Can ESG and Sustainability Create Value Effectively for Private Equity ?

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While sustainable development is not a new term for economists, consideration of sustainability and ethical factors in finance is a relatively recent concept. Sustainability and ethical concerns are mainly reflected in finance through increased attention to Environmental, Social and Corporate Governance (ESG) considerations in investments. As far as Private Equity Investments (PEI) are concerned, they have been historically led and will continue to be led by profit, regardless of their nature. Nonetheless, Private Equity (PE) will have to progressively include ESG factors in their operations.

The paper contributes to the existing body of knowledge by investigating the latest generation of PE Funds (PEF) which are attempting to use ESG to "create more value with less risk" (Indahl and Jacobsen, 2019). The paper also seeks to understand whether PEI, as time-bound short-term financial tools, could be an instrument for long-term planning, fostering sustainability and enhancing an ethical approach to investments; and whether, in doing so, value can still be created, if not increased.

The paper is based on a review of existing literature on the issue. In addition, as the topic discussed is rather recent - and thus the literature is limited - the paper is supported by targeted interviews of managing partners and directors of some well-known PEF with offices in Europe and of members of the Italian Private Equity, Venture Capital and Private Debt Association (AIFI) who operate mainly in Europe.

The originality of this paper lies in the fact that it weighs all the pros and cons related to the use of PEI as a tool to foster sustainability and reinforce an ethical approach to investments and tries to identify the ways in which ESG can be leveraged to create value in the industry, and whether these levers are already used or should be further exploited by the industry. The paper also develops various recommendations that could be useful to the industry to seize the opportunities offered by ESG for value creation.

PE and the components and dimensions of sustainable finance

When it comes to the evolution of the industry, Indahl and Jacobsen (2019) divide PE's history into four time periods. According to them, during the 1980s, leveraged buyouts (LBOs) were used to create value through financial engineering. High leverage coupled with large equity stakes were used to motivate managers to cut the costs of mature businesses. "PE 2.0" developed in the 1990s and focused extensively on increasing operating efficiencies by hiring successful CEOs. The 2000s brought the third wave of PE, characterized by large financial institutions that "continued to function as value-added buyers" and expanded into multiple asset classes and new areas of expertise. The latest generation is defined as "PE 4.0: Using ESG to Create More Value with Less Risk". As seen by the various versions outlined by Indahl and Jacobsen (2019), PE is a malleable and forever changing form of investment type, which makes it a good candidate for adapting to the constantly changing needs of the future.

Environmental, Social and Corporate Governance factors, also known as ESG, are now considered central pillars in measuring the ethical, environmental and social impacts of investments and businesses. Added together, the three ESG factors describe "sustainability". However, there exists a plethora of definitions of ESG factors in the literature, each stressing a particular aspect, mostly related to the nature of a business and its products and services.

In general, *Environmental* considerations focus on a company's impact and ecological footprint, whether it relates to its waste production, use of energy or pollution of land, air or water. Recently, increasing attention is also being paid to climate change concerns, highlighting the ability of a company to limit and/or offset its greenhouse gas emissions.

Attention to *Social* standards covers a wide range of issues, from the health and safety of workers to labor fair practices and standards throughout the value chain, as well as general ethical factors. Human rights concerns, gender and diversity, and animal welfare are also aspects considered by many companies.

Governance aspects are even more complex and difficult to define, as they address a vast array of issues and standards for running a company. Overall, governance refers to the management and leadership of a company, including aspects such as salaries and compensation, employee conditions and relations, controls and audits, and concerns over bribery and corruption. Governance can also refer to the ability of the company to align with the interest of its shareholders and in some cases, political contributions and sustainability standards in local countries, particularly for multinationals.

Why the shift towards sustainable investments?

The author identifies three main reasons for a transition toward sustainable investments: (i) a *bottom-up* one, triggered and supported by the purchasing power of young and informed generations; (ii) a *top-down* one, which refers to governmental polices and regulations, imposing compliance on businesses and their investments; and (iii) a *reputational* one, whereby a business decides to become more sustainable to wash away past stains.

