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ESG Materiality and Integration in Private Equity Industry

RELATORE:

CH.MO PROF. ANTONIO ZOTTI

LAUREANDO/A: GIACOMO LAZZARIN

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APPENDICE

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Abstract

After the financial crisis of 2008 the characteristics of Private Equity put the spotlight on this asset class and confirm it as one of the most interesting in the market. Number of deals and capital at stake are consequently increasing year over year as results of a greater interests by investors.

Most of the investment made in the last 10 years has an ESG focus, signal that the economic environment has not been the only one to change in these years where stakeholder theory established as an improved model to describe investors behavior and orientation.

What really push investors to pursue ESG investment in Private Equity? Starting from analyzing the environment can be easily seen as international projects, associations and companies are working together to help the transition to a more sustainable economy. Value drivers and facilitators as risk management, lower costs, new business opportunities are pushing investment firms, and thereby investors, to commit capital in specific ESG-friendly companies. Barriers that years ago were considered impassable are now changing, and with them also the communication process and fiduciary duty between Limited Partners and PE investment firm. Empirical analysis performed to assess the level of ESG integration in Italian PE industry give us some important insights. The PE environment in Italy is mainly represented by small and medium companies, most of them already had a formal ESG policy and integrate ESG principles in their investments process. The integration is led by value creation opportunity, and therefore the increase in financial performance. Despite Italian companies realized the effectiveness of these drivers and declare to fully integrate ESG in their investment process only few firms effectively measure the impact of ESG activities on financial performance. This misalignment is due to a lack of standardized data, tools and models that allows to process and analyze the information collect, that lead to difficulties in measuring such impacts. The short-term expectation in this field predicts an increase in interests by LPs and portfolio companies, with them also PE firms will need to adapt by pursuing new approaches and improve the process of analysis.

Introduction

Environmental, Social and Governance issues are arising all around the world as some of the most important topics covered by newspaper and in television. Not only mass-media share these themes, but it is also easy to see them even in a common web page of a firm, and here to find documents, reports, or press-release where words as “positive impact”, “sustainability” or “diversity and inclusion” play an important role. Retrieving data from Google Trend the interest in the word “ESG”, representing a summary term to indicate these issues, increased of almost 600% during the last 5 years[1]. The Global Risk Report 2021 published by World Economic Forum report a survey regarding the global risk perception. In this survey, completed by over 650 members of the World Economic Forum’s diverse leadership communities, were asked to respondents the perception of the impact, likelihood, and timing of critical threats for the world. In 2021 societal and environmental risks represent the 100% between the five most likely risks of the future, a huge change respect to 2015 where these categories together represent the 20%. According to the results of the survey societal and environmental problems represents clear and presents dangers, with an immediate effect between 0-2 years.

These results make clear the global concern about these topics, and both reflect and affect the increasing attention by consumers, organizations and obviously, investors.

A different category of investors, the thematic investors, is spreading in the market, focusing on macro forces and their potential impact on deals. They do not consider passing trend that quickly disappear but only real high-impact themes that will change the economy over the next 10 to 15 years.

Globally we are experiencing a demographic transition that will shift the weight, tastes and spending patterns of the US and European population from the dominance of the baby boomer generation, born between 1946-1964, to that of the rising echo boomers, this reveals how consequential a macro theme can be for thematic investors.

Life cycle spending patterns can determine billions of dollars in business opportunities, a huge opportunity to catch for companies and investors during the demographic transition.

This wave of interest regrading environmental, social or governance issues spreads in the intricated economic net through their nodes, the firms. Firms represent the real engine that move

[1] Data retrieved from Google Trend for the search term “ESG” worldwide, interest in August 2016 was 13, in August 2021 90. Numbers indicate the interest over time, defined as the search interest relative to the highest interest for a given region and time. A value of 100 is the peak popularity for the term. A value of 50 means that the term is half as popular.

an economy and the way in which these company are managed, starting from their funding till their communication with stakeholder, is therefore affected by the ESG phenomenon.
After the banking crisis of 2008 an increasing number of firms is finding difficulty in fund themselves through bank loans or other common methods, and alternative ways are emerging in the economy. One of them, the private equity, allow to cover both the need of funding and lacks in management and financial skills, that nowadays affect especially small and medium firms (Bradley III & Cowdery, 2004). This asset class indeed perfectly fit in this environment and data confirm this, recording a sharp increasing number of assets managed by PE firms.
Nowadays in developed countries it's easy to hear about firms adopting new sustainability initiatives, contributing to fight against climate change, or empowering diversity and inclusion initiatives. These changes reveal the existence of an economy focused on stakeholder, substituting the so call "Friedman doctrine", where businesses must solely pursue the interests of their shareholder.
Understand how the economy works and the reciprocal interests between shareholder-stakeholder and firms may be difficult. Tariq Fancy in his famous essay "The Secret Diary of a Sustainable Investor"[2] proposed an interesting example comparing modern capitalism with a basketball match. In capitalism, private firms compete between them in fair and competitive marketplaces to maximize profit, all of which serves us (society) by fostering innovations and efficiency improvements that ultimately improve our lives and wellbeing. In basketball we can find an analogy, players compete on a specific court with specific rules to score points, all of which entertains us (fans) through a fair and highly competitive game that fosters the best showcasing of skills, inspirations, and strategies. The scoreboard for the competition is clear and quantifiable for both: profits in capitalism, points in basketball.
In capitalism, the private firms that act as "players" in the marketplace are formed as legal entities to allow groups of people to work together toward a shared purpose, exploiting each ability to pursue a higher profit. To keep our basketball analogy connected, let's assume that the players on the basketball court can be controlled remotely by groups of us fans sitting in the arena, like in a videogame. Each person, depending on his/her skills and interests can control a part of the body for different players, just as in the real economy most people work in different functional areas of private companies. Senior managers such as the CEO, for example, control the player's brain and, thus, all major decisions on how those body parts are used.
To set a match we need something more than players and fans, a league with it is own rules, Similarly, nothing exists in a capitalist society without a government to create the preconditions

[2] Fancy, Tariq; The secret diary of a "sustainable investor"; August 2021

for private firms to compete and innovate their businesses, devising rules and regulations around private competition in a way that serves the long-term public interest, defining laws on everything from contracts to intellectual property to data privacy, and enforcing these laws on a daily basis. In other words, a competitive market, like a competitive sport, is based on rules. Without rules we cannot have a game.

By introducing sustainability in the economy, we are referring to the concept of externality. An externality is a side effect of a specific business that can negatively or positively affect all of the society. Pollution and his direct effect of climate change is a traditional example of a negative externality. Referring to the basketball example a negative externality is something that can harm the fans without producing effect on the scoreboard. An example might be when one of the players jumps into the crowd to retrieve a loose ball and ends up seriously injuring a few fans in the first rows. The players in this example, by trying to pursue the goal of retrieve the ball to score more points, he takes a careless risk and end up harming the fans.

By contrast, a positive externality in basketball might be LeBron James off-the-court personality: aside from any points he scores, he has the positive side effect of being a likable role model for youth that engages in social and charitable work. In our economy, an example of a positive externality might be the private development of free software that creates side benefits for others, such as Google Maps.

As Fancy said in his essay in capitalism the firms who compete are all technically owned by us, the public. This includes people who don't think they own anything: whether the lending that a commercial bank does with the deposits in someone's savings account or the investment portfolio of a pension plan managed on someone else's behalf, almost everyone has an indirect stake in various private endeavors. This is a bit like saying that the players on the basketball court don't just employ most of the fans in the arena (that control them); indeed, they were also built and are owned by the fans. Some fans own lots of shares in lots of players, whereas others own next to nothing, but ultimately the fans in the arena own all of the players.

But if it's true that players are owned by fans, as soon as firms are owned by society, why society allows firms to conducting their business without considering side and undesirable effect that can harm the society itself? Why do firms not manage their business in the solely interest of society?

Even if we all own an interest in firms, majority stocks are not held by mom-and-pop investors. We have "sports agents" that act as owners of players an all of our behalf, and has the power of hiring, fighting and directing the CEOs. PE firm as BlackRock are part of these "sport agents" from which is defined the path to a sustainable and fair capitalism.

Sports agent as a PE firm is subject to an agency issue since must act in the interests of fans (the society), they cannot do whatever they want with the capital they collect. They are constraint to a legal bind, what's called a fiduciary duty to act in the best interests of who commit capital.

This work is aimed to explore the connection between PE firms and their investment decisions, how and why PE integrate ESG issues in their business, and which factors or external element are modifying this relationship.

The entire work is structured in three main chapters. The first section provides a theoretical framework regarding Private Equity and a brief explanation of the history of this asset class and his evolution over time, until the arose of the ESG phenomenon.

An introduction to the Private Equity environment is helpful to understand the structure of this asset class, and therefore figure out which ones are the actors involved, how the investments process works, and decisions are taken. Furthermore, a subsequent brief history of PE can underline the historic rationales behind this asset class and the forces that pushed its change over time.

The second chapter underline what really are the ESG and which organizations arose from this phenomenon, and how they rule it. It's also investigated the role of Socially Responsible Investment, and the new investment styles and strategies adopted to pursue a sustainability and financial interest.

The last part instead emphasizes the relation between PE firms and ESG, studying the different drivers that could lead to a full integration, and also the barriers (perceived and existing) that obstacle its realization.

Chapter 1

1. About Private Equity

Economics has always been considered one of the most important factors in a society, a particular social science focus on how an economy and its participant function and behave.
One of the key areas of focus is the study of transactions: the efficient exchange of goods or services aimed to increase the utility of the agents. Transactions involves not only physical product produced by an industry or specific services provided by an office, but also contracts on specific assets or ownership rights of a firm. Different type of exchange defines different places where exchange: a steak can be bought in a restaurant, a delivery of a package can be bought on the website of a shipping firm, but what about where to buy the shares of a company? In this case the existence of a financial market allows this kind of transactions.
A financial market is a forum that bring together people or organization willing to lend money (the lenders) with other that are asking for funds (the borrowers). These markets can be country specific, regional, or global depending on the size and the player involved. There can be a lot of variety in these markets, from highly regulated and standardized public markets to more informal and unregulated private markets.
Public markets use standard contracts to trade stock or bond and are subject to strict disclosure rules established by the exchanges and government agencies. In contrast, private markets are more flexible due to the direct negotiation of the contracts between the parties involved. While the standardization of contracts in public market appeals a wider range of investors respect to private markets and so make the latter less liquid, the disclosure requirements, firm size and credit worthiness of borrower can induce firms to prefer private form of lending.
In this market individual investors, hedge fund and private equity represent the main players.
In this thesis I focus my attention on Private Equity. To show the increasing relevance of this asset class in the last decades its useful provide some data. Worldwide the value of private equity-backed buyout deals more than doubled in the last 10 years, from a 250 billion of USD in 2010 to 592 billion in 2020, with a peak in 2018 of 621 billion.
About 1 in 10 cross-border deals are undertaken by private equity firms. These firms are in direct competition with multinational companies that can exploit some advantages like stronger synergies opportunities, easier access to capital markets and higher creditworthiness. Even

considering these disadvantages PE firms have a superior track record in improve financial performance in target firms respect to multinationals. (Baziki et al, 2017)
Even if USA remain the hottest country for PE deals, regions as Europe and Asia-Pacific nowadays represents important markets with a value of deals of 185,37 and 166,78 billion, respectively. PE deals are growing worldwide not only in value but also in number of transactions: in 2019 2515 deals were concluded in Europe, much more respect to the 1397 transactions of 2013[3]. This trend represents a great opportunity for investors, in a survey of Bain & Company[4] were asked to institutional investors how much capital they want to invest in 2021 vs the previous 12 months, 45% of them said they would invest more, 39% keep the same investment. This sentiment in the market, right after the Covid-19 crisis even more empathize the increasing relevance of Private Equity and the confidence that investors place in it.

1.1. Introduction to Private Equity

To start is useful give a sense to the word "Private Equity", a rather broad definition has been given by Megginson (2004):
"a professionally managed pool of money raised for the sole purpose of making actively managed direct equity investments in private companies and with a well-defined exit strategy (sale or IPO)"
Private equity refers to an active ownership or interest in companies not-publicly traded (defined private companies) on a stock exchange, usually for a short-term horizon. Investments in private equity are generally conducted by angel investors and private equity firms, the difference between them is the focus of the investment and the structure of the organization.
While PE firms are structured investment management companies, an angel investor is a single high-net worth individual who provides capital for business start-up, in exchange of convertible debt or equity.
PE firms provides capital and expertise to target companies through a wide mix of investment strategies that differ from firm's size, industry and transaction expertise. The two most common are leveraged buy-out and venture capital (VC).
Buy-out investing is the most important category of private equity since involve the largest fraction of funds under management. Most of buy-out are conducted using stake of debt

[3] Data retrieved from Statista, using dossiers on Private Equity worldwide and in Europe
[4] Bain & Company, Global Private Equity Report 2021

borrowed from a bank, hence the term leveraged buy-out (LBOs), this portion of debt is secured against firm assets or cash flows, both actual and future. The capital composed by an equity and a debt stake is then usually invested in middle-market companies with stable cash flows and limited potential for internal growth, or in distressed firms. (Iannotta, 2010)

As the debt balance is lowered and the company's value increases, the equity grows as a proportion of the company capital structure.

LBOs usually involve large funds since can manage bigger deals and take on the most debt. LBOs transactions represent a wide category, size of deals can vary from ten of millions to ten of billions of dollars and can involve a wide variety of industries and sectors. Due to the nature of sector, consumer products and food manufacturing companies are easily targeted in this kind of transactions.

In contrast Venture Capital involve a minority stake of equity in innovative start-up, growing or emerging firms with high potential growth but minimal revenues.VC is popular among young companies since they usually find difficulties in access debt market to raise capital. Therefore, VC is used help "build" new business in their early stages instead of acquiring an existing one, an example is the case of digital technologies in Silicon Valley. Considering the nature of the target Venture Capital investments have a higher risk profile respect to buy-out.

VC investments are generally the smallest in PE, since is focused on the early stage of companies' lifetime, varying from few dozens of thousands of dollars up to 5 million.

Investments are usually addressed in high growth industries such as technology, life sciences or software.

Even though in US and Europe buyouts represent the largest portion of the deals value made by PE firms, VC investments in US play a more important role respect to Europe, where are still limited (Iannotta, 2010).

Beyond VC and LBO a fund can perform other kind of strategies such as growth capital, mezzanine financing and distressed buyout.

Growth Capital invest in firms in their early-stage lifecycle, but more developed than VC target, reducing the risk associated but also the upside potential. Investments are usually in a range of 5 million up to 50 million, involving small and mid-tier companies in most types of industries.

Mezzanine Financing in PE is performed by offering subordinated debt or preferred equity with a return expectation around 15-20% per year. As growth capital the average size of investments is 5-50 billion of dollars in small-mid tier firms. Since mezzanine financing is expensive companies usually search for other source of capital. However, this type of capital can help cover the gap between senior debt and equity when a PE consider a LBO, reducing the required equity investments.

Differently distressed buyout (or turnaround) involves financially distressed companies, purchased at discount and sold in future for higher value. This kind of strategy involve judgements regard the value, survivability, legal and restructuring issues. The size of the deals can be similar to LBO, with a focus in struggling sectors.

PE fund can be categorized respect to the geographical address of investment, that describe not only where the investments will be, but is also related to the size of the fund.
Considering the geographical domain of investments can exist:

- Local funds (or "Country funds"), whose investment activity is addressed to the companies within the national borders. Local funds' size can range between 50 million to 500 million of dollars.
- Regional funds, that focus their investment beyond national borders but inside the regional borders. Example of regional funds can be pan-european funds, that invest in companies within European area. This kind of funds are bigger than local funds, with a dimension between 500 million to 5 billion dollars.
- Global funds, the broader category that address their investment in any geographical market. These funds are usually the biggest, with a size between 2 to 10 billion of dollars.

It is clear the broad opportunities that PE can offer respect to the strategy, geographical focus and size. For this reason, the choice must be carefully evaluated according to the specific objectives of each investor (Campanella & Ricciotti, 2012)

1.1.1 The Structure of a PE Fund

At macro level in Private Equity market can be found two different types of actors. In this universe large investment banks such as JPMorgan Chase or Goldman Sachs compete with a number of private equity firms, also known as PE funds, to buy good private companies and help build and grow the nascent ones.
Along with PE firms we can define in market other sub-category referred to the same asset class. Business Development Companies (BDCs) differ from classical private equity firm by the public nature of company, offering the possibility to average investors to invest in PE. Firms as the Blackstone Group, Apollo Global Management, Carlyle Group and KKR belong to BDCs.

Linked to BDCs there are funds-of-funds. Funds of funds are mutual funds that due to SEC restrictions regarding illiquid securities holding, invest in PE by buying shares of publicly listed PE companies.

This work is focused on “classic” private equity funds.

In defining the dynamics of a PE fund it’s important to emphasize from the beginning how is structured and how the decisions are taken.

In a private equity firm everything start with the collection of money from accredited investors, the pool of money collected and ready-to-use for an investment represents the private equity fund, a closed-end fund with a finite lifetime, usually between 7-10 years.

In a fund there are 2 distinct classification of fund participation: general and limited partnership. The role of General Partners (GPs) in a PE fund is usually covered by Private Equity firms, small entities averaging 10 professionals each with high expertise in investments and deals.

These firms represent the partners of the fund and cover different roles: they have the right to manage the fund and make decisions regarding investment to undertake and then include in their portfolio. As GPs, PE firms are liable for any legal actions and debts the company may face.

GPs are also responsible for request the capital commitment (*capital call* or *drawdown*) from the investors, the Limited Partners, that sign a legal agreement to commit capital as and when GPs ask for funds. This period (investment or commitment period) usually last for the first 5 years of the fund, once the committed capital is raised the fund is closed.

The capital call is issued whenever the GPs find a company to acquire or other portfolio assets to buy, and in some case, this can take years. The money that has been called remain invested, and so LPs cannot access to this capital for a long time.

An effectively marketing, unique value proposition and reputation of the fund greatly impacts the amount of capital committed by investors. A successful PE firm raise a new fund every few years and number its successive funds. (Iannotta, 2010) .

Having strong relationship with business leaders, banks, financial advisors, accountants, supply chain management are important sources for the deal flow.

To uncover more hidden gems, PE firms will have to spend time building out their network. Once a firm has defined its sweet spot and has a strategy for sourcing suitable potential deals, it can use a strong network to help execute the strategy. The goal of an expanded network is to gain an edge even before a deal comes to market.

In a PE fund also GPs commit capital, even if in a smaller fraction (usually 1% of shares)

Differently limited partners (commonly indicated as LPs) hold the largest stake of shares but they have no influence in investment decisions and, at the end of commitment period, the exact investments included in the fund are unknown. This is important because LPs, which outnumber GPs in the fund, would commonly object to certain investments due to governance concerns, particularly in the early stages of identifying and funding companies. However, LPs can regularly assess the quality of investment made by GPs and, if dissatisfied, can decide to not provide further capital with the fund or portfolio manager. In US this category is usually composed by pension funds, whereas in Europe banks plays a central role. Beside to these main players also high net-worth individuals, universities endowments, insurance companies or hedge funds can play the role of Limited Partners.

In recent years LPs experimented new ways to participate in PE deals, differently from the constrain of being a passive partner in a fund, putting to work an increasingly higher sum of money and forming the so called "shadow capital". These investors are putting capital to work beyond the traditional LP–GP fund relationship through a wide variety of practices, including co-investments, separate managed accounts, co-sponsorships and some direct investments without the involvement of a GP. Shadow-capital enable LPs to directly tailor PE deals with their unique preferences. This is translated in paying lower fees, boosting returns and exerting more influence in the investments they make. Even if shadow-capital is growing larger still remain small in comparison with the conventional capital collected by GPs and LPs in private equity funds.

After the commitment period the PE firms starts to look for potential deals and investments. This is a crucial phase in the life cycle of a fund and strictly depends on the original objective for which that fund was created.

With most deals now shopped by intermediaries and sold through auction, sourcing attractive proprietary deals has become harder in the last decade. As in the latter stages of a gold rush, PE investors have to get smarter about where and how to dig.

In the early decades of the industry, few PE firms contested head-to-head for deals. Pitch books were democratically distributed onto every firm's desk, with relatively little chance of overlapping interest from several firms. The industry has matured and attracted more investors worldwide, and most assets now draw multiple bidders at auction after being shopped around by investment bankers who make sure that all the right bidders are in the room. PE firms can no longer plan on finding many proprietary deals.

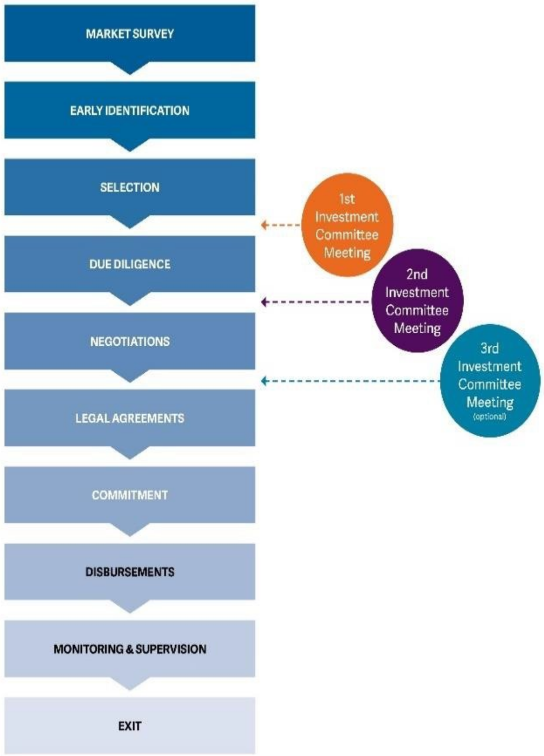


Figure 1: Investee selection using a Investment Commitment. Source: the GIIN 2018

As in other business, in PE a source of success is looking for deals in the "sweet spot", sticking to what they are good, using a combination of unique qualities deeply ingrained over time in the firm's DNA, like ambition, talent and area of expertise.

In total a fund plans to spend 12 or more months looking for possible deals. Networks, relationship, partnership with local intermediaries and effective processes for evaluating potential investments are essential for a functional investment pipeline. This phase aimed to identify good deals can lead to a large basin for target firm, with even more than 1000 firms.

Next step is the screening process, a refinement of initial search process where secondary selection criteria are used: market opportunity for the business, risk-return expectations, company organization, management skills and effectiveness of business are relevant criteria used to screen the first pool of potential targets. How a fund sources deals can differentiate funds in the market for potential investors, for this reason PE firms underline in each fund document the criteria used to demonstrate a disciplined approach.

Fund managers must also evaluate the impact potential of their investee companies and the fit between target firms and fund mission and impact objectives.

Approximately three-quarters of respondents to the Global Impact Investing Network's (GIIN) 2017 study, The State of Impact Measurement and Management Practice, use impact data to pre-screen investments or inform due diligence (76%) and to inform investment selection or portfolio allocations (74%). Forty-five percent use these data to inform portfolio modeling and strategy. (Mudaliar, et al., 2017).

The entire screening process is aimed to reduce the universe of possible investment, narrowing down the possible targets to 10-20 firms.

