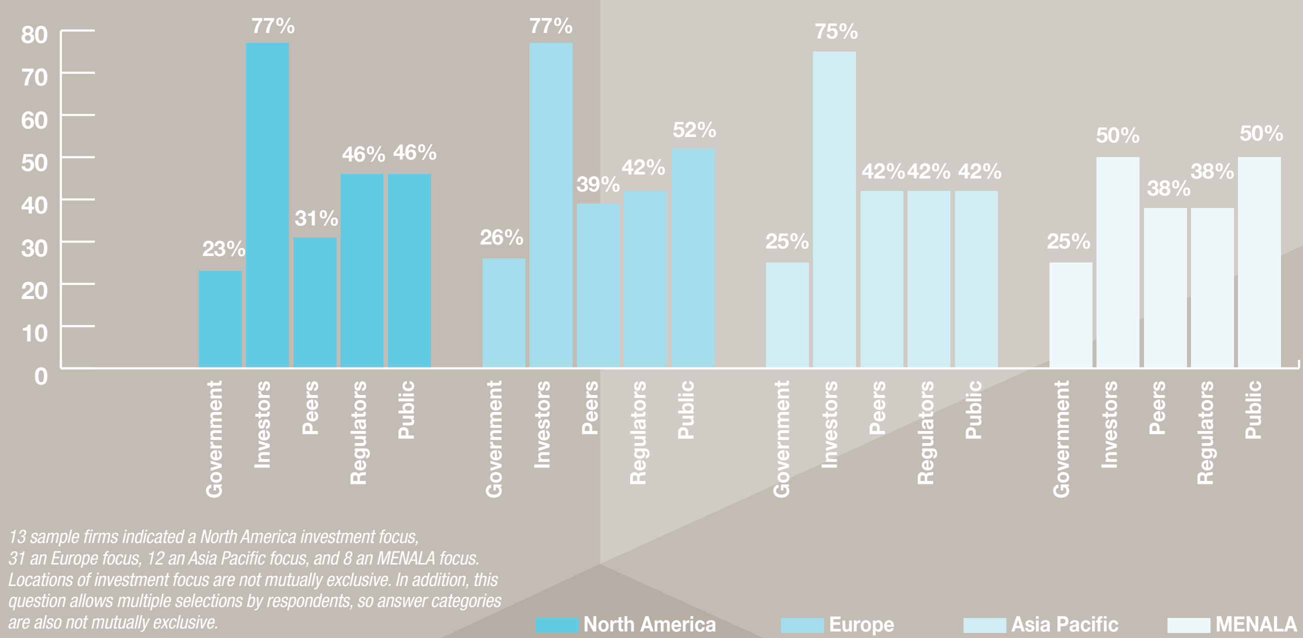
The survey explored not only current but also expected future pressures for ESG integration (see figures 5 and 6). It uncovered some key differences between who is currently leading the push, versus where pressure is expected to increase in the future. Specifically, the largest firms in our sample reported almost equal pressure expected by peers, the government, and the public, while in relative terms, small and medium-sized firms were more likely to expect pressures from regulators, the government and, to some extent, their peers. When analyzing these differences between current and future pressures in terms of investment focus, we also found that in future, government and the regulators are relatively more likely to push for ESG integration in Europe and in the Asia-Pacific region. This represents an interesting shift from the current state, in which investors are predominantly exerting these pressures. For instance, we already know that China is moving swiftly towards more regulation regarding environmental issues, and towards the establishment of a cap-and-trade carbon market. Lastly, to the extent that such pressures may appear in the future in the MENALA regions, the results indicate that very few firms expect them to be exerted by the government.

Figure 3: Sources of Current Pressure to Adopt ESG Policies by Firm Size



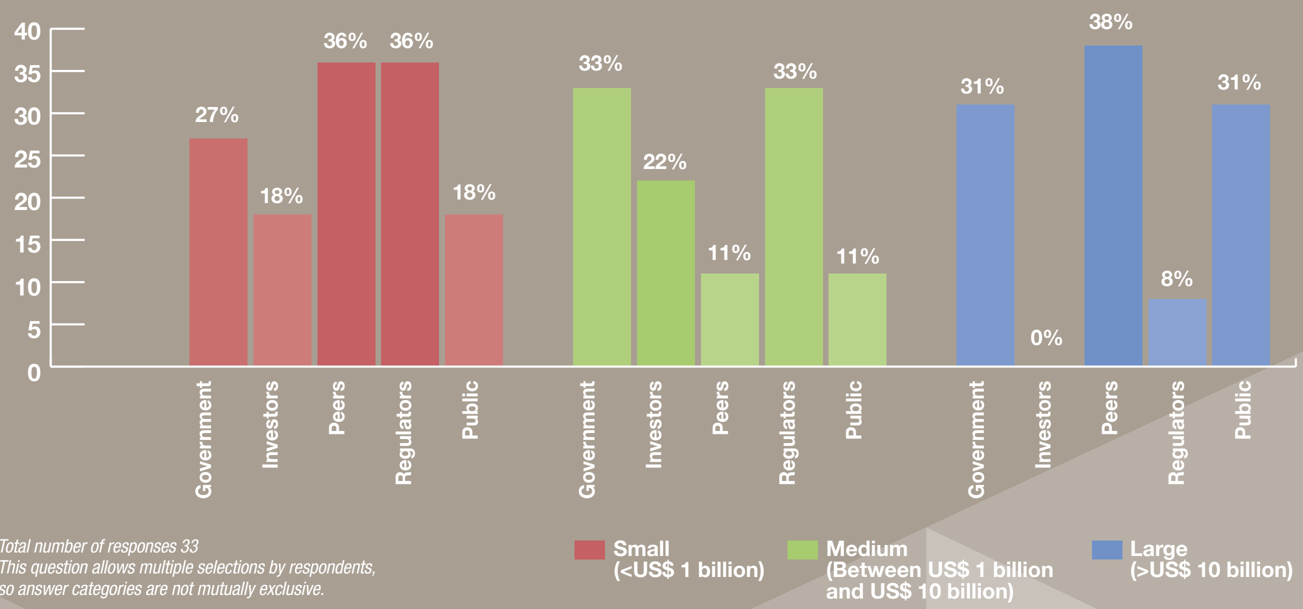
Total number of responses 33.
This question allows multiple selections by respondents, so answer categories are not mutually exclusive.