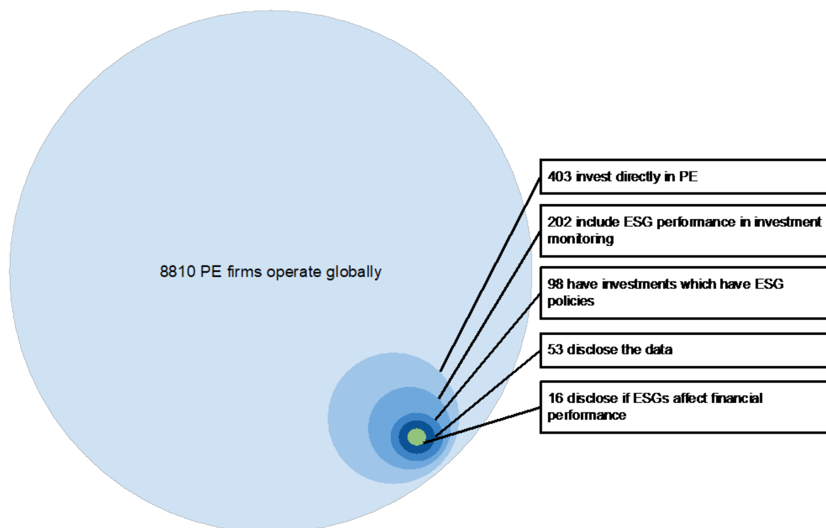
According to UBS Group (2018), 65% of investors believe in "helping to create a better planet" and say this has a strong influence on their spending, lifestyle, and career decisions. However, 65% of investors does not equate to 65% of capital. According to EY (2020), 80% of CEOs believe that governments, businesses, and society will reward companies which take "meaningful action" in the next five to 10 years. In 2021 PitchBook, the online data platform dedicated to PE, found that 95% of limited partnerships were "already evaluating" or planning to "increase their focus" on ESG risk factors.

These insights highlight a clear trend in the market beyond the existing anecdotal evidence. Yet the trend could be characterized as developing in slow motion. Numbers can easily be inflated or manipulated to bring home a point that may not truly reflect reality. Pucker K. and Kotsantonis S. (2020) highlight this in a paper where they unveil the true impact PEFs have on ESGs and call it a "PE-ESG Bubble" (see Figure 1).

Pucker K. and Kotsantonis S. (2020), argue that numbers demonstrate the discrepancies between what is being declared and what is truly happening behind the scenes. Therefore, the evidence of a shift towards an ESG and PE partnership cannot only be based on the fact that the market may be trending in this direction.

More concrete reasons of the shift to sustainability that many authors identify related to two major factors: (i) the purchasing power of millennials and the Gen-Z cohorts born since the early 1980s and (ii) supernational, international and national legislation.

Figure 1. Figure 1: Representation of the "PE-ESG Bubble". Adapted from Pucker K. and Kotsantonis S. (2020)



The literature seems to concur on the fact that regulatory imperatives are further advancing ESG initiatives. Regulatory bodies are starting to push for sustainability and ESG-compliant behaviors in all aspects of business. The EU, for instance, requires a wide range of "financial services participants" to disclose ESG factors and reporting requirements (Lapham, K., et al., 2021). These regulations have introduced a new level of transparency for the asset management sector and apply to EU fund managers and financial advisors, as well as other non-EU funds which market their funds in the EU.

Another motive for embracing ESG is to improve the generally 'bad reputation' that PE firms have. The debate about whether PE is intrinsically bad or simply needs better PR is ongoing. However, the literature hints at the fact that taking the industry in an ESG direction could be the reputational redemption that PE firms require to ease the potential pressure they may face in future for tougher legislation.

Advantages and challenges of the ESG transition

There are several reasons why PE could facilitate the transition towards sustainability better than other financial institutions or tools:

- PE and VC have a unique position in the financial system because they precede bank loans and capital markets as

the first source of investment for many firms. Therefore, PE can identify and gain access to younger and more innovative firms five to 10 years before they are ready to hit public markets (Loiacono S., 2021).