The next step is the so-called due diligence. Due Diligence is an exhaustive review of records, organization, and information about the company in order to find a "deal breaker", such as undisclosed liability or risks, and therefore convince the PE firm to run out from the investment

The practical route to accurately assessing and realizing the margin expansion opportunity starts with operational due diligence, combined with commercial, and in recent years ESG, due diligence. Together they provide a robust, realistic view of the target's full potential. It's also a way to evaluate the effectiveness of business plan, management's stated operational and financial figures, and the amount to invest. In this whole process the involvement of Investment Committee (IC) plays an important role.

If fund management is a matter of finding, making, and managing investments in private companies, it is the "making" part that holds the key to the success of the portfolio. That's where the investment committee adds its value. (Klonovsky & Callinan, 2012)

The IC helps the fund evaluating among possible investments, ultimately authorizing the final process for due diligence and budgeting.

After the target and the stake to invest are decided follows a legal agreement between the fund and the firm.

Once the deal is completed the firm enter is the fund's portfolio and the phase of Monitoring & Supervision start. Most of PE fund actively support the management of the firms in their portfolio, by introducing young company's executive staff through best practices in strategic planning or financial management. Furthermore, they can help implement new accounting, procurement, IT systems or ESG policies to add value to the investment.

By doing so PE can increase operational efficiencies and earnings, turning underperforming businesses in stronger ones. This is not the only driver for value creation in private equity, by aligning the management views with the interests of the fund and investors PE can add further value.

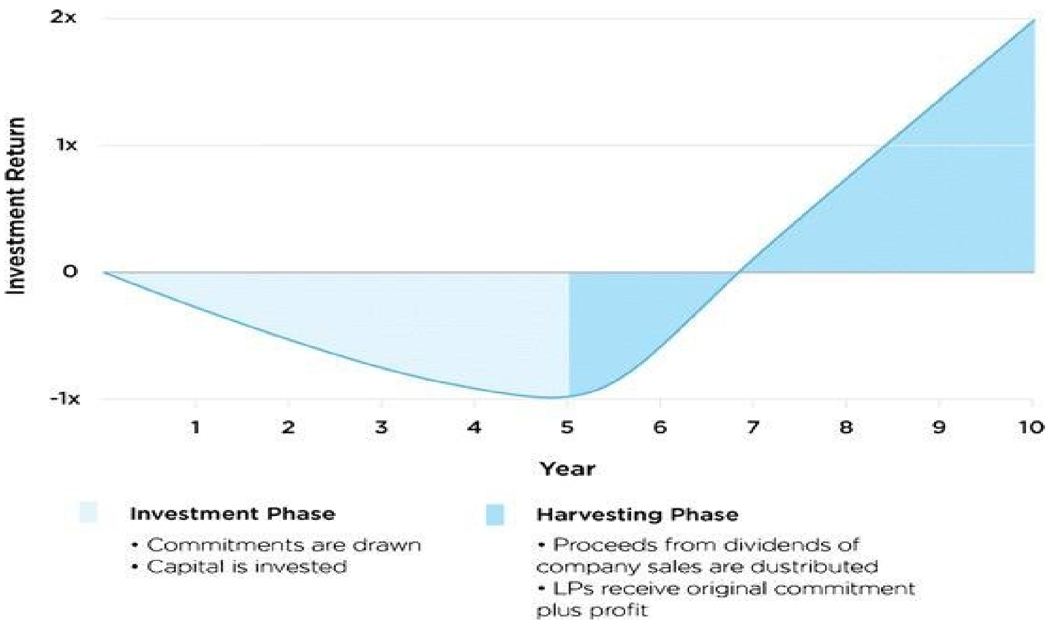


Figure 2: Ten Year Private Equity fund cycle; Source: Stringham, E.; Vogel, J.; (2018); The leveraged invisible hand: how private equityenhances the market for corporate controland capitalism itself

These characteristics of private equity offer a number of advantages to medium-small companies and startup.
According to the results of European Central Bank (2013) and Serrasqueiro, et al., (2021), compared with large firms small and medium enterprise (SME) are more exposed to problem of information asymmetry, implying difficulties in accessing to external finance, mainly in period of financial crisis and recessive economic cycles.
These limitations forces small companies use internal funds as far as possible, and only when these are insufficient do they typically recurr to debt.
PE allows SME to access an alternative liquidity sources to conventional mechanism such as bank loans or listing on public markets.
A confirm of that, that sounds as a prediction of the post-crisis market, arrives from the French National Economics Analysit Center: “Thousands of SME, which make up a large share of our country’s productive structure, do not have today, and will even less tomorrow, any other financing source than Private Equity” (Glachant, et al., 2008)
More than one studies, including Gilchrist & Himmelberg (1995), argue that unrelatedly to the high level of investment of young and small firms, these investements strongly rely on the availability of cash flow. A further study by Fagiolo & Luzzi (2006) conclude that liquidity restrictions create a negative effect on firm growth, with a stronger growth after the overcome of these constraints.
As said before the LBOs structure of PE deals, where target firm’s assets and cash flows secured the debt stake in order to facilitate the transaction, can lead to incentives for managers in avoiding unprofitable expenditures or exploiting profitable opportunities (Jensen, 1986; Wright, et al., 2000), and for adopting entrepreneurial practices and innovation strategies to exploit their R&D investments. (Bruining, et al., 2013)
But PE has also negative aspects. Unlikely public market where there is ready-made book order that matches almost instantaneously buyers and seller, in a private market a firm need to undertake a search for a buyer for the sale of its company, or investement. This search process is obviously more costly and time spending respect to a public market. Furthermore, the price of shares for a PE fund, the stake of LPs, in majority of cases is not determined by market force but by a direct negotiations, allowing the availability of this asset class only to few investors classses.
Third, the rights of private equity shareholders are generally decided on a ad-hoc basis through a direct negotiations instead of a broad governance framework that typically dictates rights for their counterparts in public markets.

Another critics to PE argue that the short-term investment horizion force firms to undertake investment aimed to a short-term profit and a high leverage, instead of creating a longer term view to built a sustainbale business capable of repaying future debt. (Rappaport, 1990)

1.2. History and Development

1.2.1 From the early years until the Modern Era

The acquisition of businesses and minority interests in private companies can be dated since the down of industrial revolution. One of the first examples is represented by the private merchant banking house Drexel, Morgan & Co, nowadays knows as JPMorgan Chase. Founded by John Piermont Morgan in 1871, became famous at the end of 19^{th} century for the huge investments in railroads.
Between the end of 19^{th} century and the beginning of 20^{th} these kinds of investment where an elitary and uncommon practice, run only by some banks, wealthy individuals, or families like the Rockfeller, Whitneys and Warburgs, to cite the more notable.
In the following decades thanks to technological development due to the WWI and WWII the private equity, especially VC, could rise in United States, and the firsts real private equity investments began to emerge.
With only few players in the market in the first half of 20^{th} century PE represented only a side role without appeal among investors and public institutions. The first turning point is dated back in 1958 with the passage of Small Business Investment Act, that provided federal funds to venture capital firms to help finance and manage small business in US. This act had a huge effect in the growth of professional PE investors in the US market, making this asset class a real alternative form of investment.
Despite of this new trend in market private investment were mainly related to small and innovative business, while larger and mature companies preferred to obtain funds from the public market.
Stock market capitalism and public companies were celebrated as a great 20^{th} century invention (Mickletrwaite & Wooldridge, 2003), but after the ‘80s this opinion changed completely, and journalists and academics start to see public companies as problematic.
Among them Michael Jensen proposed a new point of view that pictured public corporations as social invention that suffered an agency problem since agent/managers do not reliably act for

shareholders/principal interests, creating a divergent orientations and conflictual actions. (Jensen, 1989)

For this reason, the LBO boom in late ’80s was welcomed by Jensen, that claim:” Who can argue with a new model of enterprise that aligns the interests of owners and managers, improve efficiency and productivity, and unlocks hundreds of billions of dollars in shareholder value?” (Jensen, 1989)

The LBOs boom in ‘80s definitely ensure the private equity as the emergent asset class of the decades. For the first time, the public became aware of the ability of private equity to affect mainstream companies, by aligning the interests of smaller number of new owners with those of managers. The boom reach is peak in 1989 with the leveraged buyout of RJR Nabisco, as one of the largest LBO ever. However, besides the enthusiasm wave regarding PE, many were not convinced by Jensen’s arguments and LBO were questioned. Institutional investors failed to renew commitments in follow-on funds, together with rising interest rates the boom halted until the mid of ’90.

A renewed enthusiasm come back in the late ‘90s, supported by journalists[5] and favorable tax and regulatory treatment that help to re-acquire the appeal lost after the ’80s boom (Froud & Williams, 2007).

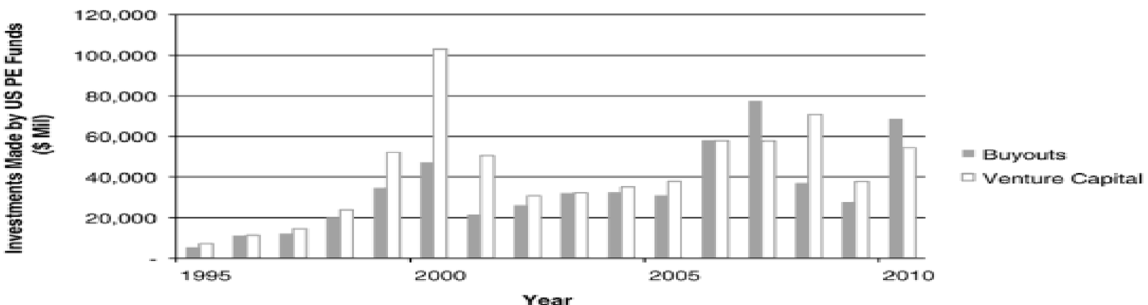


Figure 3: VC-buyout investments made by US PE Funds 1995-2010, source: Cendrowsky et al. (2012) Private Equity: History, Governance and Operations

Private Equity in 2000s, at the turn of the century, represented one of the major growing periods for both buyouts and venture capital. A series of boom-and-bust business cycle characterized these years, starting from the dot-com bubble of the early 2000s to the “Golden Age” period in 2007.

[5] Martin Dickinson, “Why Private Equity is a pure form of capitalism. Disadvantages of public company market”, Financial Times, 12 November 2005

Regulatory changes, decreasing interest rates and loosening lending standards helped the PE industry to enter in the third boom, experienced even in Europe and Asia-Pacific, the "Golden Age" of private equity, characterized by some of the largest deals ever.
In these years the convergence of private equity and the public equity markets attracted significantly greater attention when several of the largest private equity firms pursued various options through the public markets, an unusual move since PE funds often practice the opposite, buying publicly listed companies and taking them private. This "evolution" of private equity can be pursued by publicly listing a private equity firm or a PE fund, such as The Blackstone Group and Kohlberg Kravis Roberts (KKR) respectively, exposing these companies to public scrutiny, regulation, and disclosure.

For nearly three decades since the rise of the PE industry, PE firms made money by focusing on the microeconomics of businesses and letting the macro conditions take care of themselves. While investors focused on industry dynamics and company performance, macro factors such as currency movements, monetary policy, banking system trends, global trade trends, technological changes and demographics faded into the background, the global financial crisis of 2007 marked an emphatic end to that era. Macro now matters.
Starting from 2013 PE experienced a turn, passing from the uncertainty and worry of previous years to enthusiasm. Better macroeconomic condition such as low interest rates and strong equity markets pushed up the return of private equity, especially buyouts.
Fundraising and capital commitments increased, turning to their best year since the crisis and revealing a renewed LPs's faith in PE as asset class, in 2015 PE funds exceed their raising target for the first time since the Golden Age. Positive macroeconomics conditions and a confident capital market continued until 2019, where a worsening of geopolitical and economic environment slowed the market momentum. This turn did not affect much private equity, that continued to pursue a high fundraising, with a peak of $894 billion of private capital collected in 2019, one of the biggest ever, and continuing demonstrating the ability to overperform public equities markets, even after a heavy stock market volatility, in both short and long-time horizon.

The number of PE firm steady increased year-by-year, and with them also the average number of active funds per firm, from 2.6 in 2011 to 3.9 in 2018. Furthermore, GP's selection criteria became more selective, limiting the search only to safe investment and thus increasing the competition.
As PE firms wrestle with new competitive threats, they need to reckon with institutional investors' shifting priorities as well. The LP community has always been a diverse group,

representing many investment styles, behaviors, and objectives. This heterogeneity, emphasized after crisis, grown year-by-year until our days.

The ability of GPs to clearly communicate how their investment approach differentiates them from their peers has become a relevant factor for winning investor confidence and acquire financial backing. Indeed, a sound differentiated strategy is increasingly viewed as the platform on which successful and durable future performance can be built. It will be the centerpiece of the once-in-a-generation transition that many PE firms are now facing as they set their sights on rising to the industry's top tier.

Many leading PE firms are getting ahead in this challenging environment by taking a thematic approach to investing that enables them to get an early read on emerging macro forces, such as the demographic transition, organize around them and incorporate a deep understanding of their potential impacts on the deals they choose to make (or walk away from). To do so they exploit their deep analytical skills to quantify how an overarching investment theme will influence consumption patterns, capital flows, supply chains and affect frontline results at the individual business level. (Bain & Company, 2016)

But the real turning point of the century is represented by the rise of ESG phenomenon, environmental, social and governance issue now are of relevant importance in investment decisions.

4.1.1 The ESG Trend

In September 2019, institutional investors with $2.4 trillion in assets drew a line in the sand: They made clear that they were serious about wielding their financial clout to combat climate change, pledging to transition their investment portfolios to become carbon neutral by 2050.

This trend is not new in the industry, the first socially responsible investments (SRI) fund is dated back to 1971, the Pax World Fund, for US investors contrary to the Vietnam war and military practices (Crifo & Forget, 2012), while the sustainable investing wave in '90s, pushed by environmental protection and human rights, produced little in terms of return and environmental impact.

Despite these previous cases, the first official intersection of ESG and PE can be dated to 2009, when the US Private Equity Council starts to provide guidelines to cover environmental, health, safety, labor, governance, and social issues. (Schell, 2020), helping shifting SRI from a marginal niche market as occupied in the early 2000's, to a mainstream practice.

This trend is clearly represented by the steadily increase of PE companies committed to the ESG principle, and with them the amount of asset under management.

In the few short years since ESG appeared on the scene, the industry has tended to view it as a sideshow, something good to do in addition to a fund's normal business of buying and shepherding companies. As ESG matures, however, the firms leading the charge, mostly in Europe, talk less about discrete, segregated ESG initiatives and more about delighting customers, gaining market share, engaging.

One of the most important turnarounds about ESG investing is represented by the 2018 annual letter wrote by Larry Fink, the president and co-founder of the biggest investment firm in the world BlackRock. In this letter, titled "A Sense of Purpose", Fink introduced the idea that successful companies needed to serve a social purpose, and "they need to contribute to society as well if they want to receive the support of BlackRock"[6]. Despite it wasn't the first time someone had said it, it was the first time such someone as Fink, leader of a 9.6 trillion of U.S dollars of AUM[7] company took this position. With that letter Larry Fink showed himself as a symbol of a new worldview that purpose and profits can coexists and that companies need to serve society rather than just their shareholder in order to prosper. Together with it such a declaration officially opened a debate about the future of capitalism and the role of sustainability in business and investment model.

The popularity of an ESG-focus on the investments approach give birth the idea that ESG is only a persistent investments fad, a mainstream practice, that one day will fade away, as happened before, but as reported by Bain & Company in the Global Private Equity Report of 2021 this time the social environment is different.

In these years an historic groundswell of global concern around climate change, social upheaval and corporate responsibility is taking place, modifying consumers preference, employee's needs, bankers request, regulator's approach and obviously, LPs decisions.
If in 1995 the US SIF Foundation Trends Report on SRI tracked $639 billion in total of AUM, 25 years later the size increased enormously, recording a size of $17 trillion, but the transition it is not only a matter of size.

The industry passed from applying a negative screen to remove "un-responsible" companies in portfolio to evaluate investment using a robust set of ESG factors, where investors build their business by promoting their ESG credentials. (Lowe, 2021)

[6] Sorkin, A. R., 2018. BlackRock's Message: Contribute to Society, or Risk Losing Our Support. New York Times, 15 January.
[7] Norrestad, F.; "Total assets under management (AUM) of BlackRock from 2008 to 1st quarter 2022", retrieved from Statista May 12, 2022.

Starting from 1990s several scholars argued the arose of a new, highly principled, group of “aware” and “ethical” consumers. (String, 1996)
Some academics labelled this period as the “caring-sharing” ‘90s, in opposition to the materialistic mindset of the “Friedman doctrine” that characterized the 1980s, where a firm's sole responsibility is to its shareholders as described in the well-known shareholder theory. (Friedman, 1970).
The firm, indeed, is then not considered responsible only versus the shareholders, but instead is responsible to all the stakeholder that may benefit or be harmed by its operation, both directly as customers or suppliers, or indirectly as the community in a generic sense. (Freeman, 1984)

We are shifting from a shareholder-based view to a stakeholder approach. Using the basketball example used in the introduction it’s like converting a team that spent decades creating and training basketball players focused on score points, since was the only thing that mattered.
By passing to a shareholder-based economy, and by saying that companies with better sustainability performances can enjoy larger profits in the long term, it’s kind like saying that good sportsmanship in basketball can lead to scoring more points. A revolution.

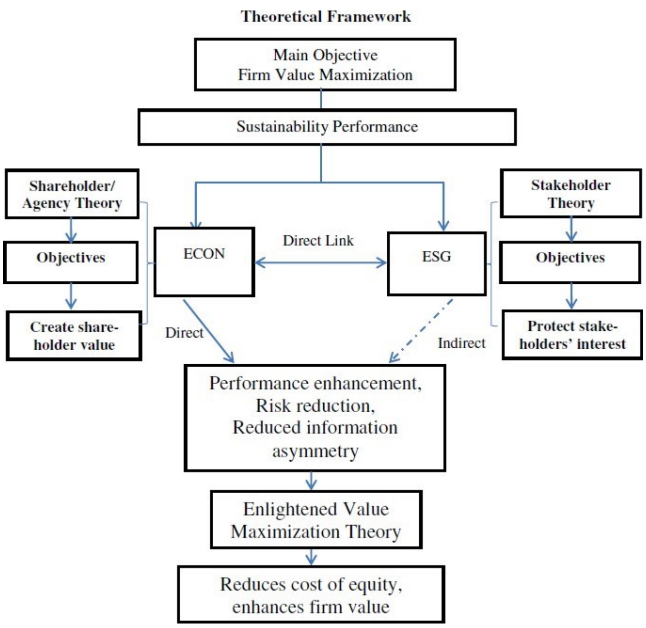


Figure 4: Differences in value creation process between stakeholder and shareholder theory. Source: Ng, A. C. & Rezaee, Z. (2015); Business sustainability performance and cost of equity capital.

The concept of ethical consumerism is generally accepted as the evolution of green consumerism, defined as a trading that involves beliefs and values aimed at supporting a greater good that motivate consumers' purchases (Hendarwan, 2002), and so buying products which are not harmful to the environment and society.

This new groups of consumers changed their shopping behavior, they do not only consider their wallet but also their morals in their consuming decisions, by for example, boycotting products that involve the use of animals in product testing, or examining a company record in promoting minorities and women. (Cowe & Williams, 2000; Roberts, 1996)

In this decision-making model the motivation that defines the purchase of a product rather than another is closely linked to values, the criteria that individuals use to justify their behaviors. (Eccles & Wigfield, 2002), the role that values plays in consumption behavior is important, especially in an ethical context, where choices are taken considering value-related goals.

An important feature of the ethical consumptions is represented by the "ethical trade-off" that appear in many situations. For instance, when purchasing homemade organic food, usually expensive compared to an industrial alternative, a consumer may trade off the higher cost for the product against the social and environmental benefit of an ethical purchase. This example is referred to a simple economy, an individual that purchase food, but can be reflected also in a more complex situation, where, for example, an investor allocate money in companies that support a sustainable behavior, trading off the opportunity to invest in firm with higher returns, but operating in "bad" business.

In the last example another issue arises: the self-interests in appear ethical.

When managers report ESG initiatives this can be construed as self interest in form of psychological egoism (Baier, 1990), departing from the responsible attitude that distinguished the ethical behavior.

Indeed, in an ethical context all actions can be shown a self-interest goal, a sort of "being green" to feel good (or not feel guilty), or in an extreme situation, to be seen green. (Freestone & McGoldrick, 2008; Malhotra, et al., 2017)

Along with increasing media coverage of corporate social responsibility issues, companies themselves are taking visible steps to communicate their CSR initiatives to various stakeholder, including customers (Xuemimg & Bhattacharya, 2006)

Academics Young, et al. (2010) proposed an explanation of the decision model descripted above.

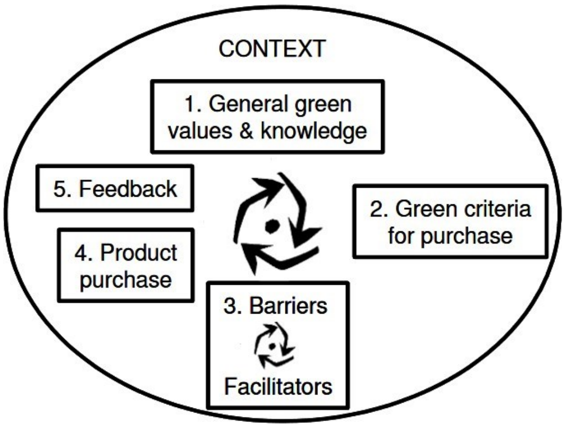


Figure 5: Green consumer purchasing model. Source: Young, et al., (2010)

The most important part is represented in the third block, the barriers and facilitators of the purchase process.

Young and colleagues represented 5 barriers in the ethical purchasing process: the lack of time for research, price, lack of availability of ESG information, the cognitive effort in researching for products, and the prioritization of non-green criteria. While all of them could applied to a micro-purchase process, for an investment firm most of them could be easily overcome, but poor-quality data for ESG information still represent an important issue.

Together with the barriers, 3 factors facilitate the application of green criteria in the product purchasing decisions: trust in certain information sources and data quality, the availability of green options and the "guilty" of not prioritizing green criteria.

At Private Equity level, and so not considered in Young's model, another facilitator is represented by regulation. Policy makers helped increase the awareness of the need for SRI investment and supporting the growth of the trend. Just in the first half of 2021 several policy changes were undertaken: the Biden administration transformed limitations enacted by previous government related to the consideration of ESG factors, increasing them. In addition, the SEC issued a request for information about climate risk and other relevant ESG factors.

What's made the PE industry successful in the past is its ability to anticipate future currents of value creation and to think more broadly about how they will reveal themselves, understanding their key effect on governance risk and costs.

The ESG preposition must be "real", getting it wrong could lead to a massive value destruction. Overdoing can cost time and focus, underdoing is even worse since company that perform poorly in environmental, social and governance criteria are more likely to face materially adverse events. (Henisz & McGlinch, 2019) A weak proposition can cost a company double digit decrease in capitalization in the days their missteps came to light, and most of the time the tail event can came of nowhere, even from a tweet or a post on Instagram.