Figure 4: Sources of Current Pressure to Adopt ESG Policies by Geographical Investment Focus



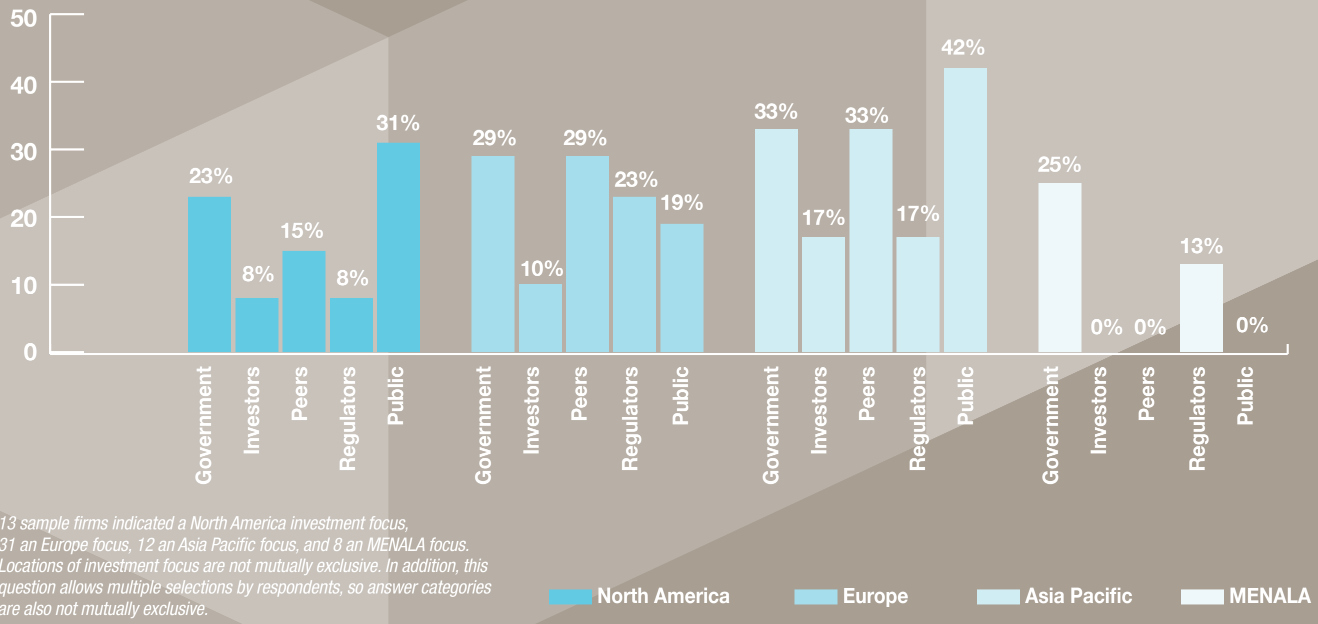
13 sample firms indicated a North America investment focus, 31 an Europe focus, 12 an Asia Pacific focus, and 8 an MENALA focus. Locations of investment focus are not mutually exclusive. In addition, this question allows multiple selections by respondents, so answer categories are also not mutually exclusive.

Figure 5: Sources of Future Pressure to Adopt ESG Policies by Firm Size



Total number of responses 33
This question allows multiple selections by respondents, so answer categories are not mutually exclusive.

Figure 6: Sources of Future Pressure to Adopt ESG Policies by Geographical Investment Focus



13 sample firms indicated a North America investment focus, 31 an Europe focus, 12 an Asia Pacific focus, and 8 an MENALA focus. Locations of investment focus are not mutually exclusive. In addition, this question allows multiple selections by respondents, so answer categories are also not mutually exclusive.

Barriers to ESG Policy Adoption and Implementation

Despite the multifaceted current and future pressures that they are facing, the sample firms reported some key barriers to adopting and implementing ESG policies. In particular, we asked respondents to rank order a number of given barriers, but we also gave them the option of adding to the list. Table 2 presents the top reasons respondents identified as barriers to implementing an ESG approach (the lower the number, the higher the ranking). We note that this set includes responses by private equity firms (four (4) in total) that had no ESG policy at all (we discuss these later in the section).

Tellingly, the difficulty of collecting ESG data emerges as the primary reason and therefore a major barrier to ESG integration in the private equity industry. This is followed by the difficulties that result from the idiosyncratic nature of ESG (broadly, non-financial) data itself as well as its comparability across investments. On the other hand, the cost of collecting ESG data appears to rank last. In the "other" category, an issue emerged that respondents considered an important barrier: internal managerial ESG intent and competence of the fund and the portfolio companies. It appears that, while ESG integration has become common, there remain pockets of internal managerial resistance to the whole idea of considering such issues as relevant for investment decisions.

This type of resistance might arguably reflect a slower speed of adjustment compared with the public equity markets, where scholars have discovered a shift away from "agency logic" and towards a "stakeholder focus" amongst investment analysts. Specifically, Ioannou and Serafeim (forthcoming) document a shift in investment analysts' recommendations, from negative to increasingly more positive for firms with high ESG scores; an explicit acknowledgment of both the relevance and the materiality of such issues for investment purposes.

In general, the fact that the nature of the data and the challenges in collecting it are identified as major barriers raises the question of whether there is scope for the emergence of new information intermediaries in the private equity industry or even the entry of existing players that collect, verify, and disseminate comparable ESG data across geographies and across industries in the public equity market. Yet, on the other hand, the heterogeneity across private equity firms in terms of their ability to gather data, to understand its materiality, and to then integrate it into investment decisions may well be a source of advantage in the industry currently; an advantage that may become more difficult to sustain if information becomes more easily available to other private equity firms. Nevertheless, comparability of ESG information across portfolio companies might allow for higher quality decision-making, while more transparency is likely help investors to reward ESG champions with higher asset allocations.