- PEF do not have strict regulatory requirements and have a far smaller pool of stakeholders compared to other financial institutions, which allows them to be more flexible with their investments, thus making them far better candidates to finance and buy the equity of smaller and younger ESG-compliant firms.
- Successful PEF know how to implement 360-degree management at a company and often restructure management in order to improve efficiency, reduce costs and enhance synergies (Barber F. and Goold M., 2014).

Pucker and & Kotsantonis (2020) identify the holding period of PEF as the first obstacle to more PEF getting involved in ESG: the median holding period of a company in a PEF's portfolio is 4.5 years. Sustainability challenges are usually addressed and solved over longer periods of time and require investments that pay off in the medium to long-term.

They also highlight the difficulty of quantifying the value of ESG investments. An investment, like the purchase of higher quality water filters, is relatively straightforward to quantify. However other initiatives are far more difficult to measure, such as striving towards gender balance in upper management or investing in animal rights monitoring at an overseas farm.

The third obstacle to the progress of ESG in PE relates to sustainable finance in general, where there is a lack of standardized ESG definitions, measurements, and regulations.

Finally, the size of companies backed by PEF is far smaller than the average publicly traded company (Pucker K. and Kotsantonis S., 2020). This puts smaller firms at a disadvantage as they might not be able to access the same resources and expertise as larger companies to help them build solid sustainability records.

Value creation is a central theme to this paper as it is the measuring stick against which the success of ESG factors is assessed. According to PwC (2018) the private equity industry is now a mature market and is in a third wave defined by the "requirement to pull on a full suite of value creation levers in every asset to achieve its full potential". PwC outlines how firms can reach their potential through a "holistic" approach which looks at: i) operational performance; ii) improving strategic capabilities; and iii) effective capital management.

The eight ways in which ESG factors drive value creation in firms held by PE

McKinsey's report (McKinsey, 2020) identifies "top-line growth" as the first way that ESG creates value. Top-line growth is achieved through attracting more B2B and B2C customers with the proposition of more sustainable products and achieving better access to resources through stronger community and government relations (Henisz, 2020) (McKinsey, 2020).

According to McKinsey the second way for ESG to create value in businesses is through "cost reduction". Cost reductions can come about through better sustainability practices; for instance, reducing water usage and electricity for sustainability reasons will reduce costs, all other factors remaining equal.

"Reduced regulatory and legal interventions" is the third way for ESG to create value according to McKinsey. Strength in ESG helps reduce "companies' risk of adverse government action" across multiple sectors and locations. McKinsey calculated that on average one third of corporate profits are at risk from state intervention. However, some industries are more impacted than others; for example, the banking system sees 50-60% of its EBITDA at stake.

McKinsey's fourth way for ESG to create value is "productivity uplift". EY highlighted a similar reason for "why" PEF should "embed purpose and transparency" in its strategy namely, "to win the best talent". (Although EY's definition of "purpose and transparency" is not clearly stated, references to ESGs are numerous.)

McKinsey's fifth and final way for ESG to create value is through "investment and asset optimization". For example, firms should avoid investments that may not pay off because of longer-term environmental issues, such as huge write downs of oil tankers. An ESG proposition could also enhance investment returns by allocating capital to more promising and more sustainable opportunities.

Indahl and Jacobsen (2019) identify cases in which the public and regulatory attention received by the industry in recent years has come to be viewed as the model for best-in-class ESG practices. They add that "this reputation is giving it a strong competitive edge, allowing it to grow market share and demand premium rates for its high-quality services." McKinsey uses competitive advantage as an example of a negative consequence of not investing in asset optimization: firms may "fall behind competitors that have invested to be less 'energy hungry'."

EY adds another reason why it is important to embed purpose and transparency in PEF strategy:

"to meet the demand of LPs" (also known as investors in the PEF itself).

Indahl and Jacobsen (2019) state that their fund assesses "how the situation in the world at that point is affecting the value and performance of our companies". Regarding climate risk, "companies face a significant ancillary potential risk".

The opinion of PE managers

To substantiate the arguments of the paper, the author decided to include focused, in-person in-depth interviews with PE managers to gather more detailed, first-hand information on the above. Interviews were conducted with four funds investing and receiving funds predominantly in Europe, and a private capital association to which they all belonged.