Being thoughtful and transparent about ESG can enhance long term value, and sometimes generate short term pain.

A perfect example is the American retailer Dick's Sporting Goods. In 2019 Edward Stack, CEO of the company, announce to want to restrict the gun sales by stripping firearms and other hunting products from 125 of its stores in US, this announcement costs a fell in Dick's shares of 11% from the previous close. Some of Dick's 45,000 employees felt the same about Mr. Stack's decision to restrict gun sales, with 62 resigning over the same year (Hsu, 2019). Yet company's stock climbed of more than 300% in three years following the shift.[8]

Sustainability and the awareness on contributing to build a better world are only a motivator, the real rationale is business, moving apart from a mere philanthropic approach to an ESG investing where return is still primary importance.

[8] Data retrieved from https://finance.yahoo.com/quote/DKS/ on February 5th 2022. Th initial price per share is referred to March 11th 2019.

Chapter 2

2. The ESG Phenomenon

Sustainable investing is now representing the frontline of the Private Equity industry, passing from a side role in the early years of 2000 to a mainstream practice in the last 5 years. In a review of the top ten global PE firms (defined by AUM)[9], including The Blackstone Group, KKR & Co, The Carlyle Group, Apollo Global Management, all of them included a mention of ESG in their report or are going to incorporate an ESG approach in their corporate strategy.
This characterizing halo in the private equity industry is only the effect of a social phenomenon, the demographic transition and the increasing awareness of new cohorts in environmental, social and governance issues is pushing investors to incorporate specific tools and metrics in investment decisions, leading to a change in companies' production and behavior.
Other than investors, further external forces are indeed forcing corporations to change their behavior in favor of a higher ESG consideration in their activities. The spreading of ethical consumers is forcing firms to provide products that are environment friendly, employees are looking for jobs started considering other aspect rather than salary, aiming a better work-life balance.
Growing institutional focus and pressure lead governments to play a significant role in regulating business behavior, with stringent rules and reporting guidelines. The 2018 Budget Law amended Decree no. 254 to incorporate the specific requirement to describe "the approach to managing" the main risks generated and faced. In June 2019, the European Commission published a supplement on reporting climate-related information to its Guidelines on non-financial reporting. Furthermore, the Task Force on Climate-related Financial Disclosures (TCFD) created by the Financial Stability Board (FSB) has prepared recommendations for approaching climate-related financial disclosure.
History shown as private equity investors are extremely well-positioned to demand swift and responsible corporate actions to address critical problems, like social and environmental challenges, (Alfonso-Ercan, 2020)

[9] World's Top 10 Private Equity Firms by Kolakowsky, M. (2019) – article retrieved from Investopedia

By invest money in business that successfully address these challenges, they help raise awareness about different global issues, such as climate change, irresponsible resource management, governance malpractice, and unfair or unsafe working conditions.
What differentiate these investors from traditional ones is the use of ESG tools as key instrument in decision making.
These tools can be either technical instruments such as software or standard to apply, or principles to consider during the decision-making process to develop o more sustainable global financial systems, the latter of which are widely used in the investors environment and these guidelines, such as UN PRI, are increasingly more important today.

The climate, the people, the health, and many other factors will surely thanks for this good new practice in investment making, but besides this philanthropic slope based on the impact of "doing good" investors also look for value creation and returns as well.
And here Private Equity open a larger, and controversial, debate: "Do an ESG-based investing approach achieve higher returns compared to classical investment? Do firms experience higher performance when subset to a ESG oriented management?"
Academics, journalists, and asset managers published lot of articles regarding these questions. Most of them found a small, but positive, relation between ESG and firm's performance, and the same between ESG and investors return. But even if studies and literature report to have faith in this approach a full integration of these information in investment decisions remain difficult.
Lack in technology widespread and managers experience, heterogeneity in the approach used, unclear regulation and difficulty in collect data represent barriers for many PE firms and investors, firing up critics in the ESG adoption, even from important character like Tariq Fancy, a former BlackRock executive, the biggest investment management corporation worldwide.
In the next paragraphs I will explore each area introduce before, underlying the relevance of the ESG phenomenon in PE industry and how it's managed.

2.1. What is ESG

Investing can be more than a mere opportunity to achieve returns and gain money, can be also a source of social change. With investors, consumers and regulators that are addressing the

attention in global issues such as climate change, unfavorable work conditions or gender gap, is arising a new focus around the concept of sustainability.
Regarding sustainability RobecoSAM, the world's first company focused solely on sustainable themes, defined sustainability as "a company's capacity to prosper in a hypercompetitive and changing global business environment. Companies that anticipate and manage current and future economic, environmental and social opportunities and risks by focusing on quality, innovation and productivity will emerge as leaders that are more likely to create a competitive advantage and long-term stakeholder value." (RobecoSAM, 2013)
Sustainability finds its application in the real world through the so called "ESG" aspects.
ESG is an acronym standing of Environmental, Social and Governance, but despite those words the definition is broad and uncertain. ESG has an ambiguous and inconsistent meaning, if you ask to different managers to provide a definition of ESG they will likely answer with all different responses. (Esty & Cort, 2017)

ESG criteria are generally understood to be a set of tools or practices that illustrates or govern the non-financial performance of an investment (Alfonso-Ercan, 2020), where the non-financial performance is represented by the three area of interests in ESG. In other terms can represents the "firm's collective conscientiousness" for social and environmental factors.
It is typically a score that is compiled from data collected surrounding specific metrics related to intangible assets within the enterprise. It could be considered a form of corporate social credit score. Research shows that such intangible assets comprise an increasing percentage of future enterprise value. (Eccles, et al., 2012)
When socially conscious investors consider ESG criteria, alongside to financial factors, to screen potential investments we have an ESG investing strategy. ESG investing is a term that is often used interchangeably with sustainable investing, socially responsible investing or mission-related investing.

Let's briefly consider individually each element of this acronym:
The E, Environmental criteria, includes the energy a company takes in and the waste it discharges, the resource it needs and the consequences on the living being. E includes environmental issues such as climate change, carbon emission, air and water pollution and the use of hazardous material during the production. The issues often represent externalities, such as influences on the functioning and revenues of the company that are not exclusively affected by market mechanisms.

This area is subject to a relevant influence by social media and its importance growth in parallel with the exponential growth of their subscribers, that passed from 2.86 billion of users in 2017 to 3.78 billion in 2021[10]. This broader use of such platforms helps increase the awareness and perception of harmful issues, such as climate change. Even if climate change is a distant and abstract concern, when people perceive and interpret information's, this lead to a more concrete idea in people's mind, and so a more likely believing in the issue, perceiving more risk. (Myers, et al., 2012)

A study of Arlt, Hoppe & Wolling (2011) underline as a frequent use of online social media was positively associated with intentions to adopt more political behaviors related to global warming and environmental issues.

Social media have then a double effect, from one side they they increase the knowledge around the problem, in the other hand inrcease the value and the awareness, influencing then consumers behavior and political partecipation among others.

The S, Social criteria. Every company operates within a broader and diverse society, this criterion represents the way in which the company address his relationship with people and institutions in the communities where it does business. A good consideration inside the community allows the firm to obtain a sort of "social license", helping it to work at its best.

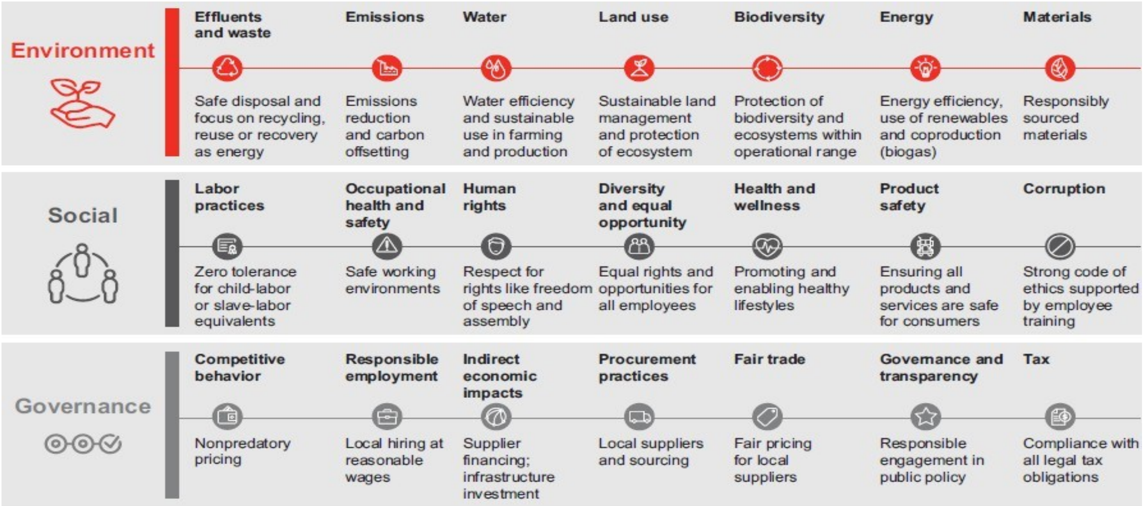
By encouraging diversity or gender equality, for example, firms can enlarge the pool of talent open to a working position, and then find a better fit.

Some of the major issues covered in this area are human rights, modern slavery, animal welfare, child labor or unsuitable working conditions.

The G, Governance. Every company, that represent itself a legal creation, require governance. Governance is defined as the internal systems of practices, procedures and controls a company adopt. These tools are addressed to govern itself, comply with the law, make effective decisions, meet, and balance the interests of external stakeholders, if well-defined governance can be a useful instrument for the long-term strategy of a company.

ESG Corporate Governance from the Board of Director's view, Governance Lens watching over Corporate Behavior of the CEO, C-Suite, and employees at large includes measuring the Business ethics and providing rules to avoid anti-competitive practices, corruption, tax transparency and providing accounting transparency for stakeholders.

[10] Data retrieved from Statista: Number of social network users worldwide from 2017 to 2025, https://www.statista.com/statistics/278414/number-of-worldwide-social-network-users/



Sources: Global Reporting Initiative, G4 Sustainability Reporting Guidelines, 2013; MSCI; Bain analysis

Figure 6: ESG pillars and covered issues. Source Bain & Company (2020) Global Private Equity Report

Even if the 3 pillars of ESG criteria can be separately defined in most situation they appear together. Social, environmental and governance criteria commonly overlap when a company deal with environmental regulation and broader concerns about sustainability. (Henisz, et al., 2019)

Moreover, there is a fourth factor that connect the E, S and G aspects and allow to understand why the ESG trend is more than a philanthropic interest: the economic aspects.

Long-term creation of value for shareholders, society and local communities through sustained wages and productivity growth, jobs creation, shareholder returns and earnings, R&D, capex, and the enhancement of human capital, all these factors explain why governments, companies and investors care about sustainability and his pursuing.

2.1.1 UN initiatives and the SDGs

Several organizations contributed to the phenomenon by introducing objectives and best practices to adopt to comply with a sustainable business.

The most important, the United Nations, in 2015 published the 2030 Agenda for Sustainable Development, to be adopted by all UN members. This agenda provides a shared blueprint aimed to peace and prosperity for people and the planet. The core aspects are described by the 17 Sustainable Development Goals (SDGs). The SDGs describes a set of objectives to reach with urgency, claiming for action by all countries, whether developed or not, in a global partnership. They recognize that ending poverty and other deprivations must go hand-in-hand with strategies that reduce inequality, improve health and education, and spur economic growth, and in the meanwhile, help tackling the climate change and working to preserve the environment and the biosphere.

Although federal and local governments can design policies to fight these problems, it is essentially the business and marketplace that are likely to play the greatest role in developing and realize the solutions (Indahl & Jacobsen, 2019)

The urgency of SDGs arose in 1992, in the Earth Summit in Rio de Janeiro. Since then, years of work by countries and the UN Department of Economic and Social Affairs (UNDESA) help in building an organized platform for the follow-up and review of SDGs.

Together with UNDESA the Division for Sustainable Development Goals (DSDGs) provides support and capacity-building for the SDGs and related issues, such as climate, urbanization, technology, transport, covering a broad landscape addressed to sustainability

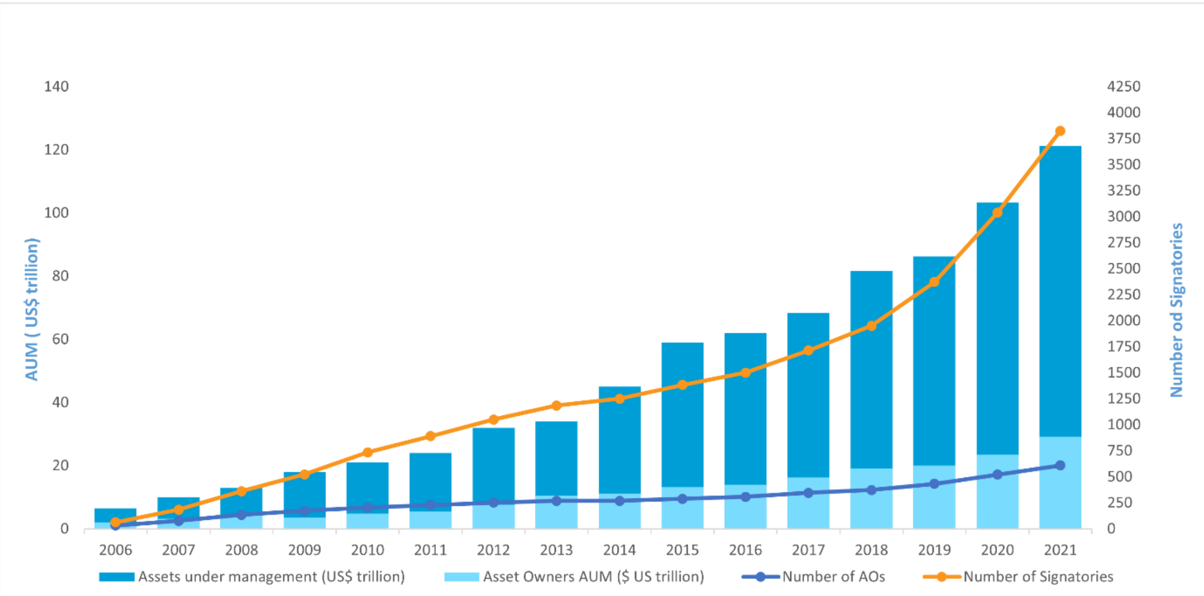
In order to make the 2030 Agenda a reality, DSDGs aims to help facilitate the strong commitment required by stakeholder to pursue the global goals.

Differently from SDGs, which use a broad approach addressed to different users and stakeholder, others framework born to increase the awareness for the ESG cause.

Among them, the UN PRI, is addressed to investors, both institutional and private.

As for SDGs the UNPRI was promoted by United Nations. In the early 2005 the UN Secretary-General Kofi Annan reunited a group with the world's largest institutional investors with the aim of develop a set of principles address to the ESG integration in investment decisions, the Principle of Responsible Investment.

The principles where launched in April 2006 at the NYSE. From less than 1000 signatories the UNPRI are now used by almost 4000 organizations.



Today the PRI represents the world's leading proponent of responsible investments. It works to understand the ESG implications in the investment process and help incorporating these factors in the investment and ownership decisions of its international network of investor signatories.
The long-term focus of UN PRI is represented by its signatories, the financial market and economies in which their members operate and obviously, the society and the environment.
The whole UN PRI organization is based on 6 principles, developed by investors for investors, aimed to build a more sustainable global financial system.

- **Principle 1:** We will incorporate ESG issues into investment analysis and decision-making processes.
- **Principle 2:** We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3:** We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- **Principle 4:** We will promote acceptance and implementation of the Principles within the investment industry.
- **Principle 5:** We will work together to enhance our effectiveness in implementing the Principles.
- **Principle 6:** We will each report on our activities and progress towards implementing the Principles.

Figure 7: UN PRI Principles, Source: UN PRI website https://www.unpri.org/pri/about-the-pri

For each principle the PRI suggest a set of action and behavior that organizations can adopt to incorporate ESG issues. These practices can vary from internal actions such as advocate ESG training for investment professionals to communication-based actions like disclose how ESG issues are integrated in investment practices, develop or support appropriate collaborative initiatives, communicate ESG expectations to investment service providers.
Parallel to the PRI United Nations also promoted the UN Global Compact. Launched in 2000 is both a policy platform and a practical framework for companies that are committed to sustainability and responsible business practices. UN Global Compact is based on ten principles in the areas of human rights, labor, environment, anti-corruption, and is aimed on align business operations and strategies to support the UN goals. With more than 7000 signatories worldwide is the largest voluntary corporate sustainability initiative.
While UN PRI and UN Global Compact are international guidelines also European PE industry activated and created his own guidelines, represented by EVCA Invest Europe. Invest Europe is the world's largest association of private capital providers. They represent Europe's private

equity, venture capital and infrastructure investment firms, as well as their investors, including some of Europe's largest pension funds and insurers. The association reward their member by allowing access to industry-leading events, globally trusted research and expert regulatory advice, shaping principles of ethical behavior and providing support for professional standards and responsible investments.

Associated companies are required to adhere to the Investment Europe Code of Conduct, that states the principles of ethical behavior that members of Invest Europe must abide by.

2.1.2 The B-Corp Certification

UN initiatives and SDGs helps address the management of ESG issues at business level, but despite these projects and the awareness created companies that emphasize social and environmental performance in addition to profit maximization have not received considerable public attention until recent years. (Harjoto, et al., 2019)

Because change cannot happen only with the involvement of governments and nonprofit organizations, B Lab introduced a certification for companies that respect various standards and create a committed community of for-profit organizations to drive change and to work towards a greater end. Launched in 2007, one year later the release of UNPRI, the B Corporation (B Corp) certification offers one of the most noteworthy societal attempts to increase the awareness and credibility of social entrepreneurship. (Gehman & Grimes, 2017)

Certified B Companies are a new kind of business that balances purpose and profit. They are legally required to consider the impact of their decisions on their workers, customers, suppliers, community, and the environment. The number of B Corporations, as well as other for-profit social enterprises and purpose driven businesses, has grown in the recent decade. Although some multinational public companies, such as Unilever and Group Danone, have joined the B Corporation movement in recent years, most of the B Corporations in existence are small and privately held.

One of the main characteristics of the BCC is that it is one of the rare certifications available to companies in all industries and in all regions (Gehman, et al., 2019). Also, the specificity of the B Corp Certification is that the entire company is evaluated and not only some products or some specific aspects of the corporation.

As mentioned above, the B Corp Certification's main purpose is to work on social and environmental issues, assisting the transaction from a shareholder-based economy to a stakeholder-based one. This means that it aims at lowering the ingrained idea that shareholders are dominant and that a company's sole obligation is to fulfill their needs by maximizing profit, at the expense of other stakeholders' needs. In B Corp this view is reversed and the stakeholder idea has to be respected and matter as the shareholders' ones. (Alsberge, 2020)

Depending on company size and industry, there may be as many as 130 to 180 factors a company must address in the certification process. A business must also have goals in five impact areas: accountability, employee, consumer, community, and environment. Finally, a company must score over 80 out of 200 total points to qualify for B Corp certification. (Wilburn & Wilburn, 2014)

Becoming a certified B Corp is a voluntary action. On spontaneous decision, companies decide to tackle the responsibility of their externalities, improve the positive ones and reduce the negative ones, and decide to begin the process of obtaining the certification.

Today there are roughly 4111 certified B corporations around the world, spread in more than 70 countries, considering the BCC born 15 years ago these numbers reveal there are hidden benefits in becoming part of the B economy.

Thanks to his great international reputation, the B Corp certification is a strong tool to obtain a competitive advantage. Companies certified as B Corporations comply to very high standards and commit to certain rules that allow them to align their internal business practices with their values, enhancing the reputation of the firm (Roth & Ingo, 2018). A last but very interesting aspect is that currently, the vast majority of B Corps are small or middle-sized companies and B Certification allow to differentiate from other companies, usually MNCs, that could potentially do "greenwashing" by investing heavily in marketing, proving the authenticity of the business. (Kim, et al., 2016).

The fear of greenwashing, defined by Cambridge Dictionary as a "behavior or activities that make people believe that a company is doing more to protect the environment than it really is", is a social problem that is spreading among lots of companies in the last years. Nowadays appear "green", as a matter of fact, is a way to help the funding, gain consensus and in general, a powerful marketing tool.

Even inside a certified environment as the B community the concern about greenwashing is real, but as a survey of Rosalie Alsberge (2020) reports there is little or no greenwashing in the B Corp community. Generally, all companies part of the survey agrees that the requirements for becoming a B Corp are strict and that the external and independent audit is rigorous and meticulous. B Corps, indeed, are generally well-perceived and truly want to improve their practices.

As a group, Certified B Corps tend to perform better on a range of measures than other sustainable businesses with commitments to corporate social responsibility. In its 2012 Annual Report, B Lab (2012) noted that Certified B Corps scored 25% higher across 200 metrics used to measure overall corporate impact on workers, the community, and the environment, an interesting result that can represent an opportunity for impact driven investors and lead to a positive impact for shareholders.
A second widely acknowledged benefit of being a B Corp is that brings you a great network. Although it appears that the importance of the community effect differs from country to country, the fact of being a B Corp member is always positive.

2.2. Business model and investment model in sustainability era

The key components of each asset management company are the business model and the investment model, together they both help define the aim of a company, the values and how the business in managed.
In the era of sustainability these dimensions changed, new type of investors and clients appeared, new regulations and new strategies were elaborated to best fit in this new environment.
Asset owners and asset managers must have a business model to function, and it comprises these elements (CFA Institute, 2021):

1. An economic model of how value is created from the application of various sources of capital
2. A clear identification of the clients served, and the stakeholder outcomes sought
3. A model to describe the external factors that may influence the clients demands and needs, including those arising from regulations
4. A clear organizational identity that comprises value, beliefs, brand, and culture

These components together define the core attributes of investments organization and the way in which they create value and competitive differentiation.
Changes in client demand are pushing investment organization in changing the business model and then develop new funds, with a different focus and with a better sense of stakeholder responsibility.

The business model for investment companies pursuing sustainable investing must make commitments on a full range of resources, process, and incentives that are necessary to drive innovation. Sustainability orientation should be exercised at first by senior leaders and be embedded into values, reflected in beliefs and extended into values.

While is already known that the interest in ESG investing is growing, another trend that help defined the transition in sustainability era is the average age of sustainable investors. Among retail investors aged 25-34, 19% now use strategies related with an ESG approach, whereas among those 65 and older only 3% use ESG strategies. This is consistent with the fact that younger investors are the ones who will bear more of the cost of an unsustainable world, and for this reason, they show more interest and indeed, actions.

Different business model is reflected in different investment model, that could be resume in the thinking and processes that results in the end portfolio. Investment model not only comprehend pillars as beliefs, risk management frameworks, and the portfolio construction process. It now empathizes also the investment objectives (financial and non-financials), the outsourcing of activities and the degree of suitability of investment managers.

All these arguments wanted to point out a simple concept: investors in 80s were different from actual investors. Different backgrounds and motivations define different type of investors and new strategies, with objectives and beliefs that can fit with social and environmental need and shift in client demands.

Core to the investment process is the need to identify relevant information that can affect the performance of the investment, address an investment process in accordance with LPs best interests (financial and non-financial) therefore, means understand which ESG issues is material and which not.