Table 2: Major Challenges to the Adoption and Implementation of ESG Policies by Firm Size

Size of Firm	Data Collection Difficulty	Idiosyncratic Nature of Data	Comparability Across Investments	Costly Data Collection	Other	Respondents
Small	2	3.3	3.5	3.3	4.5	7
Medium	2.1	2.3	2	4.1	4.4	7
Large	1.8	2.3	2.4	3.9	4.6	10
All	1.9	2.5	2.5	3.7	4.5	24

The above numbers represent average ranking. A lower number suggests a higher ranking. Total number of responses: 24

Reasons for No Adoption of an ESG Policy

Our survey identified that 4 firms reported having no ESG policies in place at their fund, representing about 9.5% of the total sample. What are the characteristics of these funds and what are their specific reasons for not adopting ESG policies?

All these respondents commented that they were too small to adopt ESG policies. In fact, 3 of them were designated small in terms of assets under management (according to our own classification) and 1 was designated as a medium-sized firm. Even within these size categories, the firms were on the lower end of each respective range – their average assets under management were about US$600 million. Three of these firms were exclusively focussed on investing in Europe and one was exclusively focussed on the MENALA region, suggesting that perhaps these firms are more niche in terms of their mandates.

In terms of why they had no ESG policies, among the 4 firms, 3 of them indicated that they believed ESG was not standard practice in the private equity industry, and 2 indicated that they saw no investor demand for ESG integration. Other reasons mentioned for not implementing ESG were the shortage of ESG specialists and the cost of ESG implementation.

These responses are interesting in their own right, as they appear to be inconsistent with the rest of the respondents, who indicated widespread ESG adoption driven predominantly by investor demand. We may thus cautiously infer (given the small sample size) that in some firms, perhaps smaller firms in niche markets, ESG is not yet perceived to be a material issue and there is little investor demand for it. It is also likely that these smaller firms attract a different investor profile. In fact, prior research shows that pension funds are more likely to demand the integration of ESG factors but also, that they have a preference for larger private equity firms (Cornelli and Vasvari, 2014). Therefore, these smaller firms have yet to feel the pressure or the need to adopt and implement ESG policies.

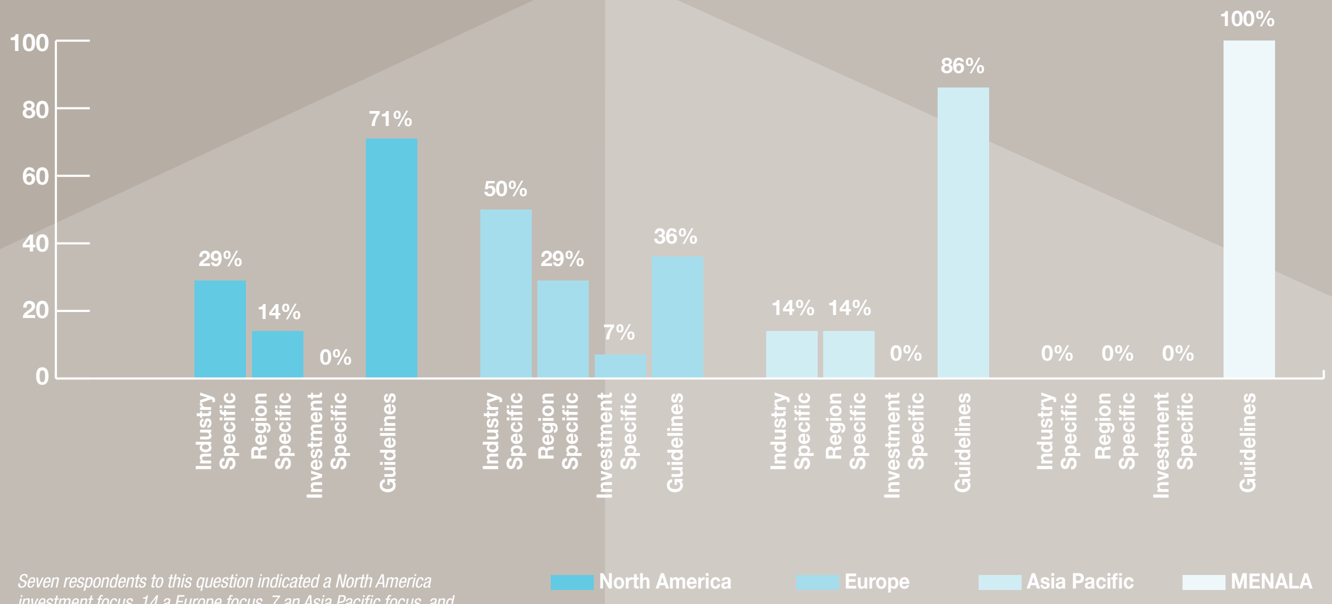
Reasons for Lack of Uniform Adherence to ESG Policies

Among the majority of firms that do report adopting some form of ESG policy, a substantial number do not uniformly implement them across investments. In fact, our survey found that 17 out of the 42 firms (40.5% of all respondents) articulated that ESG policies are not uniformly implemented across investments at their funds, even though ESG policies are in fact in place. We suggest that this revelation highlights an important gap between the adoption and uniform implementation of ESG policies in the industry, and also generates the critical question of whether, and to what extent, the diversity in the way that ESG policies are implemented has implications for the ability of funds to generate value at portfolio companies through ESG.

Indeed, the most common means of implementation reported in the survey is the use of ESG policies as guidelines rather than industry, region or even investment-specific rules. Thus, ESG policy implementation appears to be rather idiosyncratic and certainly not uniform even within firms. This may reflect the current difficulty of collecting ESG data to be integrated into the decision-making process. It may also reflect the current lack of standards across ESG metrics, underlining the additional challenges associated with understanding the materiality of ESG issues across a diverse set of industries and geographies. Importantly, this finding suggests that current ESG policies are often not strictly binding at many firms and may only be used as overarching principles rather than enforceable policies.

There is a detectable difference in the uniformity of implementation by geography, however (see Figure 7). Firms focused on European investments show a strong tendency to apply ESG policies by industry, suggesting a sector-based adaptation of ESG policies and a possible industry-level understanding of the materiality of ESG issues. This is in contrast to firms operating in the Asia-Pacific and MENALA geographies, where there is almost no uniformity in ESG implementation, with most respondents operating in these geographies indicating ESG policies to be mere guidelines rather than rules. North American investors are between the two extremes, with some funds implementing ESG policies by industry or region and others merely adopting guidelines.