The interviewees' details are in Annex 1. For privacy reasons, the names of the funds and managers interviewed have been redacted.

In particular, these interviews explored the following questions:

1. To what extent does your fund view ESG factors as a means to create value, both in the fund itself and in the firms you invest in?

2. According to the literature, ESG considerations can create value through one or more of the following ways. Could you identify which of these factors you have taken into consideration when investing in a company?

3. Have any of the following ways proved to have created value for one or more company you exited?

4. In the context of ESG, which do you consider to be sound and adequate for future transactions as ways to create value, out of the listed factors?

5. In the context of ESG, do you consider other factors as drivers of value creation which have not been listed above?

Factors taken into consideration are the ones identified through the literature review and described above: 1. Top-line growth; 2. Attracting the best talent; 3. Reduced regulatory and legal interventions; 4. Improved efficiency and cost reductions; 5. Competitive advantage; 6. Risk management; 7. Meeting the demand of LPs; 8. Investment and asset optimization.

The view that ESG is either flooding into the PE sector or is already present is evident in the literature and was articulated strongly by all the interviewees. The "last few years" (indicatively 2019-2022) timeline was highlighted by multiple interviewees who noted that the emergence of ESG has accelerated and recently became essential to their activities.

The relevance of ESG to the fund

The importance of ESG is reflected in the answers to the first question, where all but one respondent saw ESG as important factors to create value.

In general, the respondents underlined the following:

- Governance is at the core of what PE is and does. PE firms pay particular attention to social and governance aspects (and this was seemingly true even before the emergence of ESG criteria).
- Some firms make the "E" part of ESG their reason to exist as a business.
- Other firms are starting to orient themselves towards environmental sustainability, primarily because there is pressure from numerous stakeholders. This includes finding areas that can be improved such as using more recycled materials in the production line and using self-generated electricity in warehouses.
- ESG requires resources; for instance, in smaller funds, it is common for the budget not to provide for an individual who is solely dedicated to the ESG cause.
- Most firms are still refining their ESG approach because they only launched an ESG fund recently.
- Value Creation through ESG is a product of correlating social value and finance, meaning that while there must be an ESG performance, the financial returns must not be forgotten.

Factors considered when investing in a company

On the second question, while replies varied, only risk management was selected by all the interviewees as a way to create value.

Some key points emerged from different answers to this question. In particular:

- According to one respondent competitive advantage is determined by three main factors: 1) continuous innovation; 2) international growth potential; and 3) total growth potential. ESG therefore is less of a determining factor, and it only becomes one if it is "integrated into the innovation process of funds".
- According to another respondent "top-line growth" is not the reason why his fund looks at ESG. As the only fund interviewed which specializes in consumer products, the assumption that they would be focused on top-line growth by connecting consumers with ESG values was unfounded. In this regard, his answer may seem counterintuitive.

- On "attracting the best talent", a respondent used the example of how the implementation of gender balance in firms allows the business to be "more credible". Gender balance was seen as a simple way of demonstrating to investors, clients, and the market at large the commitment to ESG.

- A respondent noted that risk management was very important in the due diligence phase.

- One respondent excluded "investment and asset optimization" because "in the short term one needs to invest further or increase the company's debt which could lead to a sub-optimal impact on the company in the short-term".

- All funds agreed that "investment and asset optimization" were not taken into consideration when investing in a company.

Effective ways to create value

This question should be taken with a grain of salt, because many of the funds interviewed have not yet exited or are still in the process of exiting from their more ESG-focused investments. This is in line with the "last two years" timeline provided by them, because most PEF hold their assets for longer than two years.

Several points emerged from interviews on this question:

- When it comes to exits, "improved efficiency and cost reduction" are very important because they affect both costs and EBITDA, which is often used in multiples to demonstrate value creation.

- "Top-line growth" and maintaining it at a high level are also important to demonstrate during the exit phase. As with cost reduction, topline growth has a direct effect on the calculation of EBITDA.

- During the exit phase investors have already provided the capital for the investments so what they care about is the return. However, what may also be useful for funds is to see how much buyers appreciate the value created by ESG, which can then be used to retain and attract investors for future rounds of funding.