In the context of the sustainability or non-financial reporting one of the statements of the common principles of materiality by the Corporate Reporting Dialogue (CRD) indicates that:

"Material information is that, which is reasonably capable of making a difference to the proper evaluation of the issue at hand."[11]

Materiality is a dynamic concept that evolves over time. This evolution is driven by changes in regulation and policy, by changes in risk and the understanding of risk, by changes in the social, environmental and economic impacts of the issues in question, and by changes in societal (and beneficiary) expectations.

[11] This definition is significant since represents a common definition reached by eight principal standards setters and reporting regulation such as the GRI, the IIRC and the Sustainable Accounting Standards Board (SASB).

ESG issues can be therefore divided in 3 categories (acknowledging that there is significant overlap between them):

1) Financially material issues: issues that investors perceive to have a significant impact on the financial performance of the investment within the investment period. Considering their importance these issues are assumed to be assessed during the screening and due diligence process.
2) Non-financially material issues: even if they may be important to stakeholders, if managed well, do not present a significant threat to the business. Fiduciaries would expect GPs to demonstrate that they are managing these issues effectively and should intervene if they were concerned that a failure to manage these issues could lead to a negative financial impact.
3) Wider social, economic and environmental issues: These are issues that can significantly affect the investors' ability to deliver on its organizational or investment objectives but that may have limited financial impact within the relevant time period. Investors that have made a commitment to responsible investment should threat these issues as financial material issues, furthermore, they should play an active ownership role in the in which they are invested, and to engage with policymakers to encourage the development and implementation of appropriate policy responses to these issues.

The representation of ESG issues in this framework can vary from investors to investors. While data suggest us ESG issues can have a significant impact on the financial performance on the investment, most of the investors attribute lower importance to them if compared to common financial issues. (Crifo & Vanina, 2015). This thesis is therefore focused on the third category, non-financial issues that are material to investors and investment objectives. In the previous chapter we have seen as some ESG issues can affect less the financial performance of an investment rather than others, for this reason some ESG issues might not be perceived as material by investors and therefore not consider properly during the process of due diligence or active ownership. Material and not material ESG issues can change respect to the global/local scope of the investment fund, and are affected by legislation, culture and global trends (Falch, 2016)

2.2.1 The "new paradigm" of investors

Behind the category "investors" might be recognized different sub-category that differs for investment style, scope and influence. Regarding the last features at the end of '90s Robert Monks and Nell Minow developed a new theory trying to describe a new class of investors, with such a power and influence to overcome even institutions. They first describe what's called the "Universal Ownership Theory"[12], and individuate as main character of the theory institutional investors with a large interest in the health of the economy and society as a whole due to the nature of their portfolios.

Entities typically recognized as Universal Owners include large institutional investors such as pension funds, sovereign wealth funds, mutual funds, insurance companies, foundations, and endowments.

Their influence implies a both individual and collective interests in improving the macro-level economic, social and environmental condition which both affected and are affected by their investment decisions.

These major institutional investors have now become so large and so broadly invested that they in essence "own" the entire global economy, and as consequence cannot reasonably sell out of individual companies whose activities add costs to the balance sheets of other companies in its portfolio. Imagine for example a situation in which an institutional investor has an investment in a company operating a poorly run nickel smelter in Russia whose emission cause downstream environmental issues in North America. To avoid losses on the Russian investments has been decided to avoid the necessary expenditures to reduce the pollution created. However, the gains generated will probably be offset by the impacts of dealing with those externalities in North America, where the remediation costs could be borne by other companies in which the same investor may have a financial interest.

These double-sided effects of an investment and the action undertaken to deal with externalities subject the Universal Owner to a 21st century version of Garret Hardin's Tragedy of the Common of 1968[13]. Due to the power of institutional investors instead of regulation the solution is a "Solidarity of the commons", a situation in which major investors make a conscious effort to create a virtuous circle of improved environmental, social and governance conditions that can benefit all of them. (Kiernan, 2007)

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[12] Monks, R. A., & Minow, N. (1991). Power and accountability. Robert Monks at Stephanie P.

[13] Hardin, G. (1968). The tragedy of the commons: the population problem has no technical solution; it requires a fundamental extension in morality. science, 162(3859), 1243-1248.

Several studies empathized the differences between conventional investors and socially responsible investors, and even in the subset of SR investors can be observed different investment styles. These differences can arise from the type of investing model, the focus of investments, and from the grade of integration of ESG factors in investments decisions.
In this context, Praestbro & Winther (2011) defined 3 different type of investors. A category of investors showing a “single decision model” where only financial data are valued, investors categorized by a “dual decision model” in which both financial data and ESG factors are considered sequentially and investors charcaterized by an “integrated decision model” that integrate financial data and ESG factors.
Regarding the type of investing, Gronqvist, et al. (2015) proposed a definition of investement style as “a biological predisposition that translates in preferences for value or growth predisposition in investor’s portfolio”, along with environmental, social and ethical factors influencing the portfolio composition.
According to Rubanovici (2020) can be defined 3 main types of investments styles when we consider the consideration of ESG factors: ESG investing, Socially Responsible Investments (SRIs) and Impact investing.
ESG investing style includes a set of practices that can help a company managing its risks, contributing to the development of the society and the environment in which company and investors operate. To do so ESG factors are condiered in investment decisions and companies are evaluated on the ESG performance, which can have an impact on the company value and affect its reputation. This investement style consider the financial impact of ESG factors, and their effect on the developmenmt and performance of a company.
Similarly SRIs consider investements that have a positive impact on the environment and society. Usually this investment style lead to avoid investments in less “moral” products as alcohol, guns, tobacco, coal, “sin stocks”, etc. Differently from ESG investing, SRIs care more about the impact on community rather than monetary return.
Impact investing is related to the positive output of the investement. The main goal of this style is to offer solutions and help businesses to achieve a specific goal related to ESG issues, relying to the SDGs, that represents the building blocks for impact goals and can form the basis for identfyng wheter there is an rudnerlying “real-world impact”. Impact investing can be then considered a “consequence” of ESG investing, including an active management of the investements.
In addition to the style descripted above there’s a fourth case, the traditional investements.
Traditional investements are based on a neo-classical approach focused only on financial performance, accepting only competitive risk-adjusted financial returns. This style doesn’t

consider ESG factors and then, may generate negative outcomes for the community, even if aware of it. Traditional investors aran't willing to sacrifice returns in exchange of benefit stakeholders or contribute to solutions.

For each investement style different categories of investors can be identified. Bain & Company, (2020) and CFA Institute (2021) proposed a classification of investors regarding their involvement in the integration of ESG factors and the approach used. These categories differ for financial and impact goals, and the intentions in achieve their objectives.
The literature cited above report 4 different categories of socially responsible investors: Philantrophist, ESG risk mitigator, ESG opportunity seeker and impact investors.
Philantrophist represents the "greener" type of investors, completely focused in the impact of investments, willing to accept 100% of capital loss. Usually philantrophist are focused on one or a cluster of issue areas where social or environmental need requires material financial trade-off. But philantropy should not be confused with charity, investors by pursuing philantrophist investments in non-profit organization aim to consolidate their business in the long term. An example can be an energy investor who wants to increase the presence of wind and solar power in the marketplace, to do so her portfolio might also include investments in nonprofits that support alternative energy start-ups to "support" her investements in the long term. (Putnam-Walkerly, 2018)
ESG risk mitigators represents instead a more financially focused investors, they accept competitive return but act to avoid harm, trying to mitigate and reduce their negative outcomes for people and the planet. Their commitment in ESG can range from wide consideration of ESG factors to negative screening of harmful products.
A more sustainable approach is represented by a category of investors identified by Bain & Company as "ESG opportunity seeker", as ESG risk mitigators they act to avoid harm, but in addition they pursue strategies aimed to benefit stakeholders. They don't limit themeselves avoid or reducing negative outcomes, but try to generate positive outcomes for the community and help sustain long-term financial performance. In order to achieve their goals they focus on ESG opportunities through investments selection, portfolio management, shareholder advocacy or thematic investments.
The last category is represented by impact driven investors. They consider both financial and social effects of their investments, they can prioritize more financials returns (financial first investors) or social returns (impact first investors) as defined by Monitor Institute. They not only invest to benefit stakeholder , but they also contribute to high impact solutions, generating

a measurable positive change for people or the planet. Their strategies can vary from investements selection to portfolio management.
In this spectrum of ESG commitment ESG risk mitigator, ESG opportunity seeker and impact investors represent the new paradigm of investing approach, where financial returns compete with social impact and ESG returns of investements. The question of returns, of course, lies at the heart of whether ESG and impact investing will continue to gain traction in private equity. If doing good means compromising performance (as many assume), the momentum behind these efforts will likely fizzle out eventually.

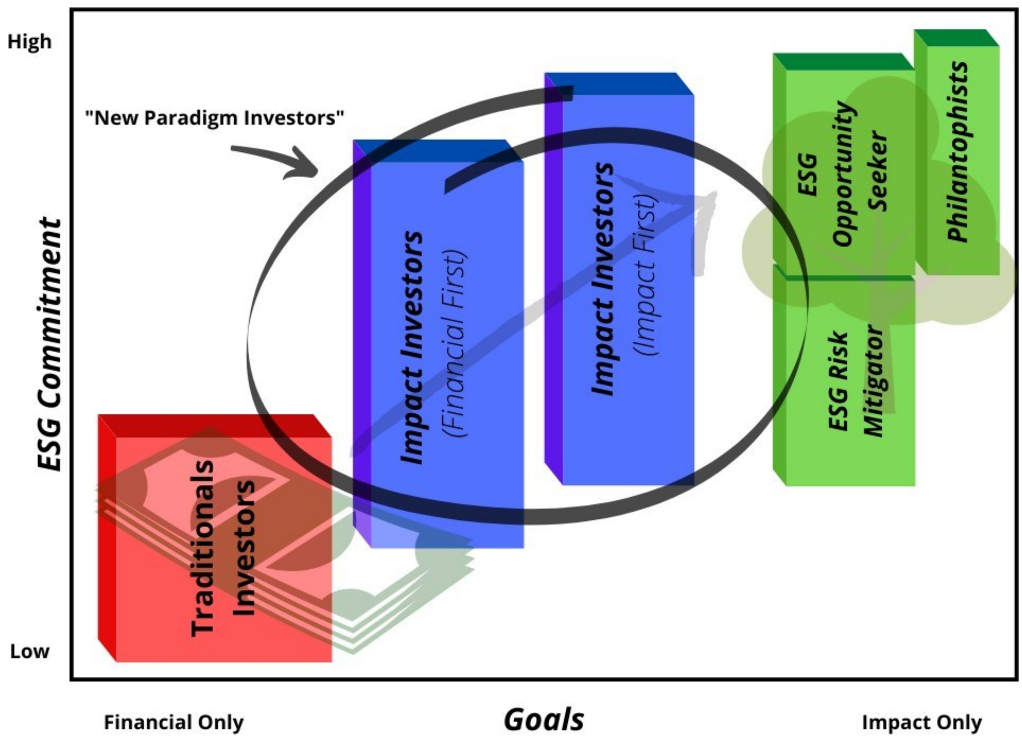


Figure 8: The Investors Landscape in dependence of ESG commitment and goals

Due to new type of investors also traditional investement approaches are under disccusion. Financial statements has always been the most important documents to evaluate an investment since accounting based performance numbers are the raw “feedstock” of virtually all contemporary investement analysis. Despite the tradition, the limitation implied in this approach noticed by recent literature, are broad and extremely serious. Collectively, they mock ESG analyis and dismiss it as a wolly-minded, subjective and imprecise. (Kiernan, 2007)
Whats rellay changed in the last forty years is the effect of knowledage and intangible assets in financial statements. According to Baruch Lev, accounting guru and financial analysis professors at NYU Stern, between 1980 and 2000 financial statements were able to capture the 75-80 percent of the real market value of major corporations. In the last two decades the

usefulness of financial information has rapidly deteriorated and nowdays financial reports provide about 5% only of the information used by investors (Lev, 2018).

The difference can be explained by the different sources of wealth: while in the ‘80s lands, factories, physical labour and finance capital represented the majority of the value of a a company now that is represented by intellectual capital, as knowledge and other intangibles. Identifying and managing it has become the most importanet challenge and driver of competitive advantage on sustainbable value creation.

The necessity of a new evaluation analysis focused in the 95% of informations left out by financial statements is of primary importance, as described by Mattew Kiernan[14] (2007) what is need is a new dynamic “balance sheet” approach, that put attention in these hidden informations.

In synthesis this definition describe the informations contained in financial statements as an iceberg: only a small part is approriately disclosed and contained in financial statements, but there is also an unseen part below the surface, much more valuable, that contains the primary drivers of the company’s future value creation capabilities, risks and unique comparative advantages.

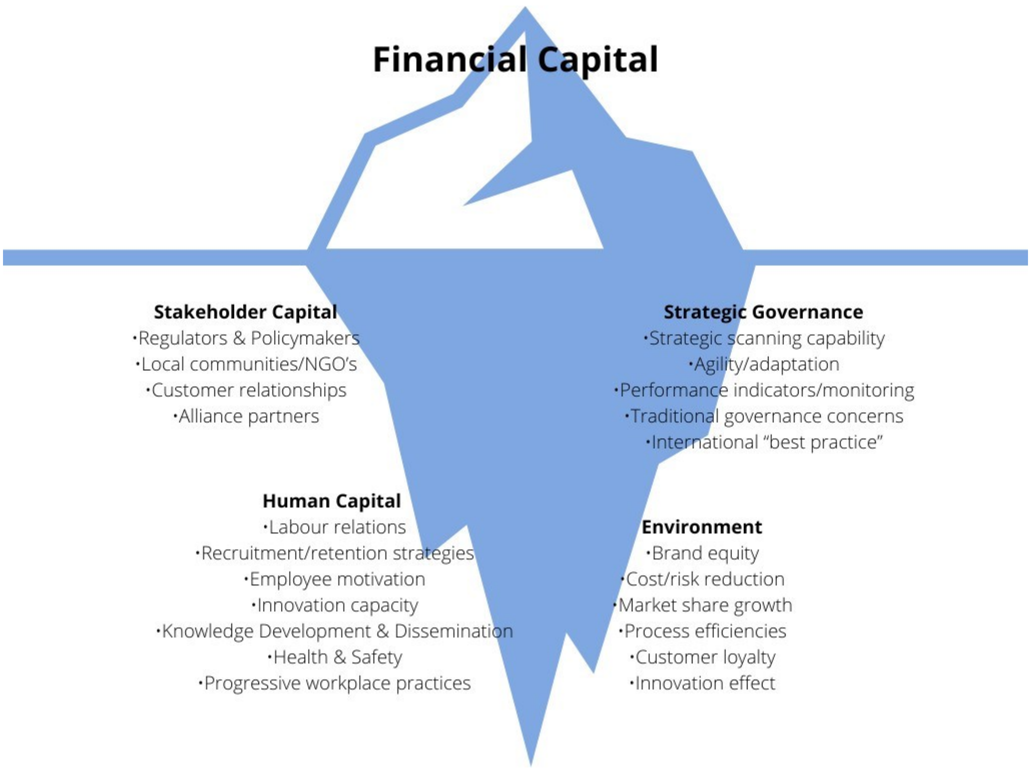


Figure 9: "Iceberg" Balance Sheet; Source: Kiernan (2007); Universal Owners and ESG: leaving money in the table?

[14] Matthew J. Kiernan (2007); Universal Owners and ESG: leaving money in the table?

As described in the Figure 6 the hidden “value informations” belong to three pillars of ESG: Environment (E), Human Capital (S), Stakeholder Capital and Strategic Governance (G).
Different type of investors imply different methods to bring these informations into considerations during the decision making process. CFA Institute defined 6 methods used by the “new paradigm” investors: exclusionary screening, best-in-class selection, thematic investing, active ownership, impact investing and ESG integration. Even if each strategy imply a different approach these methods are not mutually exclusive and are often used in combination by investors.

Exclusionary screening	Exclusionary screening, or negative screening, is the oldest ESG methods and refers in avoiding investments in companies or countries on the basis of traditional moral values, standards and norms. In value-based exclusions the focus is in the business of the company and entire sector can be exclude, such as alcohol, gambling, tobacco or military weapons. In norms-based screening the focus is on the company’s behavior regarding internationally accepted norms concering foundamental human and labor rights, according withg the principles of UN Global Compact. It’s important to underline that exclusionary screening imply the complete avoidance of sin sectors, regardless of how economically attractive it may become.
Positive Screening & Best-in-class Selection	Positive screening instead refer to the practice of concentrate the investements in particular industries, in accordance with UN SDGs . Best-in-class selection refers to preferring companies with better or improving ESG performance levels relative to sector peers (usually the top 25 or 33%). PE funds determines the relative position of comapanies by comparing ESG scores, based on both opportunities and risk that a company may face. Analyst look at wheterer a company has ESG policies and management system in place, the signatories for international initiatives and the conduct of the company.

Active Ownership	Active Ownership refers to refers to enter into a dialogue with companies on ESG issues, exercising both ownership rights and voice to lead change, in a different way respect to “active investing” of hedge funds. Active Ownership can be exercised through monitoring or influencing outcomes and practices regarding ESG issues, varying respect to the level of aggressivness of approach. Some investors may use pubblicized and confrontational measures, or use a more discrete approach. Examples of active ownership actions can be: vote in shareholder
Thematic Investing	Thematic investing is based on trends, such as social, industrial and demographic trends, usually, but not exclusively, associated with ESG issues. Popular themed funds are water- and air-themed funds, alternative energy-themed funds, food- and agricoltural-themed funds.
Impact Investing	According to Global Impact Investing Network (GIIN) this strategy refers to investing with the disclosed intention to generate, measure and report social and environmental benefits alongside a financial returns, that range from below market to risk-adjusted market rate.
ESG Integration **and** **Full ESG Integration**	ESG integration refers to systematic and explicit inclusion of ESG risks and opportunities in investments analysis. Differently to best-in-class selection, ESG integration does not require a peer-group benchmarking or any ex-ante criteria for inclusion or esclusion. ESG integration can range from analyze the managemnt of relevant ESG issues their impact assessments, using different approaches. Can be used environmental indicators, such as the ISO 14001, as well as health and safety indicators, along with analysis of government relations and local economic and community engagement. Full ESG integration

	consider the combinated use of negative/positive screening, active ownership, thematic investing, using ESG principles to improve the investments process and seeking to enhance the opportunity set.

Within these strategies, according to survey of Eccles & Kastrapeli (2018), for institutional investors exclusionary screening (47%) and best in class selection (37%) are the most used strategies, whereas full ESG integration was choose by only 21% of respondent.
At the beginning this time of transition, where the "new paradigm" investors taken place and with them the binomial ESG-financial interest, the most popular solutions are not always the most effective. Indeed only full ESG integration has the potential to deliver on the goal of sustainable value creation for all investors (Eccles & Kastrapeli, 2018).

2.2.2 The Full Integration Paradox

"Whaterver is worth doing, is worth doing well", yet, actual practices with respect to ESG incorporation vary greatly, with most investement managers falling weel short of the "gold standard" of full ESG integration. Only few firms seem to be using ESG factors to deliver alpha, while the majority demonstrate a less than plenary commitments on ESG practices. That's creates a paradox: "if the greatest benefits of ESG integration are achieved only through the full integration, why so few investement managers adopt this strategy?" (Cappucci, 2018)
More than forty years of academic and empirical evidence suggests that ESG integration in the investement process can lead to better risk-adjusted returns and long term value creation. At the same time, the concerns about financial performance of ESG based investments are not completely unfounded. Indeed, if not exercised properly, responsible investing can lead to lower financial returns. To realize these premises managers must be able to expoilt both risk and opportunities related to ESG, and the best strategy that allow this is the full ESG integration.
Within ESG integration managers adopt a variety of strategies, ranging from active ownership, positive/negative screening, risk-factor investing, with many managers tailoring these strategies to particular assets class or product.

In the dawn of ethical investing, dominated by the use of negative screening and the development of SRI, exclusionary screening failed to consistently outperform uncostrained benchmarks. According to modern portfolio theory, the exclusions of firms and entire industries, and the consequent lack in diversification due to the reduction of investments universe, increase the specific risk of the investment portfolio, leading to significant implications for the financial performance, regardless of its social orientation (Markowitz, 1952). But portfolio theory does not consider the benefit given by social screening and ESG integration, indeed, if adequately implemented, social screening can lead to an increase of financial returns.

Positive labor relation can facilitate increse in productivity, decrese turnover and increase the trust in stakeholders. Poor community relations can increse the costs of expansion and thereby limit a firm's growth. Starting from these hypothesis Barnett & Salomon (2006) found as the financial performance of firms chosen through strict social screening offsets costs from loss of portfolio diversification to some degree, higher is the consieration of ESG higher are the benefit provided by it's inclusion in investement portfolios. As firms ramp up the intensity of their sustainbaility efforts, financial performance at first declines before it levels out and eventually improves, creating an increasing curvilinear relationship between ESG intensity and performance. The declining part represent the costs of ESG integration such as the costs of obtain data, revaluating, changing and slow-down the investment process.

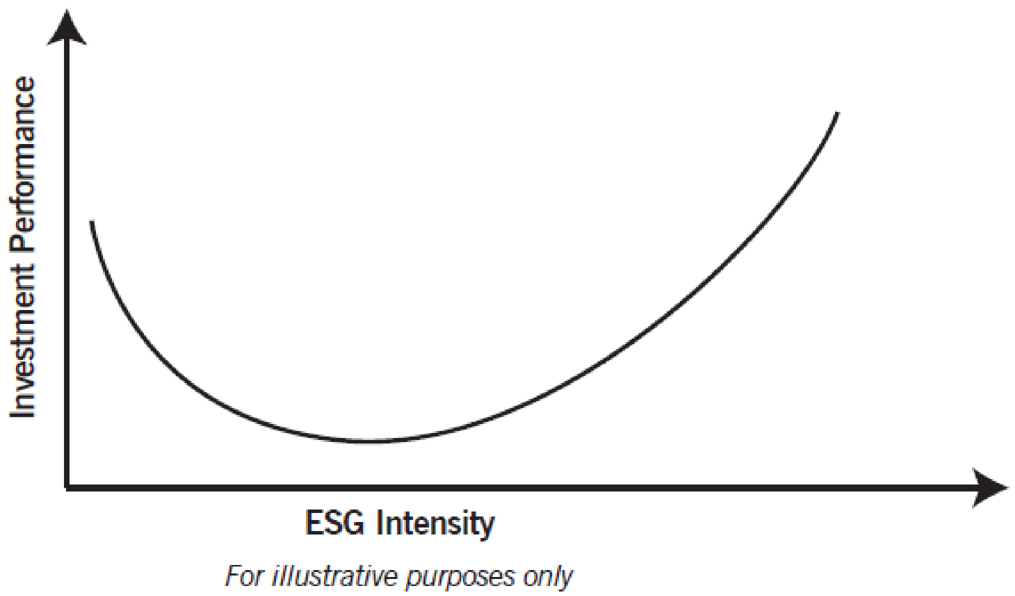


Figure 10. The curvilinear relation between investment performance and the extent of ESG integration

Poor ESG integration lead to the bottom of the curve, the "valley of lower returns" (Cappucci, 2018), as experienced by SRI funds in the early years of sustainable investing.