Figure 7: Implementation of ESG Policies by Geographical Investment Focus



Seven respondents to this question indicated a North America investment focus, 14 a Europe focus, 7 an Asia Pacific focus, and 3 a MENALA focus.
Locations of investment focus are not mutually exclusive. In addition, this question allows multiple selections by respondents, so answer categories are also not mutually exclusive.

Exploring the Array of Existing ESG Policies

Through our survey, we were also interested in gaining further insights into existing ESG policies within the private equity industry, especially in terms of contractual commitment towards ESG integration, either with LPs or portfolio companies, but also in terms of the range of ESG policies and the level of organizational integration within firms. Thus, we asked specific questions regarding each of the key pillars of ESG (i.e., environmental, social, governance and ethical issues), as well as questions that sought to understand where the responsibility lay structurally within the organization, in terms of setting ESG policy and monitoring the integration of ESG issues into investment decisions. Given the wide variety of ESG categories, some would argue that some issues, such as those related to the environment, are more likely to be top of mind whereas other categories, such as ethical issues, might be more difficult to mandate and to implement.

Indeed, recent work by Eccles, Ioannou and Serafeim (2014) that focused on organizational commitment towards ESG in public equity firms identified board responsibility, monitoring and incentives, and reporting and transparency as some of the key drivers of a genuine ESG commitment. Similarly, here we were interested in understanding the extent to which such pillars are in place at private equity firms, thus providing a solid indication of private equity funds' organizational commitment to ESG integration.

The survey responses demonstrate that, on average, private equity firms seem to adopt a sophisticated and diversified catalogue of ESG policies. Overall, firms are perhaps surprisingly comprehensive in their approach to ESG, given the challenges that our survey identified in terms of collecting, understanding and comparing ESG data: those firms who adopt environmental policies are also likely to adopt the other forms of ESG policies, including policies related to ethical issues. For example, of the firms that invest in Europe, 22 indicated having environmental ESG policies, 24 indicated having social policies, 20 indicated having ethical policies, and 24 indicated having governance policies. Such relative patterns do not differ much by geographic focus – no particular category of ESG policy appears to be more prominent in certain geographic investment targets.

We also find that private equity ESG policies are more likely to be internal policies, (see Table 3) and relatively less likely to be explicit in agreements with outside parties, such as LPs and portfolio companies (see Table 4). To the extent that funds were likely to have any explicit ESG clauses included in their contractual agreements with external parties, it is more likely to have been with an LP than a portfolio company. Again, the overall pattern does not differ substantially by geographic focus. We suggest that this is quite an interesting finding, given that some would argue that ESG integration may compromise investor returns and, as such, it could even be legally contested. Yet if ESG integration compromised investor returns, then we would perhaps have expected a much higher incidence of ESG inclusion in LP agreements, purely on an insurance and/or risk mitigation basis. The fact that we observe a higher incidence of internal policies, however, is arguably more consistent with the idea that LPs are leading the demand for private equity funds to integrate ESG, and in so doing, push funds towards adopting internal policies.

Table 3: Types of ESG Policies by Geographical Investment Focus

	Environmental	Social	Ethical	Governance	Other	Total Respondents in Geography
North America	10	10	9	11	2	11
Europe	22	24	20	24	4	26
Asia Pacific	9	9	9	10	2	10
MENALA	4	4	4	5	1	5

Total number of responses: 29.
Locations of investment focus are not mutually exclusive. In addition, this question allows multiple selections by respondents, so answer categories are also not mutually exclusive.

Table 4: Integration of ESG Policies by Geographical Investment Focus

	Internal	LP	Portfolio	Total Respondents in Geography
North America	10	8	7	11
Europe	23	17	16	26
Asia Pacific	9	8	6	10
MENALA	5	3	3	5

Total number of responses: 29.
Locations of investment focus are not mutually exclusive. In addition, this question allows multiple selections by respondents, so answer categories are also not mutually exclusive.

Officer Responsible for Setting ESG Policy

How much institutional weight and buy-in does the ESG approach command within private equity firms? We asked respondents to indicate to us who set and enforced ESG policies at their firms, given that we were interested in understanding the hierarchical placement of the responsibility within their organizations; arguably, the higher up the responsibility is assigned, the more likely it is to be genuine as well as binding.

Results indicate that ESG is supported from the highest levels of the private equity enterprise. In fact, the larger the firm, the higher the level ESG is set and enforced (see Table 5). For small firms, the most common individual responsible for setting and enforcing ESG policy was a C-level executive (4 out of 9 responses), often indicated as the CFO. For medium-sized firms, the most common individual to set ESG policy is the CEO her/himself (5 out of 7 responses). For the large firms, ESG policy is most commonly set even higher than the CEO, at the board level (5 out of 11 responses). This particular finding is consistent with work in public equity that shows that a formal board responsibility for ESG, as well as a board subcommittee for ESG issues, are key indicators of a genuine organizational commitment (Eccles et al., 2014).

Consequently, the findings suggest that at large firms, ESG is considered to be a matter of concern at the highest levels of the enterprise in the boardroom, set at the same decision-making level as functions such as audit, compensation and risk. The high levels of ESG focus and commitment suggest therefore, at least symbolically, that ESG is currently an important matter in the operations of the private equity industry.