- During the exit phase, satisfying the limited partners is often not an important factor.

- "Keeping up and being ahead of regulatory developments and reducing legal interventions", "competitive advantage" and "risk management" create value during an exit.

- Adherence to ESG criteria usually implies increased spending, hence further debt which precludes the optimization of assets and investments.

It is worth noting that an Italian fund for alternative investments also highlighted "competitive advantage" and "improved efficiency and cost reduction" as features of its exit strategies. The head of ESG added that what was very much appreciated in two recent exits was the start of an ESG process and related know-how in the firms, even though the process was not complete. This goes to the core of PE as both a way of investing and a means to build management structures that can make the firm more profitable, long after the original fund invested in the firm.

The ways ahead

The fourth question aimed at exploring what these experienced managers envisioned for the future of ESG and PE. They made the following points:

- Factors relevant for the future of the industry are "top-line growth" and "attracting the best talent".
- In terms of top-line growth, there is still some work to do on how to best harness the ESG message to truly exploit it and see it become a common feature in top-line numbers.
- Some respondents would like to see more firms that can really exploit ESG factors for their top-line growth. Thus, firms that position themselves in the market from the start as ESG-compliant can benefit from the growing trends towards sustainability and circular economies.
- Such firms are very important for the future, because they will be exploiting the rising global trend towards greater sustainability seen in recent years, which in turn could give them exponential growth prospects.
- Improved efficiency in the long run will not be a crucial element of ESG investing.
- ESG may imply increases in costs to meet future ESG standards.

Other factors

The fifth and final question was: "In the context of ESG, do you consider other factors as drivers of value creation which have not been listed above?". The most common response was related to the "Governance" aspects of ESGs. It was noted that:

- The main job of PEFs revolves around the establishment of proper governance in the firms that funds invest in. PEFs work with firms to build a better board of directors with independent directors. They also create incentives and alignments between shareholders and managers. From this point of view PE "has always been best in class".
- Historically there has been little

focus on some aspects of the "social" factors, such as diversity and "work-life balance", which have not been considered important.

- Creating more diverse boards of directors allows firms to: (i) Avoid *faux pas* which could negatively impact reputations and revenues; (ii) incorporate all cultures; and (iii) eliminate blind spots.
- Attracting consumers that are more ESG conscious can boost the top line and improve a brand's image.
- Results can extend this to improve the brand image and reputation of the firms in the portfolio, thus increasing the intangible assets.

Preferences and the importance of governance

The ways to create value through ESG that were most commonly selected across all three of the relevant questions were: (i) competitive advantage and (ii) risk management. Both are quite broad and mature concepts in the financial industry: risk management affects all industries and, likewise, for all industries competitive advantage is essential to survive. In addition, because these concepts are not new, the managers interviewed were familiar with them and dealt with them before they were also relevant for ESG. While it is encouraging to note that these concepts are recognized by the industry, the author believes that in the coming years, as the ESG "avalanche" affects markets, other ways will have to be also widely explored in order for PE firms to achieve the same degree of success in creating value through ESG as they currently do using the two ways that interviewees most frequently cited.

The least commonly selected way to create value through ESG was "investment and asset optimization". The lack of information about it in the literature review, and the shortage of managers willing to select it as a viable option, confirms in the author's view that this was the least robust approach to leverage ESG for values creation. This, however, does not mean it cannot be a valuable leverage tool for specific firms.

A crucial finding of this paper is the lack of importance placed in the literature on PE's strength as a market leader in governance. This not only emerged from the respondents' replies but was the most highlighted subject during the ensuing discussion with interviewees. As the literature review revealed, E, S and G together make up what is commonly defined as the sector's "sustainability". Because by its nature PE is a market leader in governance, the next steps should be to use this competitive advantage to improve the industry's performance in relation to the environmental and social pillars.

Interviewees also agreed that various ways to leverage ESGs can be more or less powerful in creating value, depending on the phase of the investment cycle. This is clearly visible in the importance attributed to "meeting the demands of limited partners" in the question relating to "investing in a company". Only one fund selected this category regarding the reason why it exited an investment.