As the survey of Eccles and Kastrapeli (2018) found, only 21% of investors use the Full ESG integration, either alone or in combination with other methods. Similar results were obtained by the survey of Emiel van Durren, Auke Plantiga and Bert Scholtens (2015). In their survey they shows as the ESG score of respondent (that refers to the self-assessed degree of ESG integration in their investement process) is 2.32 in scale ranging from 1 to 4, with a standard deviation of 0.77, far from the extent of full integration represented by an ESG score equal to 4. In the same survey authors reported as the most used strategy is the application of negative screening (that authors call "red flagging"), in accordance with the 58% of respondant, and with less than 20% of interviewed using ESG investing. Moreover most of investement managers prefer to incorporate ESG factors through processed data as ratings (45%) and company analysis (30%). Only 30% of respodent used raw ESG data in addition to all financial information for the foundamental analyst.

These surveys suggest that even if a substantial share of investors believe that full ESG integration is the ESG strategy with the best expected performance, that's not the best choice for their firms.

Evaluate the real use of ESG integration in investements decision is sometimes difficult. A controverse results respect to the studies cited above is represent by a survey of CFA Institutes. In this survey of 2017, CFA Institutes asked to 1.588 members: "How do you take ESG issues into consideration in your investements analysis/decision?". In this case ESG Integration resulted to be the most used, with the 59% of respondents, while the success of exclusionary screenings was lower, with only the 38% of confirmations. But the same managers that in the first question showed an impressive interests in ESG integration in a series of follow up questions exhibited a poor understanding of the strategy. They sustain the major sources of data are represented by public informations and third parties research, while reports and statement from the company and informations acquired from a direct engagement are respectively the 3rd and 4th source of data. The 50% thought was necessary the same level of indipendent verification of an audit (high level of assurance) but the same respodents did not know how much to spend for an indipendent verification of ESG reporting or were willing to spend less than one-quarter of the cost of a financial statements audit. Morover, 54% of employees (and so, also investment managers) did not receive any training on how to consider ESG issues in investements analysis, and the 25% of respondents did not think a training in considering ESG issues is necessary.

These results are themselves a paradox, exhibiting the will of managers to incorporate ESG factors in their decisions, but in a discretionary and confusing way, without equal emphasis on identifying ESG risks and related opportunities.
Another proof of the poor ESG performance of investment managers is represented by the consulting firm Mercer. Mercer develop an ESG rating that assess managers across all strategies/product types on a four point scale. ESG, the top tier, reflect investing strategies that shown a full ESG integration, while the lower tier ESG4 represents a little or no consideration in ESG issues. Globally for the PE asset class the 80% of managers was rated between ESG3 and ESG4[15], a stunning results that project the mojority of investement managers in the downward slope of the ESG integration curve, in the valley of lower returns.

[15] Data retrieved from: https://www.mercer.com/our-thinking/mercer-esg-ratings.html

Chapter 3

3. ESG Integration: Drivers, Obstacles and Disclosure

As I have described in the previous chapter, investors consider ESG issues for various reasons. Part of them may consider these topics solely as economic risks and opportunities, a source of economic value. Others may see ESG issues not just as risks and opportunities but also as a matter of moral values (CFA Institute, 2019), and their integration as a reconciliation of social and long-term economics interest of corporations.

For instances, regardless of the economic attractiveness of the tobacco industry, an individual investor may find investing in tobacco unacceptable because of the harm of smoking in human health. But other investors, pushed by stronger economic motivation, may not share these concerns. If they evaluate it as a profitable investment, they may invest in the tobacco industry, looking at ESG issues simply to complement their traditional financial analysis.

While moral values can vary widely from investor-to-investor, economic values are usually quite similar, a fundamental point in the "value versus values" debate.

Thinking and acting on ESG in a proactive way, starting to weight more the moral values, has lately become even more pressing and lead to a meteoric rise of ESG-oriented investments. The acceleration has been driven by the heightened social, governmental, and consumer attention on the broader impacts of corporations, as well as by the investors and executives who realize that a strong ESG proposition can safeguard a company's long-term success. (Henisz, et al., 2019).

Pushed by this increase in sustainability awareness academics starts to analyze the phenomenon, creating an overwhelming number of research and finding that companies that pay attention to environmental, social, and governance issues do not experience a constraint on value creation, but in fact, quite the opposite.

This positive relation it is not linear, and neither intuitive to detect and study. Starting from 1970s scholars and investors have published more than 2000 empirical studies and several review since then, using different approach and sample, and defining a fragmented understanding of the financial effects of ESG criteria.

Though there are many studies that confirm a positive relation between ESG and corporate financial performance (CFP), some researcher often claims these results as ambiguous, inconclusive or contradictory and the reasons are, in particular, concerns about the measurement and durability of the effect, or the impact of financial sector on the natural environment and society (Weber, 2014).

Heterogeneity and indeed, ambiguity, of SRI financial performance can be generated by several factors. Different SRI markets and investment approached used may affect the results of the studies. The geographical area investigated are diverse spacing from North America to Europe and Asia, sometimes spanning in different national markets. Shareholder activism and negative screening are more common in the US while positive screening (or best-in-class selection) is more popular in European countries. These different approaches may lead to different performance: according to Markowitz's Portfolio Theory a lower diversification due to the negative screening reduce the performance of the firm's portfolio, compared to EU ones.

In addition, also the investment horizon affects the financial performance of SRIs. A long-term study tends to attain more reliable and robust results while in a short-term study may be difficult isolate the specific effect of ESG on performance.

Revelli & Viviani (2015) and Capelle-Blancard & Monjon (2012) argued that the main explanation of the growing debate around the financial performance of socially responsible investments is therefore the "data-driven" nature of the single studies since in their work they used different data that were not always comparable considering their features. Moreover, some study may suffer of a "data-mining" or bias, in the sense that researchers could be value-oriented in choosing the best performing stocks in their sample from the SRI universe.

A breakthrough in the literature is represented by the study of Gunner Friede, Timo Busch and Alexander Bassen (2015). This study tried to give aggregated evidence in this puzzling environment, extracting the primary and secondary data of about 2200 individual studies, and then combing the results.

They consider both vote-count studies and econometric reviews (meta-analysis). Vote count studies count the numbers of studies with positive, negative and non-significant results and "votes" the category with the highest share as winners.

Meta analysis instead allow to apply statistical techniques to aggregate many small studies, explore the direction of causality and most important for SRI investors, it divides financial outcomes in firm based and market-based categories. (Kurtz, 2005)

Through this kind of analysis Friede, Busch and Bassen have been able to use all the different kind of data from the emergence of environmental, social and governance ratings during the prior 20 years to combine multiple method and improve the debate.
The results obtained are stunning, about 90% of studies found a non-negative ESG-CFP relation, whose 47.9% of vote-counts and 62.6 of meta-analysis yield positive finding.
The distinct positive is found across various approaches, geographical areas and asset class, except for portfolios studies (such as mutual funds and indices), where the proportion of neutral and mixed findings are higher, with the proportion of negative results that remains much lower. It’s important to be aware that the results of portfolio studies are subject by various systematic and idiosyncratic risks in portfolio, and in case of mutual funds, implementation costs.
Generalizing, the relation between ESG and financial performance is, at least, neutral and appear stable over time.

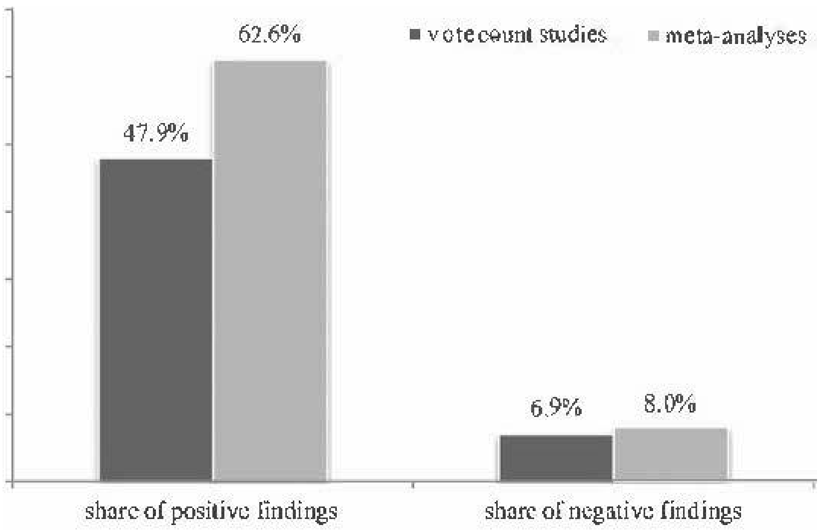


Figure 11: The positive relation between ESG-CFP. Less than 10% of studies report a negative effect of ESG on financial performance.

Even if the Markowitz theory together with the negative-screening approach of US investment firms predict an underperformance respect to European ones the regional results of Friede, Bassen and Busch reveal that in developed countries there is a higher share of positive findings in North America compared to Europe or APAC countries. Yet the United States represents the historical and indeed more developed ESG market, and its experience effects may thus be stronger than in the European market, leading to a better relative performance (Revelli & Viviani, 2015).

Several empirical studies argue that SRI funds may be oriented towards environmental, social and governance aspects and indeed their performance may vary in accordance with their orientation (Dimson, et al., 2015)
Moreover, considering the individual effect of each ESG factor, environmental and governance category exhibit a slightly more positive effect on the ESG-CFP relation than social-focus studies. However, the difference between E, G and S is marginal, demonstrating that no single category has a significant superior positive effect on the firm's financial performance.

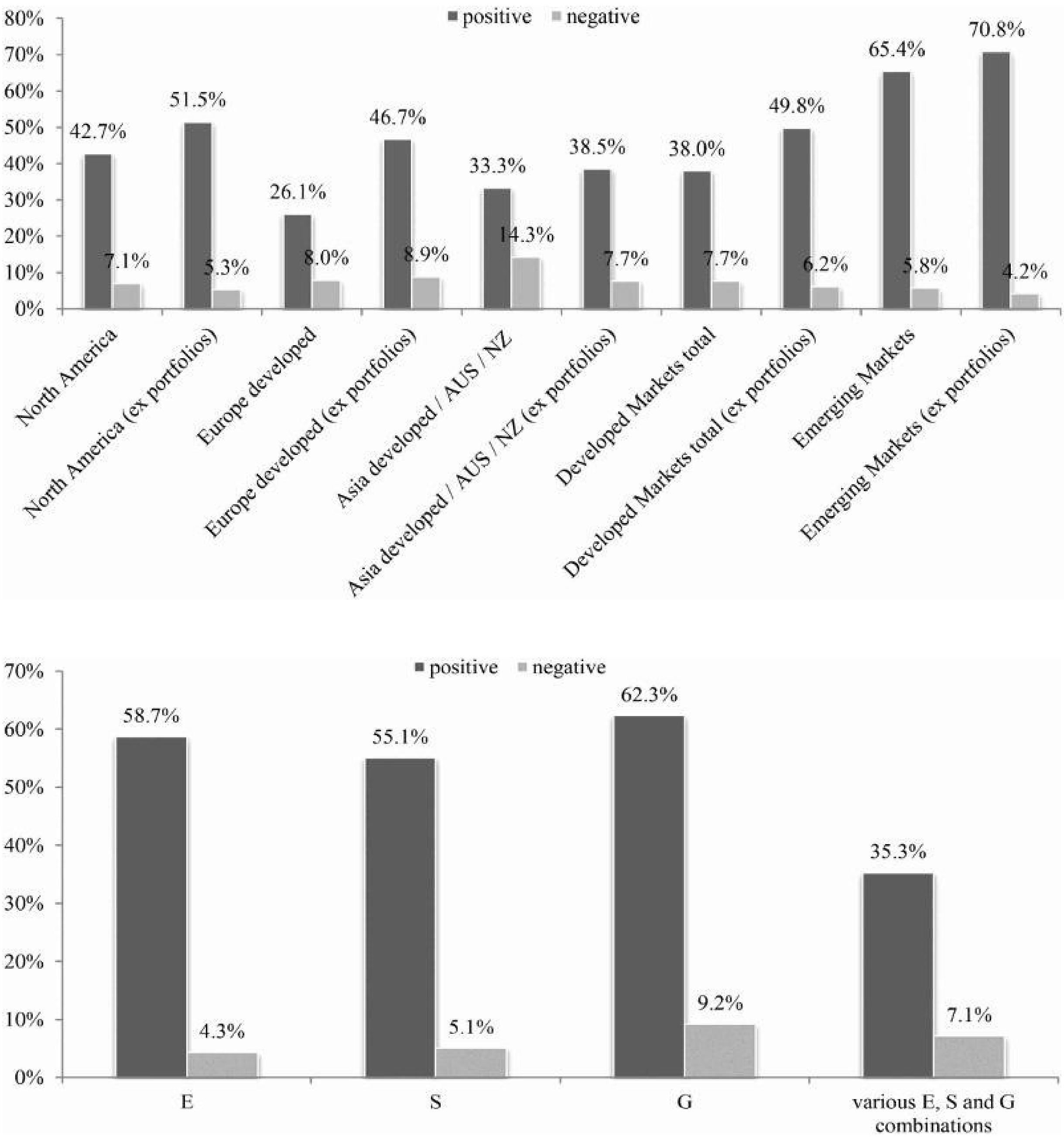


Figure 12 Regional findings of ESG-CFP relation and single E, S, G effect on financial performance

Even if ESG effort and participation became more widespread in the last decades, supported by empirical studies as seen before, remain difficult to understand how these criteria can be strategic drivers of responsible private equity.
Patricia Crifo and Vanina Forget in research of 2012 defined a set of strategic drivers for responsible Private Equity investors: value creation, risk management, differentiation and related compliance to Limited Partners demand.

3.1. Value Creation as a strategic driver

Can a Private Equity fund create values by integrating ESG in the investment process?
As seen before there is no evidence of a negative relation between CSR practices and financial performance, but from a theoretical point of view there are concerns of how SRI investments can outperform a standard portfolio, on average, since anything a SRI fund can do, so too can a non-SRI fund (Sparkes & Cowton, 2004) and the additional costs that a SRI sustain generally associated with screening.
It is important to keep in mind that PE investors structurally differs from public investors, beyond governance and operating engineering they typically do not create large and diversified portfolio based on portfolio theory but rather select and follow few companies as active shareholder over a medium-long period. Value creation in this context should be seen through the lens of the link between CSR and financial performance rather than ESG based fund versus non-ESG fund. (Crifo & Forget, 2012)
How ESG participation can drive to value creation can be explained by different reason.
In the last decades literature tried to define these rationales (Crifo & Forget, 2012; Henisz et al., 2019), that can be summed in 3 different drivers that link ESG to positive cash flow:

1) Facilitate top-line growth and the creation of new markets
2) Increase employee productivity
3) Optimize investments and capital expenditures

Each of these elements should be weighted when an investor approaches an ESG opportunities, creating a solid basis for evaluate the investments from a non-financial point of view.
These five links can be found in lot of investments opportunities but are their presence is not an assurance, and neither their “strength”. Some of them could arise in certain industries or

sectors, some others could be more powerful in determined geographical areas, but still should be always considered, regardless of the company's business model or location.

Top-line growth and new markets creation

A strong ESG participation helps companies to taps new markets and expanding in existing ones, offering wide innovation possibilities. Structurally Private Equity business exists to finance, support and pursue growth for new companies and new markets, especially PE firms operating in venture capital or seed investments. The PE industry has already seized the opportunity offered by the global ESG concerns, as witnessed by their increasing involvement in renewable energy and clean technology markets. Moreover, when a company can be trusted by public authority can easily have access to approvals and licenses that can drive to potential opportunities for growth. This can help in business linked to the extraction of natural resources, where the prior performance in sustainability is becoming an important screening criterion in public-private tenders.

To support this idea a study of 2014 found out that companies engaged in social activities were perceived to benefit by public and social stakeholder and had an easier go at extracting these resources. (Doronbatu, et al., 2014).

A perfect picture of this driver is represented by Sortera, a Swedish company that collects waste from buildings, sorts it and thanks to an innovative process turn the majority of it into valuable resources, such as woods and metals. Thanks to market and regulatory tailwinds Sortera became the third largest player in Sweden market and a model for best-in-class ESG practices. In 2016 Summa Equity, a PE firm specialized in thematic investment, helps Sortera to improve their ESG and financial targets, increasing the revenue of the company from 200 million SEK to almost 1.4 billion in 2020 and the recovery rate of waste material from 86% to 98% in 2020. During the investment period (2016 – 2021) two new division were added, consolidated his position in Sweden market and entered in the Finland's one. (Summa Equity, 2020).

ESG can also pay-off by attracting both B2B and B2C customer. 70% of consumers surveyed on purchases in multiple industries said they are willing to pay up to 5% for a greener product, if met the same performance standards as a non-green alternative.

Employee productivity uplift

A strong ESG proposition can drive a higher employee satisfaction, that is positively correlated with shareholders returns (Edmans, 2011). A more sustainable image for a company can help attract and retain quality employees and enhance motivation by providing a sense of purpose and increase productivity overall.

More employees can feel the impact of their work higher is the motivation on act in a prosocial way. Studies have confirmed this sentence and find that positive social impact is positively correlated with a higher job satisfaction. (de Neve, 2018)
Just as a higher sense of purpose of employees can drive better returns a weaker ESG proposition can drag productivity and then, financial performance.

Investment and asset optimization
By enhancing ESG efforts companies can get higher returns by allocating capital to more promising and more sustainable opportunities. A strong ESG proposition can also help companies avoid stranded investments that may not pay-off because of longer term environmental issues.
Companies should catch opportunities to optimize their equipment and plants from a sustainability point of view. A do-nothing approach, that could appear costless, is usually and eroding strategy. Continuing to rely on plants that require a lot of energy to work can drain cash in the medium and long run and choosing to wait to update the assets can be the most expensive option at all.
In this line Derwall, et al. (2005) found a positive relation between eco-efficiency and financial performance, in these terms by increasing output efficiency companies can definitely obtain a competitive advantage.
Energy cost represents a huge center of cost for companies, and the alignment of regulatory responses to emission with them could lead to a relevant effect on profit & loss in carbon-intense industries and represent remarkable constraints on multiple business. Repurposing assets with a far sight horizon should be of primary importance for getting ahead in the future.
An example of an effective asset optimization is represented by the Italian company CMC Machinery, one of the most important operators of the Italian packaging industry. CMC innovated the e-commerce industry by installing and operating 3D packaging machines, which scan products to produce packaging that fit to product size, in order to reduce the harmful environmental impacts of packaging. An effective solution that attracted a big PE firm as KKR which in November 2020 included CMC in his KKR Global Impact Fund by acquiring the 70% of the company.[16]

[16] Retrieved from: https://bebeez.it/private-equity/il-private-equity-americano-kkr-va-al-controllo-dei-macchinari-per-il-packaging-cmc/

Being committed to a senso of purpose is absolutely a strong driver for value creation. Market capitalization of firms can increase with stakeholder support, especially todays where, helped by social networks, peer stakeholders can criticize or attack firm operation and destroys firm reputation.
As BlackRock's Larry Fink stated in 2019 letter to CEOs "Fueled in part by social media, public pressure on corporations builds faster and reach further than ever before [...] Companies must demonstrate their commitment to the countries, regions and communities where they operate. Profits are in no way inconsistent with purpose, in fact, profits and purpose are inextricably linked." (Fink, 2019)

3.2. Risk Management and reduced regulations

ESG integration provides a frame through which matters of individual well-being or societal well-being becomes the subject of business ethics and financial risks and through its different actors are taking on responsibility for managing a range of risks, effectively taking up the invitation offered to them by disintermediated governance.
ESG integration introduced a new understanding of individual and institutional risk management, drawing together the interests and fortunes of dispersed investors, workers, investor-workers throughout the global economy. Importantly though, the construction of ESG risk is a dynamic process. The likelihood of future financial consequences (material for the purpose of an investment decision) associated with environmental, social or governance risks changes with economic developments and political contest. For example, environmental advocacy organizations have been successful in imposing additional costs on fossil fuel-based investments, creating a different (and increasing) risk with investing in coal and oil respect to a decade ago. Banks as Deutsche Bank or The Royal Bank of Scotland have stopped lending to new coal mine projects, generating a decrease of 80% in spending in these kind of project between 2012 and 2018. (Sanderson, 2018)
This contest helps to create another strategic rationale for promoting ESG investments, sometimes even more important than value creation (Crifo & Forget, 2012), the improved risk management, that not only consider traditional financial factors but also introduce concern about sustainability that reduce tail-risk in the medium-long run.

SME, especially in Europe, collect most of their capital through debt that must be repaid with the cash flows generated by selling goods or providing services to customer. The risk of debt is then strictly connected with the cash flow generated by operations, and PE investor's greater risk is that company will not achieve the cash flow necessary.
This condition if even stricter for LBO transactions, in which investors are most interested in the company's future capacity to generate large and steady cash flows.
Including ESG risks during the analysis of risks in the investment process are core to PE business, and "mandatory" for sustainable investors as stated by the first principle of UN PRI: "We will incorporate ESG issues into investment analysis and decision-making processes".
ESG management is commonly associated with three specific risks. (Scholtens, 2006)

- When the investor takes possession of collateral it can generate environmental danger and thereby, compliance with standards can became costly.
- Reputational risks whenever actions of borrowers may negatively feedback on its financier
- Changes in environmental and social legislation can be costly for firms operating in specific sectors, if on one side it can jeopardize the ability to generate value for the company, on the hand, it can lead higher default probability.

The latter risk is present in different markets. Governments and associations are introducing a stringent regulation to incentivize a sustainable approach in conducting business. A stronger ESG proposition can help reduce companies' risk of adverse government action and engender government support trough subsidies and costs reduction.
It has become increasingly common for governments, non-government organizations, intergovernmental organizations, and other actors to call on business leaders and investors to take action political and ethical issues. (Parfitt, 2020)
Analysts individuate that one-third of corporate profits are at risks of state intervention, its strength depends on form the industry in which the companies operate.
There is a proliferation of soft laws mechanisms, such as the UN Guiding Guidelines on Human Rights, UN Norms on the Responsibility of transnational Corporations, and others that require companies to respects environmental and social standards, and other international or local law and norms.
An example is the automotive sector, with a more and more stringent regulation regarding renewable energy and carbon-emission regulations, there is an estimate of 50-60% of EBITDA at stake from external engagements.

The food sector, instead, has a lower percentage of corporate profits at risk, around 25-30% despite of the regulation for fighting obesity, food safety, sustainability, and labeling.
Summa Equity invested in Milarex, a Norwegian company that operates within the secondary processing part of the value chain, focusing on salmon value-added products with a sales distribution in Europe and North America. Milarex promotes a sustainable production cycle from sourcing to delivery: the company acts to ensure sustainable consumption and production patterns (SDG 12) by sourcing sustainability-certified salmon (93% of the company's raw materials in 2020) and helps cover the world's growing nutrition needs (SDG 2, SDG 3). The strict regulation of the salmon farming industry represents the biggest threat for the sector, with ESG compliance and a high-quality value chain that nowadays represent a "must-have". Thanks to its business model and strict ESG compliance compared with peers Milarex increased its revenue and sustainability results, consolidating its position in global markets and representing a positive investment for Summa Equity. (Summa Equity, 2020).