Responsibility for Implementing ESG Policy

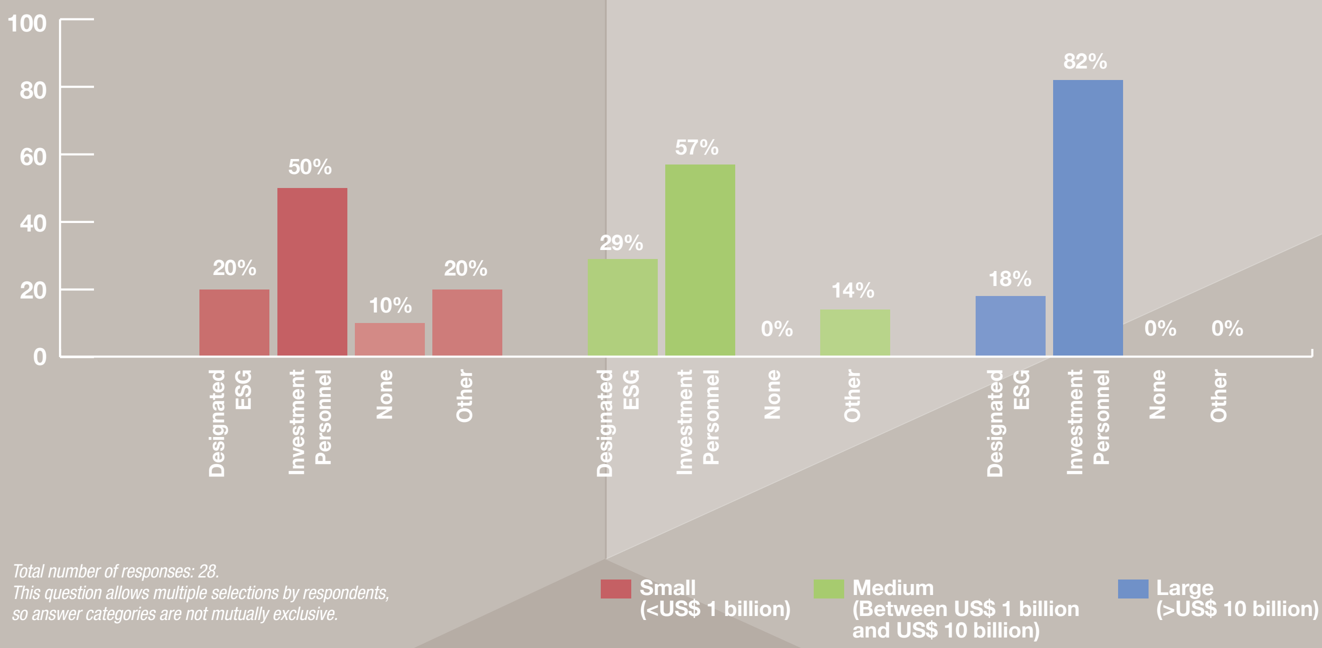
In addition to asking who sets ESG policy, we also explored who had the responsibility for policy implementation within a private equity firm. Implementation of ESG policies varied in our sample, with the most prevalent response being that responsibility lies within the duties of the investment personnel (see Figure 8). Thus, while ESG policy is set at the highest levels, implementation appears to diffuse throughout the organization. A few funds (6 out of 28 responses) also reported having designated staff to handle ESG issues, while those who reported "Other" indicated that ESG implementation may also be assigned to the Compliance Officer or Investor Relations Officer.

Some may find this result surprising, given the widespread belief that ESG issues are often assigned to a specialized individual within the investment team, typically of a legal or compliance background. Such a perception, however, is more consistent with the view that an ESG approach has more to do with compliance and risk management and less with value creation. Indeed, the fact that responsibility lies with the investment personnel for many firms in our sample indicates that ESG is an integrated and core value-creation strategy rather than an issue of compliance to be handled by an ESG specialist. This trend resembles what has been observed in public equity markets, where ESG data is increasingly taken into consideration for investment decision-making, in the same manner as traditional financial data is. Indeed, in recent years the public equity markets have experienced a huge increase in demand for ESG data, not just in the form of ESG reporting but also in the form of integrated reporting, thus allowing capital markets to make investment decisions based on an integrated (i.e., using both financial and ESG data) approach. Returning to the private equity setting, this suggests that gathering reliable ESG data throughout the investment cycle is critical. In the next section, we proceed to explore the extent to which such data is generated and reported within private equity.

Table 5: Highest-Ranking Officer or Committee that Sets, Enforces or Monitors Implementation of ESG Policies by Firm Size

	Board Member	Chief Executive Officer	Chief Investment Officer	Other C-level executive	Committee Member	Other	Respondents
Small	0	2	3	4	0	0	9
Medium	1	5	0	1	0	0	7
Large	5	1	1	2	0	2	11
TOTAL	**6**	**8**	**4**	**7**	**0**	**2**	**27**

Figure 8: Person Responsible for ESG Policies Implementation Across Investments by Firm Size



Total number of responses: 28.
This question allows multiple selections by respondents, so answer categories are not mutually exclusive.

Stage of ESG Integration in the Investment Process

To gain some in-depth understanding of the role of ESG policies play in private equity value creation, our survey included questions regarding the stage of the investment process at which private equity firms consider ESG matters. Do firms begin to filter investments through their ESG policies as early as the investment origination stage? Such a practice would suggest that ESG plays an important investment evaluation and selection role. Do firms implement ESG policies during portfolio ownership? If so, then ESG would play a crucial value-creation role for the private equity firm and may be an avenue for generating superior investor returns. Or do firms predominantly integrate ESG issues when investments are prepared for exit? Such an emphasis would suggest ESG plays an embellishment or marketing role as portfolio companies are groomed for sale.

Among the responses, we find that firms are twice as likely to be implementing ESG policies at the investment origination stage (22 respondents) and the investment ownership stage (22 respondents) as at the exit stage (11 respondents). These results suggest that ESG policies are far more than window-dressing towards an exit. On the contrary, the responses suggest that ESG issues are used to screen and evaluate investments right from the beginning and are then central in value creation during the ownership stage (see Figure 9). This is also consistent with the finding that implementation responsibility lies with all investment personnel and that policy-setting originates at the higher echelons of a private equity firm's hierarchy. Consequently, for firms that have adopted ESG policies, ESG factors now seem to play a far more central role in the investment process than one may initially surmise.