Conclusions and recommendations

Based on the literature review and the interviews, this paper has reached the conclusion that ESG is increasingly and exponentially gaining ground in the PE world. The PE industry is in its "fourth iteration", with the increased attention to ethical and sustainability factors accelerated by the COVID-19 pandemic. This is not only due to the injection of liquidity by central banks during the pandemic but also to a newly found social conscience shared by many people who have been impacted by the consequences of COVID-19.

Additionally, many PE firms, particularly smaller ones, have been challenged by new EU disclosure regulations which have forced them to develop new tools to measure and disclose ESG investments. Due to their size and budget, it has become increasingly difficult for them to compete with larger firms which have much bigger teams that are dedicated to ESG.

Given the analysis above and the results of the interviews, the author makes the following recommendations for the industry to better seize the opportunities offered by ESG to create value.

Welcome both the bottom-up and top-down approaches

When it comes to sustainability, it is important that the demands of a younger generation that is well-informed about ESG are addressed using effective legal and policy tools for the transition to be effective in ensuring the PE industry's ESG compliance. This challenge is of course not unique to PE. Sustainable development policies are agreed at an intergovernmental and national level to advance various sectors, but they can only be effective if welcomed by communities and the targets of the policies themselves. In the specific case of PE, given the demand of ESG investors to make money while doing good, regulatory frameworks are essential to move the industry in the right direction in a consistent and coordinated way.

Develop know-how and expertise in E and S

The PE industry has been at the forefront in pressing for better corporate governance since the industry's emergence in the 1980s. In order to be fully sustainable by equally addressing environmental and social matters, the industry

must continue to be a market leader in governance. However, its weaker spots remain in ascending order, S and E, which should be dealt with in more depth by experts in these respective fields. The author thus believes it is important for the PE industry to look to recruit specialized talent in these two sustainability subsets in order to build the know-how essential for the latest PE 4.0 phase that the industry faces.

Reputational redemption

The opportunity ESG presents the PE industry for improving its reputation is unmatched. The author believes the industry cannot miss this opportunity and therefore recommends that it should fully embrace the ESG trend. A better reputation can be acquired in many aspects of a business, from less financial pressure to comply with new legislation to greater appreciation of the company's merits by the public at large.

Embrace the power of market dynamics

The concept of supply and demand can be leveraged by the industry to create an ESG-friendly world. PE and VC are a source of capital for many firms in all industries and are often trend setters. If the PE industry focused primarily on ESG investments, it would help squeeze firms that do not comply with ESG standards out of the market. This would encourage even more innovation by ESG-compliant firms in all industries, while potentially creating a new type of "vulture financing" where PE firms specializing in ESG investments sought to turnaround distressed firms by implementing ESG standards.•

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Annex 1: Summary of the interviewees and their respective funds

Source: Based on information available at www.aifi.it

Manager's position (and Seniority)	Fund/Association	AUM/N° of members*	Sector*	Geographical Preferences*	Investment size *
Secretary General	European Private Capital Association	155 members	n.a	Primarily EU, ROTW too	n.a
Managing Partner	Leading Consumer Growth Fund	$28 billion globally, €1.2 billion handled by manager interviewed	Fashion, Food and beverages, Furniture, Healthcare, Retail, Luxury	Manager interviewed focuses on EU, fund itself is global	Investment: €25 - €100 million
Managing Partner (most senior in fund)	European fund investing in mid-market Italian export-led businesses	€195 million	High value-added industrial goods' sectors, non-cyclical businesses, as well as pharmaceuticals, chemicals, and certain consumer segments such as luxury and food	Italy and DACH region (Germany, Switzerland, Austria), Asia	Investment: €10 - €25 million Revenues between €20 - €100 million
Investment Director	Independent Finical Group specialized in Alternative Investments	€ 810 million	Agriculture, Biotech, Chemicals and materials, Energy and environment, Food and beverages, Industrial products and services, other Manufacturing, Retail	Italy, EU	€ 0.5 – € 30 million
Head of ESG	Italian Fund Alternative Investments in PEF	€ 2.5 billion	Fund of funds, Agriculture, Energy.	Italy, EU	