3.3. Lower costs and LP's preferences

As noted by Giese, Lee, Melas, Nagy, and Nishikawa (2019) within the standard cash-flow model of the firm, there are different ways by which ESG activities can increase the value of the firm: through increasing cash flows (through either increasing revenues or decreasing costs), through lowering the risk (higher profitability and lower exposures to tail risk), and through lowering the cost of capital. The latter two channels have received some research in the empirical literature. The general findings are that ESG activities lower the cost of capital for firms and that ESG activities lower tail risk.
Cost reduction itself represents one of the most important drivers for investors since ESG compliance can implement a substantial reduction of operating expenses (such as raw-material costs) that can affect operating profits up to 60 percent.
A practical example can be the introduction of technologies or plant that consume a lower amount of energy or reduce the water intake in a process or avoiding the generation of unnecessary waste that lead to higher waste-disposal costs.
Likewise, a company that rely on renewable form of energy can be less impact by the increasing price of oil or gas as manifested in the first months of 2022. These technologies allow company

to reduce fixed costs and increase (even if a small, but still positive percentage) their operating profits.

Moreover, McKinsey found a significant correlation between resource efficiency and financial performance.

An example is represented by 3M, a US multinational that operate in the industrial sector. In 1975 introduces the "pollution prevention pays" project, trying to prevent pollution by reformulating products, improving manufacturing processes, recycling, and reusing waste from production. Since then, the company saved more than $2.2 billion. (Henisz, 2016)

Parallel to operating costs also the cost of capital, defined as the calculation of the minimum return that would be necessary in order to justify undertaking a capital budgeting project, such as building a new factory or an investment, represents a really important metric for investors. The effect of ESG activities on the costs of capital has received a great deal of attention. As emerged from the meta-analysis of Cantino, Devalle, and Fiandrino (2017) the general findings are that ESG activities significantly lower the cost of equity, the cost of debt, and the overall cost of capital.

Literature is unanimous on the positive effect of ESG factors on cost of equity decline, so an increase in cost of CSR activities reduce the cost of equity. That's mainly lead by a decrease in asymmetric information, since the more disclosure as a result of greater transparency, reduce the risk and consequently the cost of equity (Armitage & Masrton, 2007). Moreover, findings suggest a negative association between CSR activities and the beta of company's stock, as volatility decrease with ESG effort (Crifo & Vanina, 2015). Ng and Rezaee (2015) investigate which sphere of ESG affect mostly the reduction of cost of capital. They find that only environmental and governance consistently reduce the cost of capital, while social sustainability performance does not directly affect cost of capital. The reasons are different, the strength of both environmental and governance dimensions has a direct effect on financial performance by either reducing environmental liabilities in the case of environmental initiatives or enhancing the effectiveness of corporate governance measures in the case of governance sustainability performance. Social sustainability may involve other resources, but it's not involved in value creation and then it is not linked to cost of capital reduction.

Regarding the reduction of cost of debt the literature shows different results due to different samples and data-driven bias. Some results report that companies adopting ESG effort can obtain advantageous loan contracts with banks, leading to lower borrowing costs. Social and environmental activities directly affect the cost of debt, with the social sphere affecting less the reduction in the cost of debt than the environmental one. (Cooper & Uzun, 2015; Nandy & Lodh, 2012; Zeidan, et al., 2015). On the other hand Goss & Roberts (2011) reports how lenders do not take account of CSR activities of borrowers and do not consider them as a risk mitigator factor, but instead as a risk, finding an increase between 7 – 18 bps on borrowing costs, a modest but contrary results respect to the studies previously cited.

An empirical analysis of Berk and Van Binsbergen (2021) tried to quantify the reduction of cost of capital due to ESG activities. Their study consider the fraction of U.S capital devoted to ESG investmements and from that derives the effect on cost of capital. The theory developed suggest that the observed effect of ESG investors on the cost of capital should be small since the fraction of capital actually involved is not enough. A substantial amount of socially conscius capital is required fro the strategy to affect corporate policy, given the actual AUM a more effective strategy a more effective strategy is to follow a policy of engagement, by exercise their rights of controls or by gaining a majority stakes and replacing upper management. (Berk & van Binsbergen, 2021)

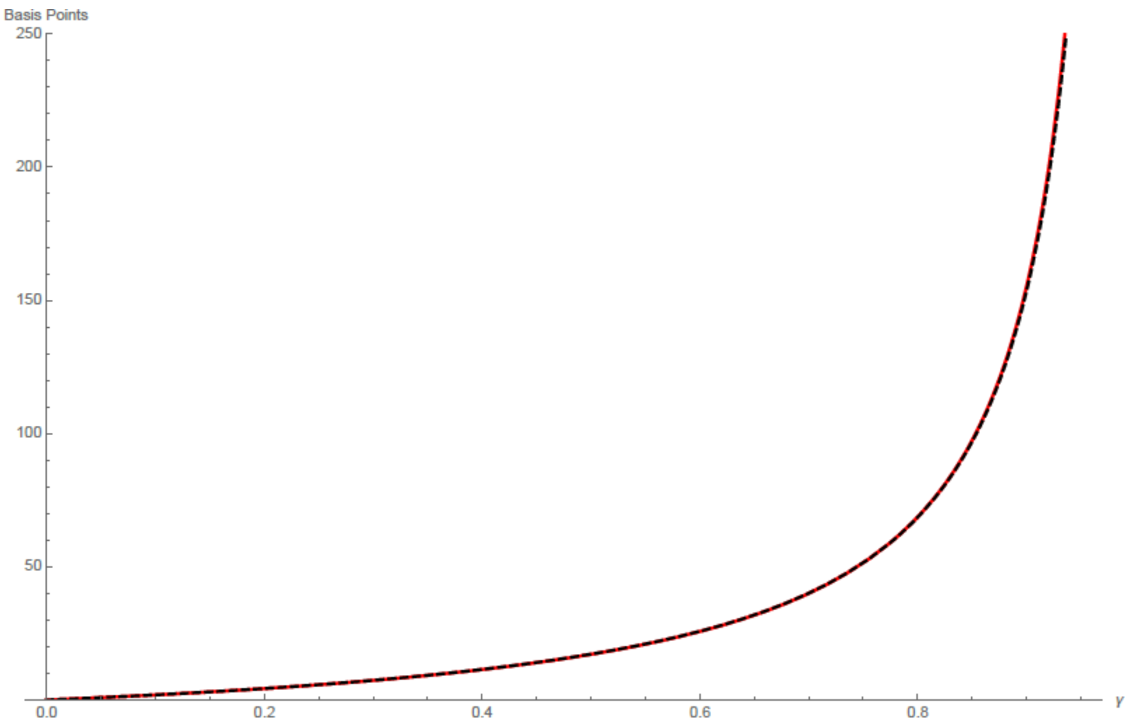


Figure 13: Effect on the Cost of Capital of Introducing ESG Investors into the Economy: The curves plot the change in the cost of capital, as a function of capital used in ESG investments; Source: Berk, J. B. & van Binsbergen, J. H., 2021. The Impact of Impact Investing. Laws and Economics Center, 22(8).

A strong ESG proposition allows funds to differentiate themselves, reducing competition intensity and capturing Limited Partner's preferences.

The financial crisis of 2009 lead to a huge withdraws of equity raising due to liquidity issued faced by the two historically main LPs; banks and insurance companies. In addition to a number

of funds increasing year over year, the competition drastically increase, and with it the need of pursuing investments to attract investors. (Crifo & Forget, 2012)
By integrating ESG criteria into the investement process PE firms can offer more attractive investment opportunities that can be financially sound for value creation and risk mitigation, and at the same time a “trend” to be surfed by individual, and sometimes noise, investors.
Compliance with LPs preferences is indeed an important tools for a PE fund. LPs, and in particular individual investors, in fact may derive non-financial utility from investing in SRI fund, a kind of philantropic feature that remains in modern investors.
Moreover, within investors there could be differences in solvency and return requirements, regulatory concerns, corporate financial and non-financial objectives and accounting rules, that create a environment where the ability to differentiate from competitors and the effectiveness of disclosure witgh stakeholder represents a powerful instrument for the success of a PE fund.
It’s important to underline as state that SRI investments has no real costs, invetsors should move their investements to obtain a similar return to that achieved theough conventional investments but also reward SR companies. As these companies gain access to financial resources theough the cash inflows generated by the investent, their financing costs should decrease and thus encourage the adoption of SR policies in a greater number of non-responsible companies. In this virtuos, and idealistic cycle, as the volume of ESG assets under management increases also the fees paid to SRI-oriented portfolio managers increase too in a stronger way compared to the increase in AUM occurred in the last years. (Revelli & Viviani, 2015)

3.4. Barrier and Obstacles

Despite over a decade of literature reported the positive effect of ESG integration in the investment process there are still several misconceptions that must be overcome to realize the potential benefit of ESG integration.
These misconceptions, that usually derive from an old perception of the economic system closely linked to a neoclassical economy work as barriers in the integration of ESG in the decision-making process. Their nature defines them as traditional barriers, eradicated in the economic behavior of investor. Thanks to the demographic transition and the consequence in the change of the society and economic mindset are becoming less pronounced.
Generally speaking, the three most commonly perceived traditional barriers to ESG investing are:

- The perception that ESG integration means sacrifice financial returns
- Fiduciary duty with Limited Partners precludes ESG investment
- Investors' performance expectations are too short-term to fully obtain the positive effect of ESG performance

Thanks to the change in economic and societal systems these barriers will disappear in the next years, but a study of Eccles and Kastrapeli (2018)[17] described a positive image where these barriers are lower than is commonly believed.

The reduction of financial returns due to ESG integration is surely the most common threat to sustainable investing since financial returns are of primary importance for investors. A result of the 2015 PRI joint study with Cerulli Associates, reported that "misperceptions of negative impact of investment performance" was noted as a major challenge by 60% of respondent and a moderate challenge by 28%. (UN PRI & Cerullli Associates, 2016)

However, the trend is changing. The study of Eccles and Kastrapeli proposed a survey, they asked: "Do you believe incorporating ESG factors necessarily means missing out on potential returns in your portfolio?". The results were stunning, only a third of institutional and private investors agreed, more than one half disagreed, the same study reveal that only the 29% saw concerns of underperformance as a barrier to ESG integration.

As perception change surrounding ESG there may be also a shift in the fiduciary obligation to integrate ESG criteria.

Fiduciary duty and financial returns are strictly connected since the primary importance is to conduct business in order to maximize the returns of beneficiaries. Once the first myth regarding the underperformance of ESG funds has been refuted, also the perception surrounding the fiduciary duty can change. Today only a small percentage of investors (about 10%) see counsel's interpretation of fiduciary duty as a barrier, and studies and trends show exactly the opposite: 40% of asset owners and 51% of asset managers interviewed believe in a shifting of fiduciary duty where ESG integration is required, or nonetheless encouraged.

The third traditional barriers perceived by investors is represented by the patience, performance expectations in a fund are too short-term for integrate ESG measures.

The same studies reporting a non-negative relation between ESG integration and financial performance usually underline as the benefits take more time to be realized respect to a traditional funds, typically in a range of six or seven years (Eccles, et al., 2014)

[17] Robert Eccles & Mirtha Kastrapeli – The Investing Enlightment: How principle and pragmatism can create sustainable value through ESG (2018)

The answers regarding the perception of institutional investors shows a different behavior, with 75% of institutional investors expecting an outperformance in 3 years or more, and 45% five years or more.
More than half of institutional investors also reported as long-term gains (more than one year after the investments) are valued more than short term outperformance, differently retail investors demonstrate to be less patience with only the 42% valuing long term benefit more than short term.
Considering the PE fund structure and investment horizon these results refute this barrier, especially for institutional investors. Nonetheless the percentage of "patient" retail investors is still encouraging in describe this barrier less difficult to overcome than may be perceived.

Investors rely on a high-quality range of high-quality financial data to make their investment decisions and the unavailability of such data represent an important barrier for the ESG integration. More than one surveys highlighted as the primary barrier to ESG integration is the lack of standardized, high quality ESG data to incorporate in their investment decision process. A study of Eccles and Kastrapeli (2018) describe different concerns regarding the quality of ESG information.
ESG data are substantial and fast growing but unwieldy, in the area of data quality investors desire their data and the relative management to be material and able to drive a successful decision-making process.
Data challenge can be characterized for investment firms as creating a technology system that aims to process and channel relevant high-quality information adaptably, cheaply, and efficiently with security and resilience into the investment process and into reporting to clients Even if a company is producing a sustainable report (a reporting practice that is growing in the last years) it's difficult for investors to find hard numbers of which ESG issues a company evaluate as important for shareholder versus stakeholder. 92% of investors look for a report on the relevant ESG issues they believe may affect financial performance.
Data quality requires two essential features: materiality and validity. Materiality, as said before, tracks the degree of insight possible from any data point in addressing investment-relevant questions that can affect the understanding of the performance of the investment. Validity, instead, tracks the actual capture of that insight in that data point. Validity will reflect objectivity, accuracy, timeliness, granularity, and transparency. (CFA Institute, 2021). In ESG area there are lot of subjective data ("soft data") that have high materiality but lack in validity. On of the most important challenge for ESG integration derive from the valuation of company ESG reporting.

The 3 informational barriers that investors face are represented by the lack of standards for measuring ESG performance (60% of institutional al 39% of retail investors), this may be strongly linked to a general lack of ESG performance data reported by companies or ESG data form other sources. Over 80% of respondent agree or strongly agree that there is a lack of standards around ESG integration and yet, how to get data on the small subset of material ESG information that affect financial performance. There are very limited national requirements for companies to report on most ESG data and which information to provide, leaving a high degree of discretionarily on which ESG factors are material to their business performance and the information to disclose to investors. Different international reporting standards has been developed in these years, each of them aimed to underline certain material information.

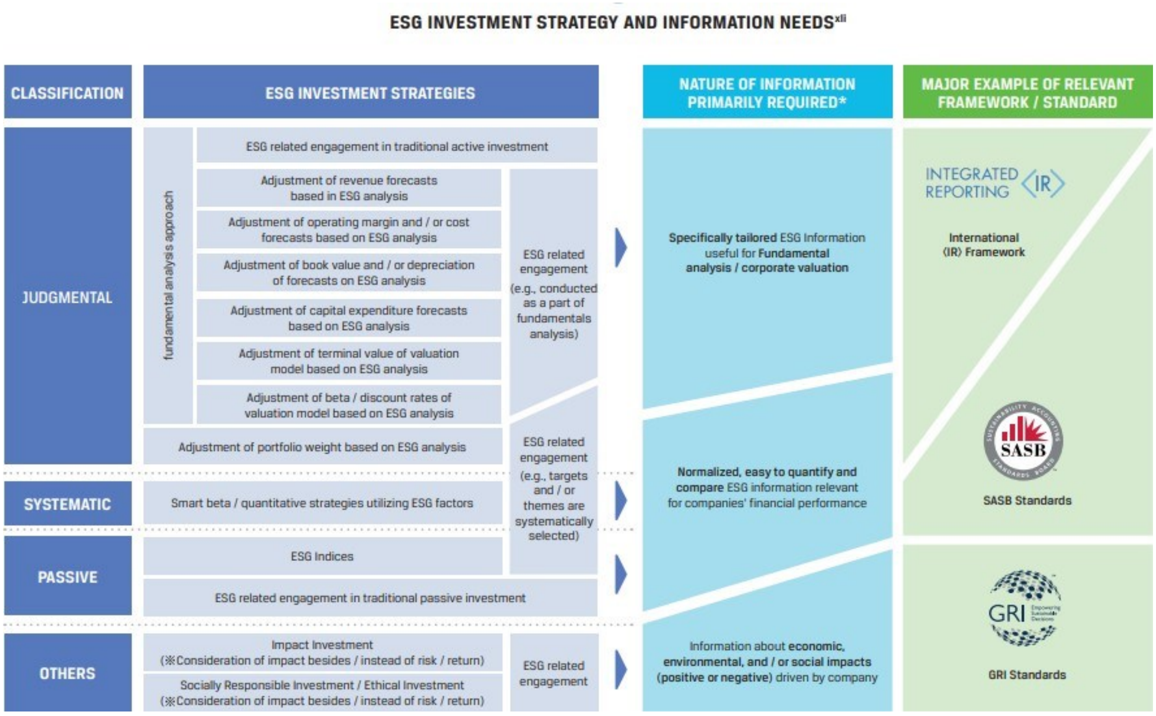


Figure 14: Most basis ESG information required for each some common ESG strategies and relative framework or standard used. Source: Prepared by Nissay Asset Management Co. Ltd. based on CFA & PRI: Guidance and Case Studies for ESG integration (2018)

Where do we stand now in Europe?

EU law requires certain large companies to disclose information on the way they operate and manage social and environmental challenges.

The primary reporting standard is represented by directive 2014/95/EU – also called the Non-Financial Reporting Directive (NFRD) – lays down the rules on disclosure of non-financial and diversity information by certain large companies. This directive amends the Accounting Directive 2013/34/EU. EU rules on non-financial reporting currently apply to large public-interest companies with more than 500 employees. This covers approximately 700 large companies and groups across the EU. On 21 April 2021, the Commission adopted a proposal for a Corporate Sustainability Reporting Directive (CSRD), which would amend the existing reporting requirements of the NFRD. The proposal extends the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises), and all large companies (listed or not) meeting two out of three of the following criteria: a balance sheet total of €20 million, net turnover of €40 million and 250 employees on average during the financial year. The proposal adds a required audit of reported information, introduces more detailed reporting requirements and a requirement to report according to mandatory EU sustainability reporting standards, moreover, requires companies to digitally 'tag' the reported information, so it is machine readable and feeds into the European single access point envisaged in the capital markets union action plan.[18]

The CSRD is being reviewed by the Parliament and the Council. It should be agreed in 2022 and the potential application will be from 2024, with companies reporting on the 2023 financial year. If adopted, the CSRD will mark an important additional change in corporate reporting and will help overcome the informational barriers regarding the ESG integrations.

Nowdays different private association introduce standards to guide the disclosure of financially material sustainability information by companies to their investors. The most important is represented by the Sustainable Accounting Board Standards (SASB), a global oriented guide available for 77 industries. The Standards identify the subset of environmental, social, and governance (ESG) issues most relevant to financial performance in each industry. SASB standards are cost-effective for companies to use and are developed using an evidence-based and market-informed process similar to the one used to develop financial accounting standards. SASB aren't the only one accepted reporting standard or framework. In Europe for example NFRD leaves a fair amount of flexibility regarding the reporting process. Accordingly, it gives companies significant flexibility to disclose relevant information in the way they consider most useful. As a result, companies may include a non-financial statement in their management report or, under certain conditions, prepare a separate report.

International and European non-financial reporting frameworks and standards include, other than SASB, the Global Reporting Initiative (GRI), the International Integrated Reporting Framework (IIRC), the Task Force on Climate related Financial Disclosures (TCFD), the United Nations (UN) Guiding Principles Reporting Framework, the UN Global Compact, the

[18] DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL, amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting; 4th April 2021.

OECD guidelines for multinational enterprises and ISO 260000. It should be noted in this context that the Commission, in July 2020, mandated the European Financial Reporting Advisory Group (EFRAG) to develop recommendations for a European non-financial reporting standard, that will be applied starting in 2022.
The application of these accounting standards and framework will surely help to overcome the need of a standardization of the ESG performance, but are themselves a barrier, due to the large numbers of standards that could be applied. Additionally, the requirements for a sustainable reporting affect only a small part of EU companies, leaving aside smaller companies that are commonly adequate for PE investments.
Although the change in scope of the amendment of the NFRD appears to be significant, continues to leave out of scope the European SMEs, that in 2021 were approximately 22,6 million, around the 99% of all enterprises, of which 93% of micro-enterprises that are too small to be subject to information legislation.

A strong ESG integration should be also encouraged trough education and expertise. The survey of Eccles and Kastrapeli (2018) shows as institutional and retail recognize how training on ESG to sector portfolio managers and analysists could be the best option to reduce the barriers on ESG integrations (34% of respondent), in addition also increase headcount in ESG expertise (23%) and hire external ESG consultant (15%) are seen as enablers for ESG integration.
Full ESG integration cannot be done when there is a sharp dividing line between the portfolio manager and analysts who are only held responsible for financial analysis, and a separate small group of ESG analysts who handle proxy voting and attempt to influence the decisions of the sector specialists. Therefore, integration require a strong degree of internalization of ESG factors by sector specialists.
Introducing training, with the ultimate goal of making sector portfolio managers and analysists responsible for determining what they believe are the material ESG factors and how they may affect financial performance
Collaboration between portfolio managers and specialists is essentials since as sustainability becomes more integrated into the investment process portfolio managers will need to become more engaged in the conversations, moreover analysts must be able to incorporate these issues in their analyses.
Currently there is a high demand for ESG expertise, an encouraging signal for the integration. A review of CFA Institutes[19] described as on more than 10.000 job posts in LinkedIn, for

[19] CFA Institutes (2021) – Future of Sustainability in Investment Management: from ideas to reality

investments related positions, around 7% of them mentioned sustainability-related skills, with peak of 18% and 9,7% for job positions of Portfolio Managers and Chief Investment Officer, respectively.

ESG training is strictly correlated with the organizational structure. There are different studies that report as when the decision to implement an investment plan is placed in the hands of a CIO instead of a broader investment team, an ESG investment is 40-50% more likely to be adopted. (Cumming & Johan, 2007; Guyatt, 2005).

Across all investments professional roles with sustainability-related expertise these professionals receive on average more LinkedIn recruiter in mails during the year compared with all other investments professional talent pools on LinkedIn.

Together with a higher demand also the supply of ESG expertise is growing exponentially, either through academic education or previous work experience. There is an established job market now, but there is still a lack of talent/specialized skills in the space relative to the high demand of talent.

In a sample of approximately 1 million of investment professionals in LinkedIn only the 0.8% disclosed sustainability-related skill in their profile. Should be noted that this kind of analysis can detect only the sub-sample of professionals that keep their LinkedIn profiles up to date with their skills, but it is reasonably to think that not all individuals list relevant skills on their LinkedIn profiles. However, due to the high demand of this skillset, the likelihood that profiles that have been kept relatively current in this regard is increased.

The same studies reveal there has been a 25,6% growth is sustainability expertise during the 2021, with analysts and portfolio managers that reach an increase of 34% and 32% respectively.