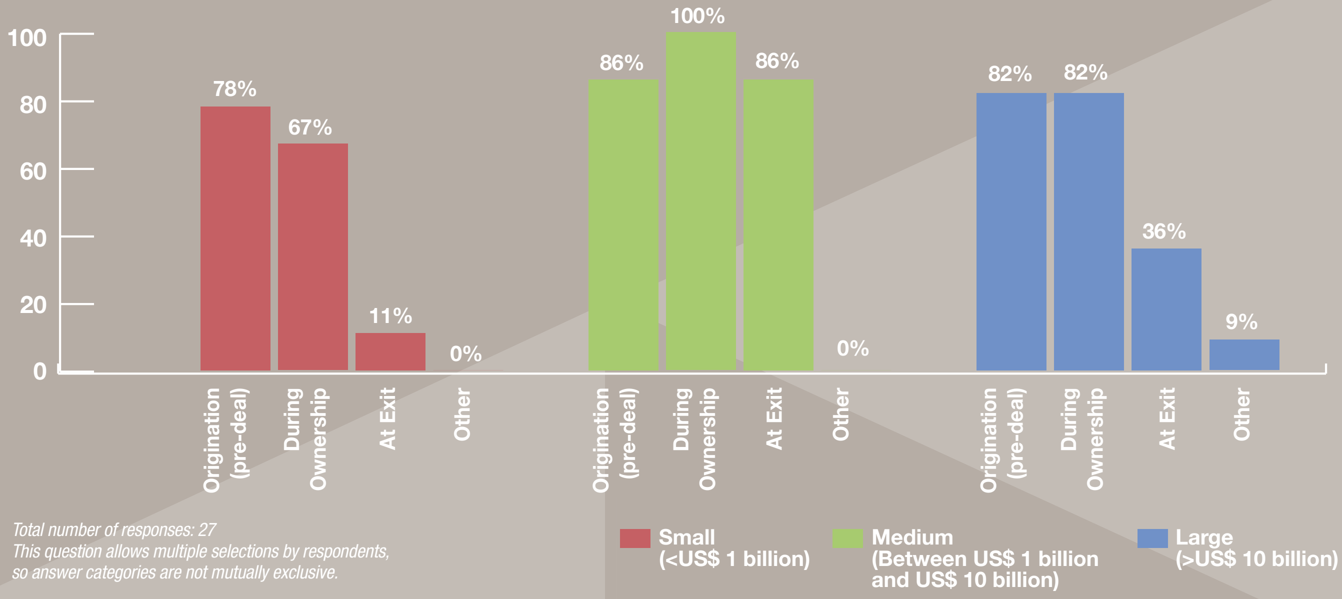
We note that this pattern of ESG focus during origination and ownership relative to exit is especially pronounced in our sample for small firms and large firms, but less so for medium-sized firms. Among the medium-sized firms in the sample, the focus on ESG appears to be more evenly distributed across all stages of the investment process.

ESG Data Collection, Reporting and Use

Prior scholarly work documents that performance measurement is critical for firms as it enables them to determine how well their strategy is executed and to make any necessary course corrections in the process, if needed (Kaplan and Norton, 2008). Private equity firms that genuinely integrate ESG issues into their investment approach face a more complex management challenge than traditional private equity in the sense that, to monitor and ensure the full implementation of their ESG approach at portfolio companies, they must also measure and report on dimensions beyond the traditional financial metrics. In doing so, they are also better positioned to report back to their LPs (where pressures for integration are coming from), their C-suite and their board of directors on the value-creation process in general and the progress on ESG issues in particular. This process becomes even more complicated in the private equity context since ESG metrics are not readily available, they are not comparable across investments, and may be differentially material across industries and/or geographies (see section on Barriers to ESG Policy Adoption).

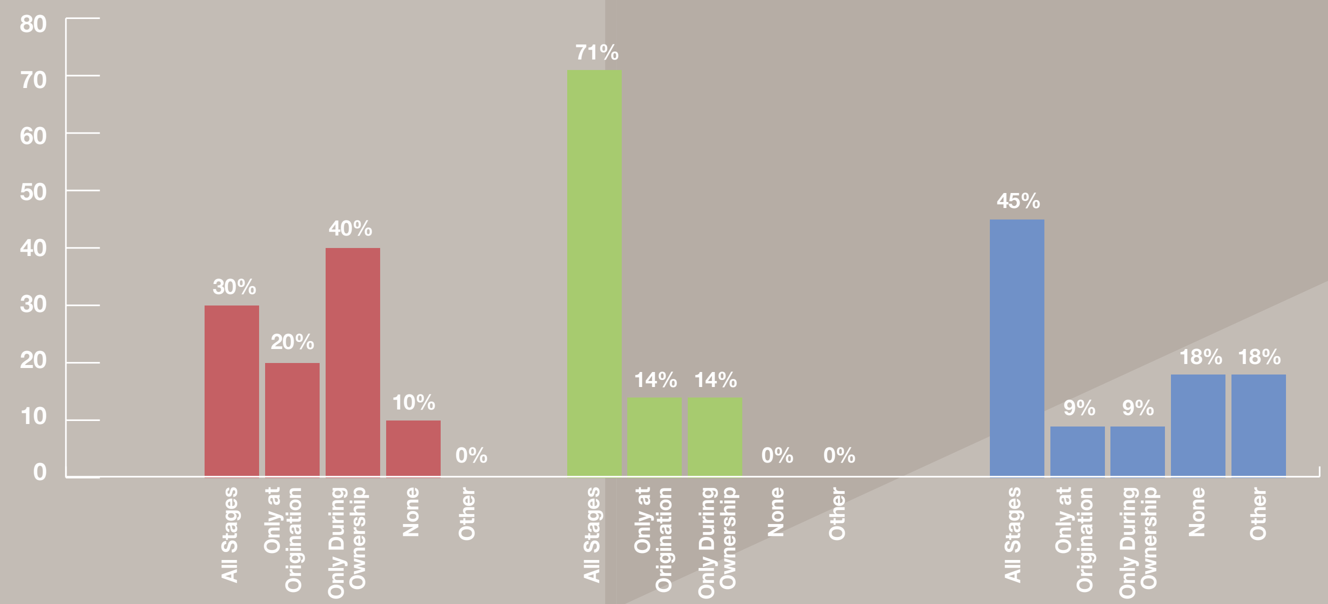
Given how central to the ESG investment approach the measurement and reporting of ESG data is, through the survey we investigated in more detail the data collection process itself, as well as the private firms' reporting practices and further use of ESG data. Based on the responses we received, we highlight three broad observations. First, among firms that do collect ESG data, the attempt is comprehensive and covers all stages of the investment process (13 responses out of 28 total). This is consistent with how critical ESG policies are considered to be among firms that have such policies in place and it is also consistent with the finding that consideration of ESG issues takes place at all stages of the investment process (see Figure 10).