Job Title Family	Job Posts on LinkedIn	Seeking Sustainability Skills	Ratio
Portfolio Managers	1.032	186	18,0%
Analysts	1.519	27	1,8%
Fianancial Advisor	7.571	364	4,8%
Chief Exective Officier	4	-	0,0%
Chief Investment Officier	31	3	9,7%
Total	**10.157**	**580**	**6,9%**

Job Title Family	Profiles on LinkedIn	Profiles that show ESG-related skills	1-year sustainbaility expertise
Financial Advisor	630.000	0,5%	32,0%
Portfolio Managers	146.000	1,5%	32,0%
Analysts	180.000	0,7%	34,0%
Chief Exective Officier	37.000	1,9%	12,0%
Chief Investment Officier	15.000	2,0%	18,0%
Total	**1.008.000**	**0,8%**	**25,6%**

Figure 15: ESG demand and supply in LinkedIn in the investment industry. Retrieved from CFA Institutes (2021)

Training has increased during the last years, especially in EMEA where 48% of investment firms declare to have provided ESG training for some employees at their company in 2020.
Training is challenging since it should not just turn in a compliance exercise. Portfolio should be better how ESG risk can affects the performance of the target company and understand how to manage tail-risk. Some difficulties can arise considering very senior portfolio manager that for years may have experienced a positive performance without considering ESG, for them a different approach for the investment process could be more difficult to understand.
Considering EMEA the survey of CFA institutes underlines as only the 3% of respondent has no interest in building skills and knowledge regarding ESG analysis, and 69% of them is planning to pursue training within few years.

3.5. The role of disclosure and communications

Several academics highlight that ESG information is relevant to explain the positive relation between sustainability and firm's performance, showing how an adequate disclosure can enhance the positive effect of ESG policies and drive value creation.
Many studies empathize how many firms, especially large multinational ones, have intensified their efforts to report on ESG matters in order to legitimate their behavior and improve their reputation in the last 20 years. A trend has been investigated by KPMG which elaborated over years a survey to analyze the level of CSR reporting worldwide: in 1996 the firms that produced a sustainable report where only 300, today more than the 80% of firms worldwide report on sustainability. (KPMG, 2020)
While many firms have adopted the Global Reporting Initiative (GRI) guidelines, the dominant global standard for sustainability reporting, the extent and quality of ESG disclosure remain heterogeneous. (Iaonnou & Serafeim, 2017)

Such effort in disclose ESG results and how CSR activities are undertaken can have different reason beyond the obvious wish to emphasize firm strengths and “hide” weaknesses. Disclosure may be used to explain changes in ESG policies or to remedy to a reputational damaged caused, for example, by an environmental harm. (Fatemi, et al., 2018)

Voluntary disclosure theory (Verrecchia, 1983) state as manager exercise discretion in disclosing information, unveiling only good results as an excellent ESG performance, instead of disclosing an unfavorable report.

As a consequence, withheld data introduce noise in market since investors can interpret these information in different ways and not as unambiguously ‘bad news’, and thereby discount the value of the firm to the point that the manager is better served to disclose what he knows.

According to this framework, firms signal their ESG performance to distinguish themselves from poorer performers trying to avoid the consequences of adverse selection. (Akerlof, 1978)

A good ESG performance and an adequate disclosure can generate positive publicity, contributing to generate value (or reduce the cost of capital) when accompanied by a favorable media coverage.

Fatemi, Glaum and Kaiser (2018) found empirical evidence of the positive relation between disclosure and firm values.

In their study when in presence of ESG strengths, high ESG disclosure vehicle the positive valuation effect of the strengths. A possible explanation is that the markets may read the higher disclosure as the firm's attempt to justify an overinvestment in ESG activities. At the same time disclosure also attenuate the negative valuation effects in case of ESG concerns, perhaps either because disclosures help firms legitimate their behavior by explaining to investors the appropriateness of their operations or ESG policies, or because firms convince investors that they are trying to improve their ESG performance.

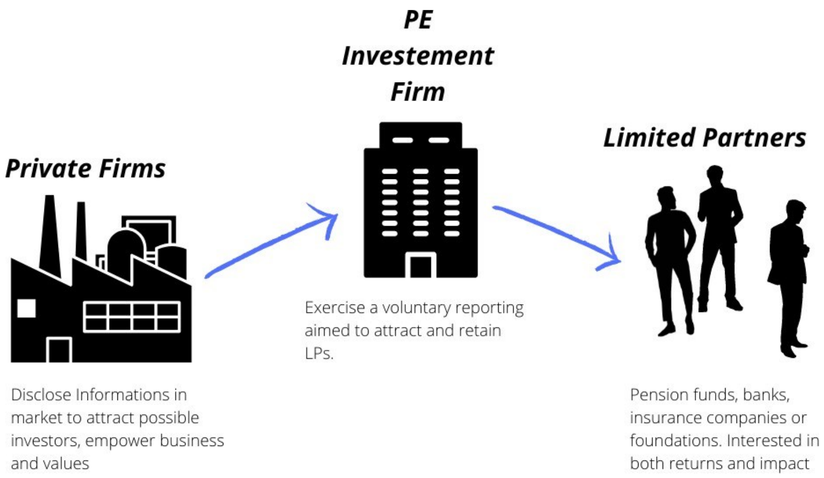


Figure 16: Communication flow in Private Equity Market

In this context a PE investment firm is placed in between private firms and LPs. From one side it is the receiver of the voluntary disclosure generated by firms to empower their business and value, on the other side it is itself the creator of voluntary reporting aimed to attract and retain LPs. These two opposites are inextricably linked since the sustainable reporting created by PE firms and addressed to LPs is also based on the disclosure of their invested firms, without them would be incomplete and unsuitable to attract LPs in his deeper meaning, by communicating the sustainable investment policy and results of the company.

General Partners play an important role in awareness-raising for LP investment teams, an efficient communication about values and responsible investing approach can help convince LPs that is a standard part of excellence in fund operations.

In the Private Equity markets Limited Partners, who are the stewards of capital, enjoy of fiduciary duty with the PE firm to ensure their committed capital is managed appropriately and in line with their interests and policies. An evidence is BlackRock, where their first and third operating principles are “we are fiduciary to our clients” and “we are passionate about performance”, respectively.

For investors, including LPs and General Partners the focus is shifting from “if” they should integrate ESG to “where, how, and if it is feasible?” and key drivers as value creation and risk mitigation (UN PRI, 2020), nonetheless BlackRock’s new operating principle (the 5th) is “We are committed to a better future”, specifying as “they advocate for sustainable and responsible business practices that drive long-term value.”[20]

LPs generally remain at arm’s length for their private equity investments, this means decide to commit capital to a fund based on GPs internal process and systems, LPs primary need is to ensure the General Partners will be able to face and manage future ESG risks within a due diligence process. Capital commitment is often a blind pool, LPs cannot know where their money will be invested in advance, underline asset are revealed only after the capital raising period of the fund, that can last until 7-10 years.

Therefore, LPs must pay attention to funds reporting, policies, and procedures prior to the capital commitment, how that? By looking to prior engagements when doing their due diligence.

A good communication can attract LPs because create an expectation, and better will be the reporting, better will be the expectation created.

The reason about the importance of communication and reporting for a PE firm is the fiduciary duty.

[20] Retrieved from BlackRock principles - https://www.blackrock.com/corporate/about-us/mission-and-principles -accessed 25th May 2022.

Fiduciary duties (or equivalent obligations) exist to ensure that those who manage other people's money act in the interests of beneficiaries, rather than serving their own interests. The most important of these duties are:

- Loyalty, since fiduciaries should act in behalf and within the interests of beneficiaries, avoiding conflict of interests or act for the benefit of themselves.
- Prudence, since fiduciaries should act with due care, skill and diligence.

Fiduciary duties are then imposed upon a person or an organization who exercises some discretionary power in the interests of another person in circumstances that give rise to a relationship of trust and confidence. Fiduciary duties became important in asymmetric relation where the beneficiary has limited ability to monitor or oversee the action of agent, the General Partners in our context.

While the core concepts of prudence did not in change in the last decades, loyalty includes now a broader area of interests and concern, and investors should answer to questions as: "Should investors take account of ESG issues in the investment process? Should they encourage higher standards in sustainable performance in target companies? How should investors respond to new risk and opportunities arising in this period?".

Over the past years there has been relatively little change in the law relating to fiduciary duty, while the law may not change quickly, there is likely to be increased use of disclosure requirements and soft law measures to encourage investors to pay greater attention to ESG issues in their investment practices and processes. (UN PRI, 2015)

The first consideration of ESG issues in the fiduciary duty definition appear in 2005 with the Freshfields Report[21] that argue for the first time that ESG issues can be material and that investors should, therefore, take account of these issues. At the time such as declaration sound controversial, nowadays looks like prophetic.

Today, the evidence from the academic and practitioner literature is seen by most investors as being robust enough to argue that, at a minimum, fiduciaries should consider ESG issues as part of their investment process. There is, however, an important difference in practitioners' perceptions of corporate governance issues and social and environmental issues.

Most of investors state that corporate governance issues are the most robustly tested and understood in terms of their impacts on investment performance, while social and environmental issues and their integration in the investment process is difficult to evaluate and understand, furthermore a lack of standardized reporting on these issues makes it difficult to draw conclusions on their financial implications. (UN PRI, 2015)

[21] Freshfields Bruckhaus Deringer (2005) - A legal framework for the integration of environmental, social and governance issues into institutional investments.

In this context fiduciary duty may be seen as an obstacle, a requirement that informs investment and management practice in a similar manner to aspects such as costs and investment returns. Instead, fiduciary duty should be seen as a process test, without focusing on the resulting decision. Though regulatory authorities generally do not consider whether or not asset owners should invest in particular sectors or activities, instead they focus on the ability of asset owners to manage ESG risks, and to pay close attention to decisions that lead to skews in portfolios. Regulatory authorities will tend to look closely at investment decisions that expose funds to particular risks (e.g., a portfolio with a massive weighting to renewable energy) and will expect them to explicitly assess the implications for the overall risk profile of the fund.

This suggests that asset owners may take account of wider ESG issues, so long as there is a clear accordance on beneficiaries' interests, and specific decision at portfolio level may be seen consistent with fiduciary duties as long as this decision is based on credible assumptions and a robust decision-making process. This requires trustees to have the discipline to set out their investment beliefs, to be able to show the relevant risk assessed and to be prepared to review the investment outcomes achieved and to have the willingness to change if the data changes or if the decision is causing significant damage to the beneficiaries' best interests.

A clear definition of material ESG issues, a well-established fiduciary duty and communication with LPs, and an efficient disclosure can ensure the integration of ESG in the whole investment process.

It can be defined in four modules

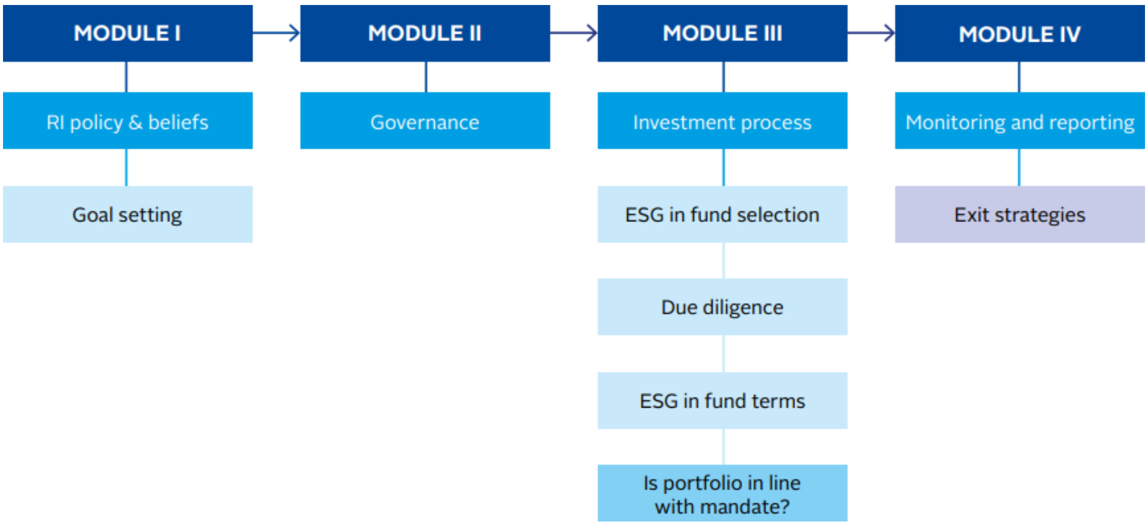


Figure 17: Integrating ESG into the whole investment process, source: UN PRI - Technical guide for limited partners: Responsible investment in private equity (2020)

The first module describes the initial process of the integration, it defines the beliefs of the company, the aim of the business and the policy they will apply. It establishes how the organization views ESG issues, and the goals of their responsible investment practice is helpful in sending a consistent message to the organization and limited partners. Clarity on why the organization is interested in responsible investing is key for developing an organizations' approaches and criteria for decision-making. The last step of this phases defined the goal setting of the PE company. Setting goals (aspirational, interim, qualitative or quantitative) is an important part of developing a coherent responsible investment strategy. Goals might be set using existing standards from the industry or business sector or following industry peers.

The second module describe ESG consideration in specific governance structure and how the business is run following the ESG policy created. The Institutional Limited Partners Association's (ILPA) has recently published Private Equity Principles 3.0 (2019) in which are defined a set of initiatives LPs should conduct to introduce private equity fund governance best practice.

The third module focus on the investment process. It enters in detail of the implementation of the responsible investment practice and executing of the investment decision. Challenges, tools and resources are described in this module. A limited partner may consider investing with a GP that does not provide adequate responses during the due diligence process if they believe the GP has the willingness and capacity to elevate their efforts during the life of the fund. In such cases, recognition by the GP of the importance of ESG issues and/or a formal commitment to improve its approach to responsible investment, and report on its progress to the LP, might be expected before making a capital commitment to a fund. During the due diligence phase the consideration of ESG issues are assessed

The last module it's finalized to the disclosure to stakeholders, including LPs. It comprehends the monitoring and reporting of performance and initiatives at portfolio companies and GP. UN PRI defined a set of key LP monitoring practices emerged as recurring:

- Exception based reporting, for any information that LPs prefer not to receive on a regular schedule timeline.
- Uses of Investors meeting and LPs Advisory Committee (LPAC)
- Uses of monitoring templates, to constantly collect information and track progress homogenously
- Assessment of the ESG score
- ESG incident monitoring, to report incidents that could have serious reputational or financial implications for the investment companies and LPs.
- Reviewing GP's internal ESG/CSR Management and initiatives

LPs are monitoring GPs on ESG integration to better understand fund's portfolio operations and to gain assurance the GPs is fulfilling its commitment to responsible investment practice. Private Equity is a trust-based business. Despite LPs have a clear understanding the role of GPs in ESG issues monitoring and portfolio company management. But, as stewards of their capital LPs are entitled to monitor the effective management of the assets in line with their expectations and by doing so they are setting expectations around any future re-allocations of capital.
Information required by LPs are usually material to the business model, future proofing and exit proposition for the portfolio company. Monitoring requirements, as introduced before, may be different for time and contents. Commonly are macro-reports on specific ESG issues, supported by an agreed set of KPIs.
KPIs are essential in ESG understanding but not exclusive, ESG disclosure indeed is more about achieving a shared understanding of how ESG can impact the value of underlying investments, as seen in previous chapter. (UN PRI, 2018)

Figure 18: Value Proposition of reporting. Source: UN PRI (2018); ESG Monitoring, Reporting and Dialogue In Private Equity

What's next for ESG monitoring and reporting?
Risks and opportunities of ESG practices are still evolving and with them also monitoring and reporting tools.
Critical point is given by the quality of data and confidence building measure.
Today the abundance of data collected and shared by private equity owners and investors in exponentially growing, so too the demand for data assurance.

One of the main controversial aspects of sustainability metrics relies on the accuracy, transparency, and reliability of the information that is at the basis of the scores. Normally, evaluations by ESG rating agencies are made using complex questionnaires and an analysis of public information sources. ESG raters may adopt different definitions of ESG performance or they may measure the same item in different ways; however, they primarily base their analyses on non-financial information released by companies. The primary source of rating agencies' information relies on the reporting issued by companies. But where financial reporting has reached standardized forms at an international level, non-financial reporting is still in its infancy. Indeed, if the information that rating agencies receive from companies is noisy at best, the released scores will be also.

Audit practices on non-financial information are taking place to cover this need but most of the times is not mandatory and, especially small firms, denied it due to the related addition of costs. As data quality improves also the technology used to process the information will improves too. One area to develop is the automation of reporting process and with it also the availability of data analysis tools. Together it will help a further homogeneity of data and a better extraction of information, with a more deeper detail level.

As "big data" technology improves, LPs and GPs will have more access to database that allow benchmarking of portfolios company ESG performances, and reporting may involve the use of increasingly sophisticated KPIs.

Chapter 4

4. Empirical Analysis

The purpose of this chapter is to assess the extent and development of ESG integration in the Italian Private Equity industry. As of today, there are only few research about the ESG integration in Italian PE firms and none of them that cover the integration form an overall point of view, ranging from a wide set of characteristics: from the materiality of the issues, changing in the organization structure, integration within the different phases and drivers/obstacles for integration.

The environment of Italian PE firms is various and their scope is wide, consisting of different point of view regarding ESG, different ESG strategies and state of integration, moreover the industry is characterized by a rapid development and a growing interest in the field of sustainability. In order to pursue my objective I followed the approach used in previous studies, as the work of Crifo & Vanina (2012), Falch (2016), and Zaccone & Pedrini (2020).

The Private Equity industry is strongly heterogeneous. The 2021 AIFI report for PE and VC reports the existence of 206 operators in Italy that had conducted at least one operation of investment/divestment or founding of capital (+47% compared with the 140 of 2020).

PE industry in Italy is not a recent phenomenon. It was born during the 90s but in the next 30 years did not reach the same maturity as in US or other European countries.

The critical factors are mainly the funding of capital, the small dimension of Italian enterprise, the absence of a PE culture, the family structure of SME and an ecosystem that is not integrated. The small dimension and the family structure of Italian SME represents two critics point for the development of PE in Italy. Italian entrepreneurs tend to be rooted to traditional way of funding as bank loans and are diffident to accept the support offered by PE operator, moreover they not always agree with the inclusion of new managerial resources, showing more close and less elastic to a development prospective.

Thus, what emerges is the absence in our country of a private equity culture and the lack of an integrated ecosystem among the various parties: funds, operators and companies.

The result is an environment that is strongly heterogeneous, as confirmed by the AIFI database, in which can be found big international PE firms as Advent International, Bain Capital, CVC or Carlyle, and much smaller firms that may operate only at regional or local level. As consequence, the AUM and average size of investments have huge variations within the database, showing important differences in the organization structure. In parallel we can find different situation regarding the perception of ESG, some firms may do not have any formal policy for ESG integration or a dedicated staff while some others may have a specific office and policy.

To conduct the survey I decided on a multiple method research strategy (Creswell & Clark, 2007), with a mixed-methods convergent-parallel design, which implies collecting and analyzing quantitative and then qualitative data concurrently during the same study.

This design is helpful because allow a more complete understanding from quantitative and qualitative database and corroborating results from different methods. (Terrel, 2012)

The choice to use a convergent-parallel design instead of an explanatory-sequential design is due to the possibility to collect all the data in a single time. This possibility is extremely important when working with PE firms, since may be difficult to obtain a time slot for an interview, especially if conducted with a Partner or CEO. Moreover, the convergent design is more intuitive and efficient and therefore represents an optimal choice for the survey strategy.

All the project is based on a digital survey, collecting answers through a questionnaire. The questionnaire is considered an optimal strategy to collect standardized data and facilitate their representation and comparation, which is helpful to gather different characteristics from a wide range of firms. The questionnaire is divided in 2 main sections.

The first section is aimed to define some descriptive characteristics of the firm. It gives me the opportunity to have an overall assessment of the industry and descriptive statistics, such as AUM, average size of the investment and head count of the local office. Thus, this section helps to outline a portrait of Italian PE industry.

In the second section of the questionnaire, I engaged a mixed qualitative-quantitative method through multiple choices questions.

This section is aimed to further analyze the extent of the integration of ESG into the investment process, what pushes it and the obstacles present. Moreover, part of the questions analyzes the actual and future perception of ESG in PE environment and the relationship with LPs and portfolio companies. It helps to obtain a richer understanding of the specific dynamics that define the industry.

The decision of use multiple-choice question relies on the speed and ease of response that this option offers, that is helpful because can strongly reduce the time required to fill the questionnaire and therefore increase the response rate.

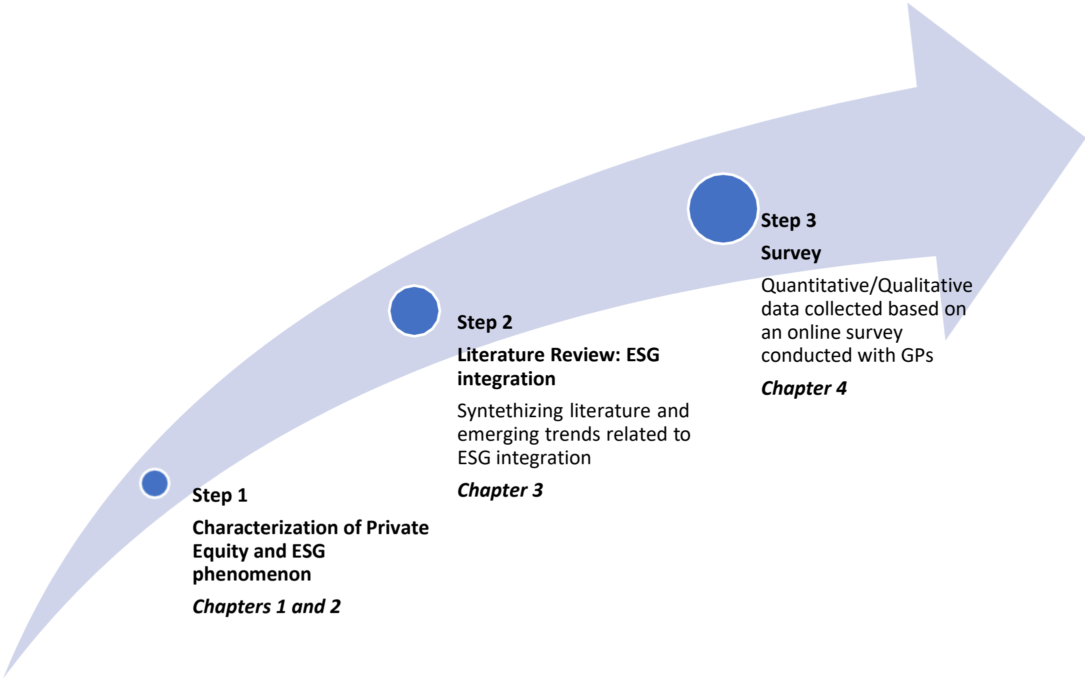


Figure 19: The thesis' main steps

4.1. Survey

Survey strategies are used to obtain evidence from a certain obtained sample that can be extended to a larger population. (Taylor, et al., 2006). In order to obtain this useful evidence is important to understand the environment and identify a complete set of cases that the sample is going to represent.

I decided to use the AIFI (Italian Association for Private Equity, Venture Capital and Private Debt) database to build my sample, thus I was able to single out all most important PE firms operating in Italy.

In my search I included all the firms operating in private equity and venture capital, and therefore excluding from the database all the firms operating in infrastructure and private debt since I have not focused these asset class on previous chapters.

I retrieved the data from AIFI database in August 2022. The database if formed by 175 companies, 111 of them operating in PE (usually together with venture capital, infrastructure or private debt) and 22 operating strictly in Venture Capital. I looked into every investment firm online and I decided to exclude all the firms for which there were no contact as emails or webpage (7 companies). Moreover, I excluded another 2 firms since were no longer in operation. Finally, I decided to exclude 46 firms because they were not relevant to my study, being for example located outside Italy, primarily interested in infrastructure or private debt, too small or without any investment in place.