Figure 9: Stage of the Investment Process at Which the Firm's ESG Policies are Applied by Firm Size



Total number of responses: 27
This question allows multiple selections by respondents, so answer categories are not mutually exclusive.

Figure 10: Systematic ESG Data Collection Across Investments by Firm Size



Total number of responses: 28

Second, ESG data is systematically reported to the LPs (16 responses out of 23) and the board (14 responses out of 23) for a non-negligible number of firms (see Figure 11). This finding is consistent and in fact complements the previous results in that LPs are exerting pressure on private equity firms with regards to ESG issues and that ESG policies tend to be mandated from the highest echelons of the firm's hierarchy. It is also interesting to note that even though ESG data is reported to investors and boards, such data are less commonly disclosed in annual reports (7 responses out of 23) and legal filings (2 responses out of 23). Thus, it appears that ESG data is primarily used for internal purposes. This could suggest that the very process of ESG integration may be considered a differentiating factor, and perhaps a distinctive value creation strategy, given that potentially strategic and/or proprietary ESG data are less likely to be shared or revealed publicly.

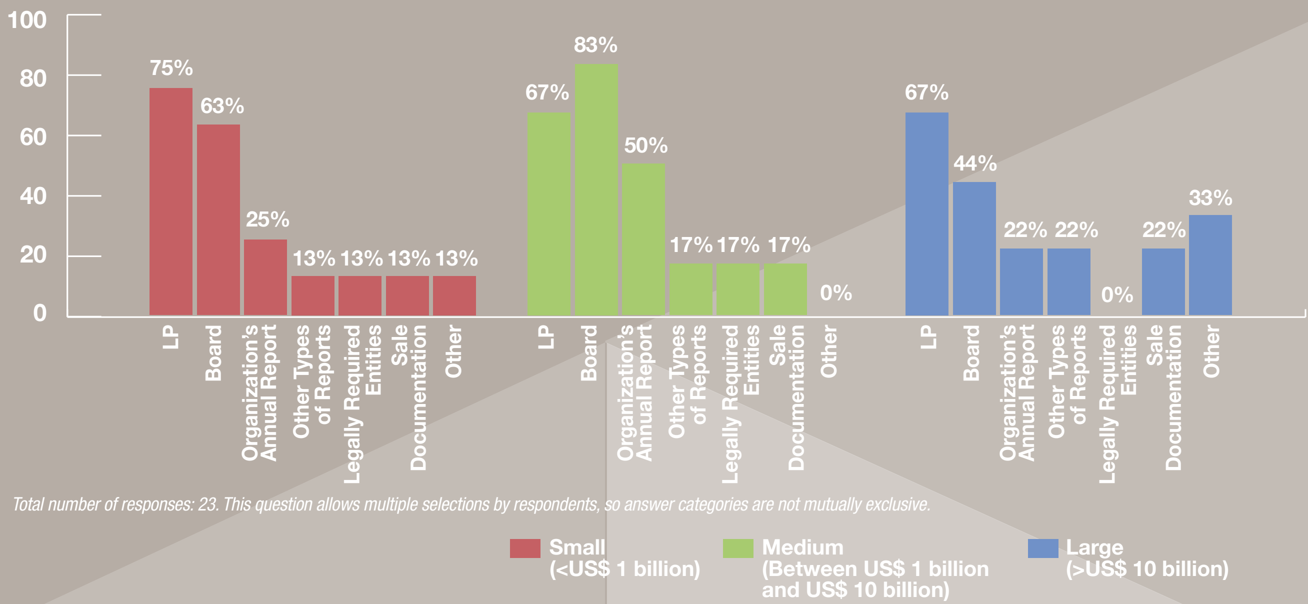
Third, in addition to being used during the investment process, firms across sizes reported that ESG data is often used for benchmarking performance targets and milestones of portfolio companies (12 out of 12 responses) and also as team performance measures (6 out of 12 responses). There was also one case of ESG data being factored into the determination of bonuses for team members (see Table 6). These particular results indicate that ESG metrics are slowly being integrated into the firm's incentives structures, at least at the team level, and importantly, that ESG dimensions are increasingly becoming relevant dimensions of performance accountability, perhaps at par with traditional financial metrics benchmarking.

The primary goal of this survey was to gain a deeper understanding of the process of ESG integration and the current state of affairs regarding ESG in the private equity industry. Without a doubt, to assess whether ESG integration results in superior value creation, a lot more needs to be done and more fine-grained data will need to be collected. Nevertheless, we did ask the respondents to indicate to us whether the ESG data that they do collect is used for risk management purposes or for identification of potential opportunities for value creation. This is a critical question, given that many market participants would argue that ESG is nothing more than risk mitigation through compliance, whereas a few would argue that ESG integration has significant implications for value creation, beyond risk mitigation.

For instance, recent work on public equity markets by Varma and Nofsinger (forthcoming) finds that, compared with conventional mutual funds, SRI mutual funds outperform during periods of market crisis – an indication that ESG integration may just be a type of insurance policy. However, they also provide evidence that this dampening of downside risk comes at the cost of under-performing during non-crisis periods. In fact, they show that this asymmetric return pattern is driven by the mutual funds that focus on ESG attributes and is especially pronounced in ESG funds that use positive screening techniques. It would be interesting for future work to explore the extent to which the integration of ESG factors has similar implications in private equity and/or the extent to which the private nature of these funds, and the active monitoring and management of ESG issues at portfolio companies, might allow them to generate value beyond risk mitigation.

Across all dimensions of ESG (except data related to measures of social return on investment), we find that firms use ESG data for risk mitigation (see Table 7). However, we also find that the vast majority of the sample firms use ESG data for value creation purposes (with the exception of ethical issues). Indeed, for the largest firms, risk mitigation and value creation are at par for all ESG dimensions. We suggest that these results highlight the need for more work and a deeper understanding of the value creation potential of ESG integration in private equity, and constitute fruitful avenues for rigorous academic exploration in the future.

Figure 11: Reporting of the Collected ESG Data by Firm Size



Total number of responses: 23. This question allows multiple selections by respondents, so answer categories are not mutually exclusive.

Table 6: Alternative/Additional Uses of ESG Data by Firm Size

	Team performance measures	Bonus calculation for team members	ESG milestones/targets during ownership
Small	3	1	3
Medium	2	0	5
Large	1	0	4
TOTAL	**6**	**1**	**12**
% of Responses	**50%**	**8%**	**100%**

Total number of responses: 12. This question allows multiple selections by respondents, so answer categories are not mutually exclusive.

Table 7: Use of ESG Data in Risk Mitigation and Value Creation Models by Firm Size

	Small		Medium		Large		All Firms	
	Risk	Value	Risk	Value	Risk	Value	Risk	Value
Environmental	4	2	4	3	4	5	12	10
Social	4	1	4	3	4	4	12	8
Governance	4	2	4	3	5	4	13	9
Ethical	2	0	3	2	4	1	9	3
Safety	4	1	3	3	4	3	11	7
SROI	2	2	0	0	1	0	3	2

Total number of responses: 22..

Conclusion

We present results from one of the first comprehensive surveys on the role of ESG in the investment practices of the private equity industry. Based on responses from 42 private equity firms, representing a broad spread of geographic and sector focus, and a cumulative total of over US$640 billion in assets under management, the findings indicate that ESG policy – far from being a peripheral consideration – emerges as a core value-creation strategy for private equity funds in portfolio companies. More specifically, in this sample, the emphasis on ESG policy as a core private equity value-creation strategy is particularly prominent in the largest of the private equity firms, where investor pressure is reported to be most acute. We acknowledge that our sample may be biased in the sense that firms self-selected by responding to the online survey. We thus caution the reader that the findings and inferences that we draw here are conditional on a firm engaging with ESG and volunteering to respond to our questionnaire.

We find that current pressures to adopt an ESG approach mainly originate from LPs, yet firms are expecting future pressures to come from the government, regulators and potentially their own peers. Given such pressures, private equity firms face important barriers to ESG integration with the most important being challenges associated with collecting, understanding and comparing ESG data across investments, industries and geographies. Although for a significant number of firms ESG integration is implemented through guidelines rather than industry, region or investment-specific rules, the results suggest that firms adopt a wide and indeed comprehensive collection of ESG policies that are then applied by all investment professionals rather than an ESG specialist who is typically tasked with compliance or risk mitigation issues.

Importantly, we find that commitment to ESG integration originates at the top of the hierarchy, with ESG policy being set and enforced at the board of directors level and/or the C-suite, and that ESG issues are regarded both as risk-mitigation and value-creation opportunities. Accordingly, ESG data is not only collected throughout the investment cycle, but it is also reported to the board, the C-suite and the LPs. In fact, we may infer that ESG metrics are slowly being integrated into private equity firms' incentive structures, at least at the team level, and that ESG dimensions are increasingly becoming relevant dimensions of performance accountability across portfolio companies, perhaps at par with traditional financial metrics benchmarking. We find that this is particularly true for environmental, social and governance issues, and less so for ethical issues.

When considering the different stages of the investment process, we find strong indications that, far from being a window-dressing set of activities that occurs at the time of exit, ESG integration is much more likely to take place during the investment origination and asset ownership stage of the investment process. Relatedly, the vast majority of the sample firms reported that the use of ESG data is not simply confined to risk management but that indeed, such data is also used for value creation purposes; a finding that may be in contrast to widely held beliefs about the role of ESG in the private equity industry.

Finally, we argue that all of the findings combined point towards an intriguing heterogeneity across private equity firms, in terms of the processes of ESG integration into investment decision-making; a heterogeneity that may arguably have important implications for any given firm's ability to realize value at portfolio companies through the active management of ESG issues as strategic opportunities for value creation. We maintain that exploring the value implications of ESG integration in private equity, both for investors as well as for the numerous stakeholders that are directly affected by ESG, are perhaps at this point, the most interesting avenues for future research, and the ones that we remain eager to pursue.

Authors Biographies

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Ioannis is a strategy scholar whose academic work focuses on Sustainability and Corporate Social Responsibility (CSR). In collaboration with other academics, Prof. Ioannou has explored Sustainability via two main themes: a) examining the role of investors and capital markets in promoting a sustainable society in general, and sustainable and socially responsible business practices in particular, b) investigating the multilevel drivers of socially responsible behavior by corporations. In recent pioneering work, Ioannou and his co-authors have established the existence of a new type of the modern corporation - the sustainable organization - and have empirically proven its long-term out-performance compared to traditional firms. His work has been published in top academic journals, like the Strategic Management Journal (SMJ), Organization Science, Management Science and the Journal of International Business Studies (JIBS). He is also often quoted in several media outlets, including Thomson Reuters, Financial Times and The Guardian. Ioannis graduated magna cum laude from Yale University, majoring in Economics and Mathematics and holds a Ph.D. in Business Economics from Harvard University.

Thomas Zhang

Thomas Zhang studies innovation, marketing, and entrepreneurship at the London Business School. His current projects focus on the innovation tendencies of small-scale enterprises in developing countries. Prior to academic research, Thomas worked in private equity and capital markets in the US, Middle East, and Asia. A graduate of Princeton University in economics and demography, Thomas completed his MBA at the Hong Kong University of Science and Technology.

Francesca Cornelli

Francesca Cornelli is Professor of Finance at London Business School. She is also the Director of the Coller Institute of Private Equity, a research institute of the London Business School. She previously held positions or taught at the Wharton School, the Fuqua School of Business at Duke University, The London School of Economics, the Indian School of Business in Hyderabad and the New Economic School in Moscow.

Her interests include corporate governance, private equity, privatization, bankruptcy, IPOs and innovation policy. She has published several papers in the major nance and economics journals and she gives regular talks in major conferences and Universities. She is an editor of the Review of Financial Studies, and has been an associate editor of the Journal of Finance, of the Journal of Financial Intermediation and of the Review of Economic Studies. She is a director of the American Finance Association, a member of the Scientic Committee of the Banque de France Foundation, and a Research Fellow of the Center for Economic and Policy Research (CEPR). She has been a member of the Council of the European Economic Association and of the Council of the Royal Economic Society.

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