These cuts reduced the final sample to a total of 78 PE or VC firms with their headquarters in Italy, a sample size related to a single country in line with the study of Falch (2016). It's important to underline I analyze the database at PE firm level, and not the fund level, since a single firms may manage multiple funds.
To increase the rate of response I sent all the questionnaires though emails, whenever possible I sent it to a personal address of a specific member of the firms, usually occupying a position of Partner, Investment Manager or Head of ESG, if present. If a personal address was not available I sent the survey to the generic mail of the organization, asking to forward it to a specific member as before.
Based on findings in recent report or articles I developed a set of relevant question to ask to Italian PE industry to map the extent of ESG integration and the point of view of PE trends and environment.
The final survey consisted of 32 questions (the complete questionnaire served to firms can be found in the appendix). All the question were closed-ended, providing a final and complete set of responses where the respondent where to choose between.
The closed-ended form of the question eases the answer for the respondent and simplify the understanding of the responses, therefore facilitating the subsequent data analysis.
I have used different multiple-choice questions, some of them are with single answer, other that allow multiple answers.
Single answer MC questions are optimal with binary questions, such as evaluation scale where you can assign a score from 1 to 10, but not more scores. A multiple answers question allows to choose between different option, without necessarily assign a score, this format allow to represent a multiple preference of the responded, for example respect to the obstacles perceived in the ESG integration.
Some of the answers were exposed using a Likert Scale, where the respondent had to assign a score representing his grade of agreement/disagreement for a statement (Likert, 1932).
While I have applied a convergent approach, my research is conducted using a cross-sectional sample rather than longitudinal, meaning that the analysis of data refers to a specific point in time and therefore can provide a well-defined snapshot into the industry.
After finalizing the survey using Google Forms, I made some trial with some university colleagues to make sure no questions could be misunderstood and the entire questionnaire could be completed in 10 minutes at most.
The execution of the summary took place during August 2022. The first week I sent the first 10 survey, explaining in each mail the purpose of the thesis and underlining the link for the survey. I had no responses in the following days, probably due to the summer holidays. I sent the

remaining 60 mails at the end of August, trying to take advantage of the return from the summer pause and the first days of September I received the first 6 answers. The first week of September I re-sent the emails to most of the companies I previously contacted at the end of August, trying to get few more responses. When I closed the survey (25/09/2022) I obtained 9 official responses, with a response rate of 11,54%, representing a small but still valuable range of PE firms.

4.2. Assessment of quality

To assess the trustworthiness of the results I examined the reliability and the validity of methods applied. For a further discussion about the empirical analysis in chapter 5.1 Research Limitations and Suggestions, are analyzed possible limitations of this study.

Reliability

Reliability concerns linked to research design (the methods used to collect and analyze data) are avoided since the techniques used has been carefully detailed before, in order to generate the same results if conducted in another study. (Saunders, et al., 2012)

As said before the aim of the study is to obtain a snapshot of the ESG integration in Italian PE firms in August 2022. As confirmed by literature and different respondent of the questionnaire, ESG integration and sustainability are emerging trend and will probably develop in the next years. The dynamics threatened the reliability of results, since in few years the survey might evidence different results. Moreover, I conducted the study alone and that may have an impact on the objectivity of the analysis.

Before elaborating the survey, I studied different survey submitted after 2015 and I studied the different approach and design used to define an optimal strategy for my objective. Furthermore, the detailed literature review about PE and ESG-related topics and the design used for the questionnaire limits the possibility of threats to reliability of the study.

Validity

A questionnaire to be considered valid must generate accurate data that correctly measures the hypothesis it is mean to be measuring (Saunders, et al., 2012). In design the survey Saunders recommend using an online survey to collect, enter and analyze the data within the same software. I have utilized Google Forms to conduct the survey, since it’s easy to use, allow to keep track of all the answers and Google platforms are widely used.

External validity of the study, to be understood as the ability to generalize the results to other relevant setting or groups, is confirmed by similar results obtained in survey regarding ESG integration in other geographical areas, as Nordic country (Falch, 2016) or France (Crifo & Forget, 2012). The differences between the results of the studies are mainly due to a different culture and maturity of PE industry in Italy respect to other European countries.
Other than external validity I asses the internal validity of the study, that is the extent to which the findings can be attributed to the interventions rather than any flaws in your research design. A threat for internal validity of the studies is represented by past or recent events that might changes respondent's perceptions. The short time span of data collection (about 1 month during the summer period) ensure that no events could have probably altered the nature of the responses.
It's important to underline that the respondent filled the questionnaire in voluntary manner. They may have been firms with a defined ESG policy in place and with an interest to be part of the study, and this may have influenced the results.

4.3. Analysis of results

In this section I will go through the different questions of the questionnaire and provide the results of the online survey. The first part is related to descriptive statistics of the respondent to introduce the readers about the sample of firms responding to the survey. All the results are presented using euro as currency.

4.3.1 Descriptive Statistics

The overall response rate obtained is 11,54% (9 firms out of 78 firms).
Most of the companies surveyed (89,7%) are located in North Italy, mainly in Milan. Only the 9% are localized in central Italy and a single firm in Naples. That provide a picture of the concentration of the private equity market in the Italian territory.
The survey investigated which investment strategies where pursue by respondent, that represented both Private Equity (55.6%) and Venture Capital asset classes (44,4%).
To assess the dimension of the company I investigated the headcount of the office, AUM and average size of the investments. Together these 3 variables can give a good snapshot of the size

of a PE/VC firm and therefore its ability to attract capital and develop a more structured investment process.
Companies of the sample are relatively small, with majority of them (67%) reporting an headcount between 10-20 employers.
In terms of Asset Under Management (AUM) the sample shows confirm the overrepresentation of smaller firms, with only one firms with more than 500 mln AUM, while the 78% manage assets for 250-500 mln. As consequence, the average size of investments is relatively small with the 56% of respondent that report to invest between 5 and 20 mln for single investment.
Most of respondent outline as their investment are mainly directed to Italian SMEs. Only 1 firm (Respondent #7) reported to vary its investment range across different area as West Europe, North America or Asia.
It is important to underline as Respondent #7 represent the biggest company in our sample in terms of AUM and dimension of organization and therefore has more investment resources and opportunity, allowing a diversification of geographical area for their investments.

4.3.2 ESG Integration and Materiality

This section is aimed to analyze the integration process of ESG into investment decisions and the relative importance of Environmental, Social or Governance issues.
Due to the heterogeneity of size and resources for Italian PE firms some of them do not apply (or partially apply) ESG principles in their investment process.
To initially discriminate these companies I started with a question to assess the application of ESG principles in their activity, if the answer was negative the respondent was directly referred to the section about difficulties and obstacles for the ESG integration, that will be analyzed in chapter 4.3.3 Drivers for Integration and Obstacles.

The results of the questionnaire report that majority of companies apply ESG principles into the investment process. 3 firms report to partially apply these principles.
During the collection of the answers I received a mail from a company of the initial database that report to not have any formal policy yet regarding the application of ESG principles, but they partially apply them by not avoiding investment in companies that manifest a clear conflict with ethical and sustainability issues. To have a homogeneous approach all the responses

arrived out of the tool designed to collect the answers (the online survey through Google Forms) were considered invalid.

The companies that report to consider ESG principles were directly referred to a section focused on the materiality of ESG[22]. The respondents were asked to express a grade of importance for some ESG issues reported by UN PRI (2018). The alternatives represent the most relevant ones arose from previous studies.

The objective of this section is to point out the most important issues for PE firms regarding ESG. Each issue belongs to E, S or G group, I choose 5 issues for each category. By summing the grade obtained for each issue belonging to a specific group we can test which is more important between E, S and G (higher the total rate higher will be the importance).

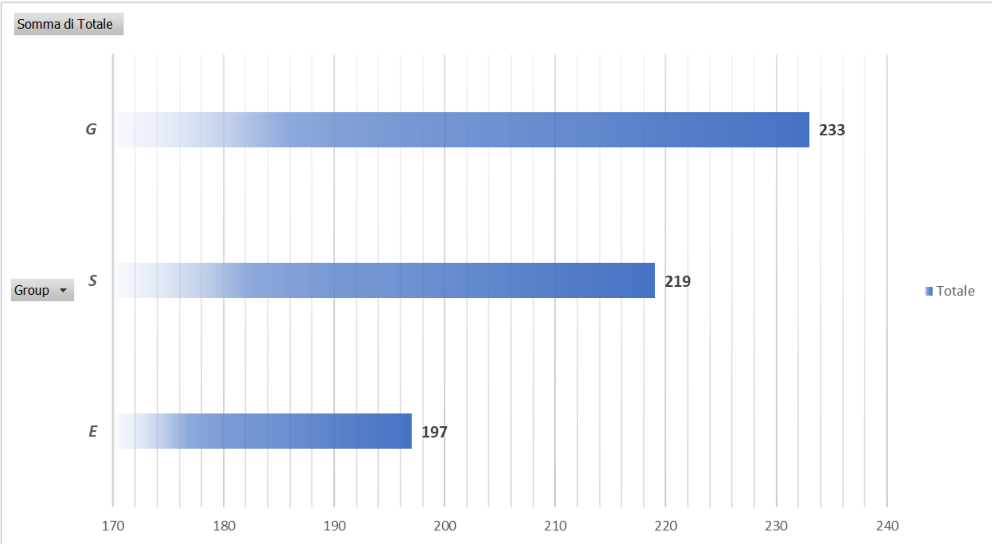
To avoid any influences regarding the preferences between one group or another I decided to mix the different options, without specifying in which group belong the issue. In this way the respondent was forced to strictly evaluate the single issue without considering the belonging group (environmental, social or governance).

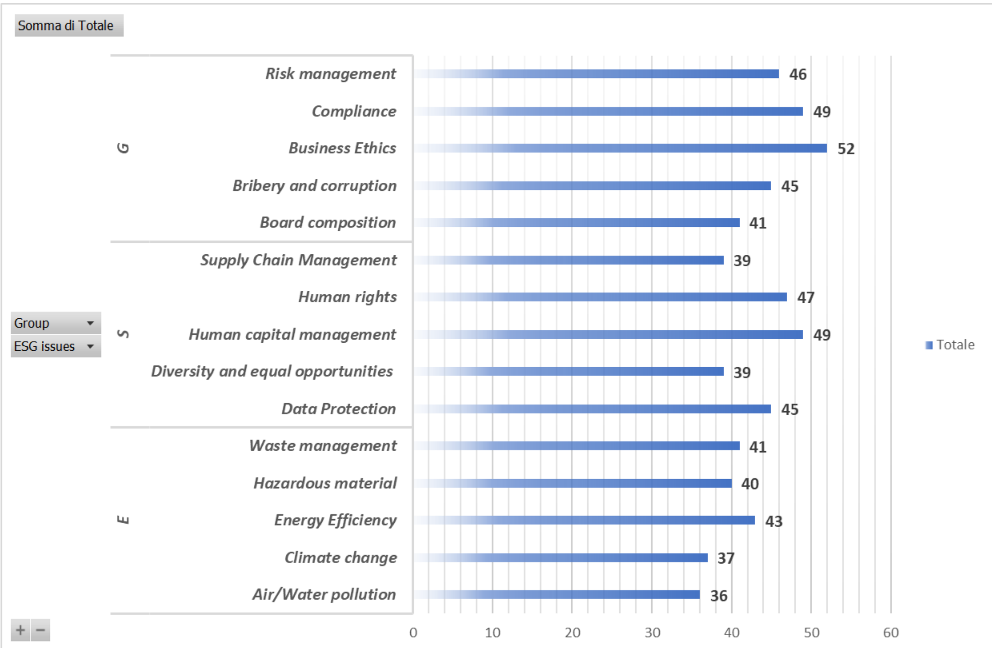
The aggregated results are reported in the Appendix B) *Table.1 – ESG issues analysis.* For privacy concern, the respondents are indicated with a number.

Governance and Social groups reported the higher score. The most relevant issues for PE firms are “business ethics” and “compliance” (both associated with Governance) and “human capital management” (Social).

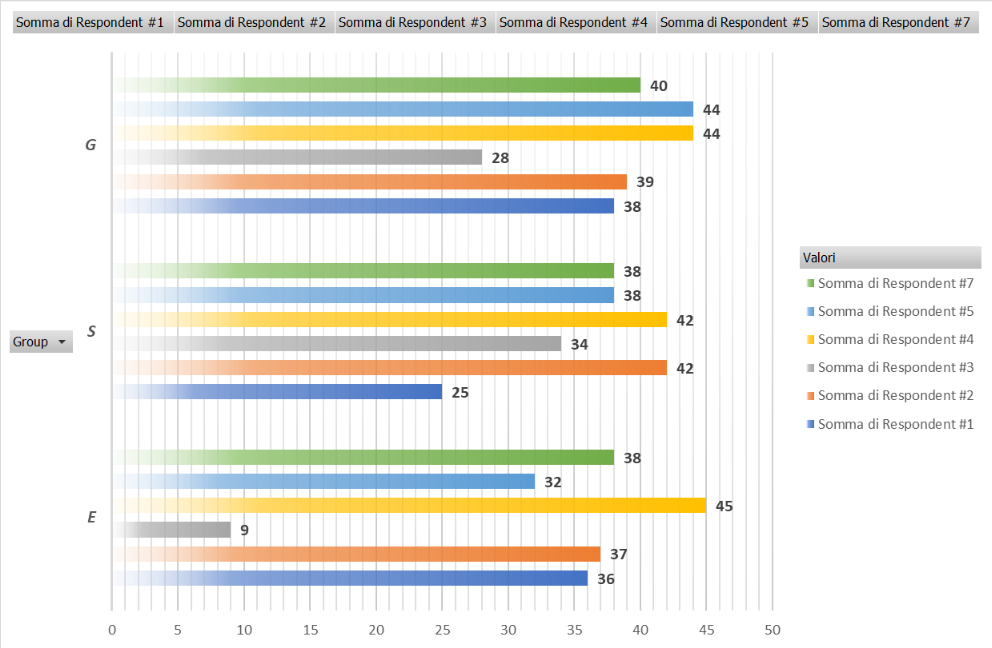
[22] A detail regarding ESG materiality is defined in chapter 2.2 Business model and investment model in sustainability era

Environmental issues show a lower interest by Italian PE firms, despite the pressure of social media and journals regarding climate change and pollution, that surprisingly reported the two lowest scores.





It is important to notice the variance of these categories, S and G report huge difference in variance respect to E, since the scores assigned by respondent were similar for all respondents. The high variance for the Environmental group is due to an outlier, the respondent #3, that report a much lower interest in environmental issues respect to the sample average, and therefore affect the variance of the group. At the same time in the Environmental area there is also the respondent that report the higher score (respondent #4). These differences inside the same group express as the perception of this category might have relevant variations within the industry.



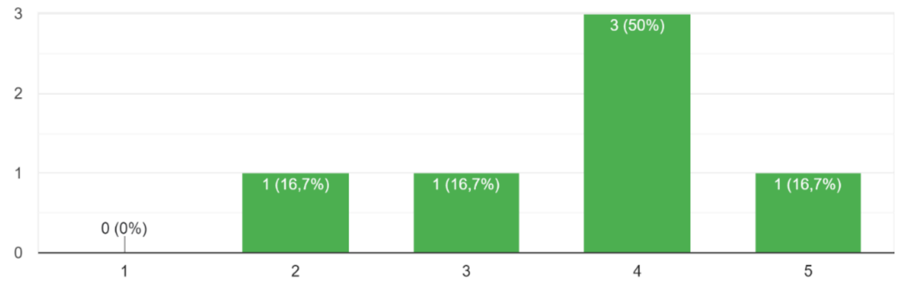
The results obtained in this study of materiality are coherent with the evidence of Falch (2016), in which Governance and Social group reported the higher scores, with business ethics reported to be the most relevant issue for GPs.

This evidence is important when combined with the study of Friede, Busch and Bassen (2015) about the effect of each group on financial performance, detailed at the beginning of Chapter 3. ESG integration: Drivers, Obstacles and Disclosure. In their academic study they shown as Governance group report the best category in terms of ability to positively affect the financial performance. Therefore, PE companies consider Governance more material than other groups, and by applying measure to improve G-performance they can exploit the best effect in term of value creation.

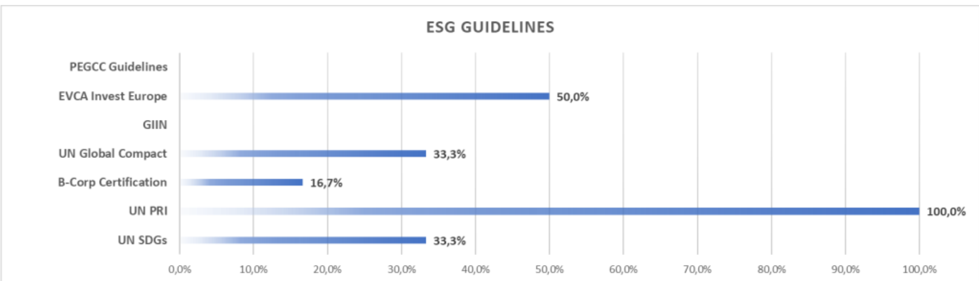
After assessing the materiality of ESG issues, the companies that declare to consider ESG principles into the investment process were redirected to a section related to ESG integration. This section is aimed to assess the importance of ESG in company agenda.

All the firms report to have an ESG policy/established standards for socially responsible investments, demonstrating that firms recognize the importance of integrate a well-defined policy in order to achieve a better performance.

Moreover, the importance of ESG within the organization is confirmed by the question: "Do you agree with the following statement – Considering a normal workday, ESG are important in your company agenda?"



The question, exposed in the form of a Likert scale, asked to respondent to express a score from 1 to 5 to express the agreement with the statement.
The 83,3% of respondent express a medium-high score (between 3 and 5), demonstrating that ESG analysis became a mainstream activity for PE and VC firms and therefore companies are adapting their organizational structure, policy, and agenda to accommodate this transition.
Considering the previous sample, 60% of the firm attend events related to ESG, as conference or sponsorships, confirming the growing interests in the field.
Considering the abundance of framework and guidelines regarding ESG integration I identified the ones most commonly used by GPs. Starting from the literature (see subchapter 2.1.1 and 2.1.2 for further details) I identified the most relevant guidelines used worldwide.



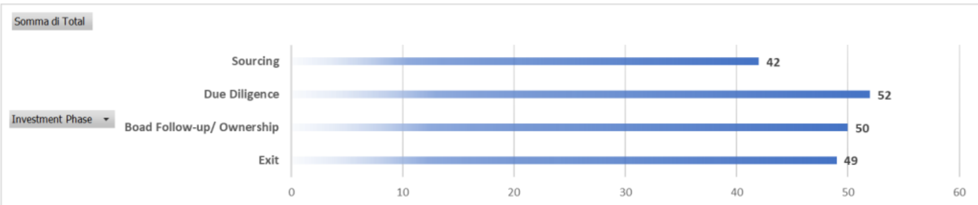
United Nations Principles for Responsible Investments (UN PRI) confirm to be the most widely used guidelines, showing the importance of this principles to help the integration of ESG into the investment process. Born in 2006 this guidelines and framework represent today the world's leading proponent of responsible investment and the adoption of their principles a "must have" to comply in the industry.

Worth noting that only 1 firm consider the B-Corp Certification, demonstrating that certification if more widely used in North America, while its adoption is only starting to spread in Europe.

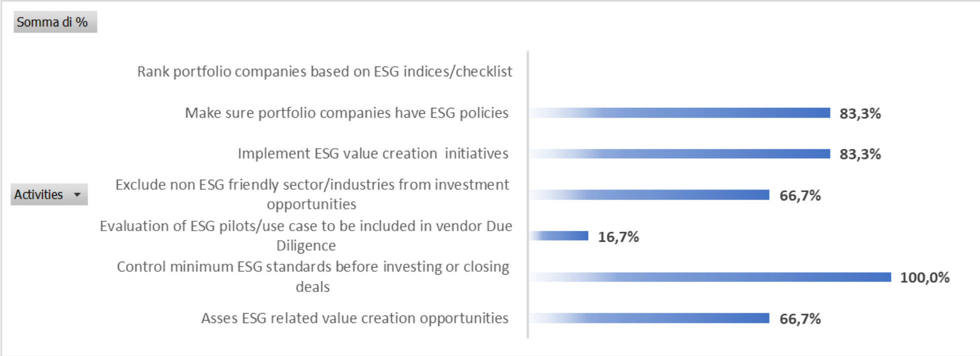
The success of Comparing these results with the survey of Falch (2016) we can find a correspondence regarding the success of adopting the UN PRI guideline. Differently, Nordic PE firms showed a higher interest in ECVA and UN Global Compact framework. This result may be related to a less rigorous ESG integration and framework knowledge in Italy respect to Nordic countries.

Since the ESG integration can be pursue with a different intensity within the various investment phases I decided to analyze this feature by asking to give a score from 1 to 10 to the relative importance of ESG integration within the different phases of the investment process. A detailed table of responses can be found in the Appendix, *Table B.2* and *B.3*

Surprisingly, during the sourcing phase GPs appear to be less in analyze the extent of ESG integration, while in subsequent phases as Due Diligence and Ownership they commonly exercise more effort, as confirmed by the lower level of variance.
Due Diligence phase shows the higher interest from GPs with an average score of 8.7 out to 10.



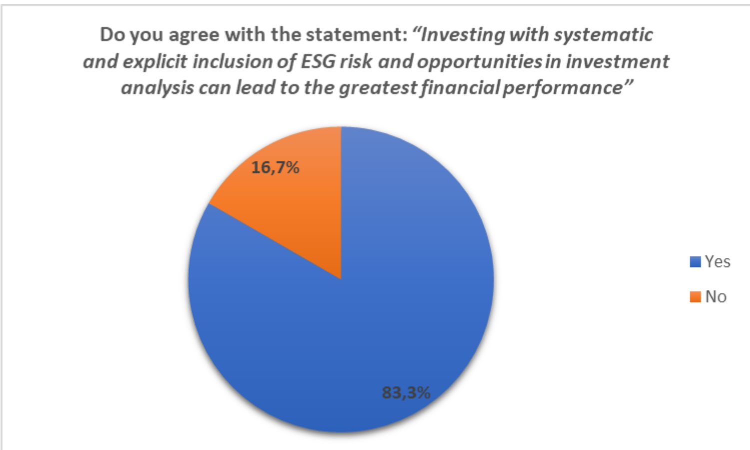
Following a previous study of Zaccone and Pedrini (2020) I indagated the specific activities performed by GPs during the different phases, to further determined which ones are effectively performed.



Consistent with the expectations and the findings of Zaccone and Pedrini, all respondents answered to control minimum ESG standards (e.g., ISO 14000 and ISO 26000) before investing or closing a deal. Only few firms assess the value creation opportunities during the Due Diligence phase, while it is preferred to further introduce value creation initiatives associated with ESG during the follow-up and ownership phase.

These results confirm that GPs recognize the ability of ESG to create value and lead to a better performance, and to do so they integrate ESG principles withing the whole investment process. The mix of activities performed by PE companies define a certain intensity of sustainability effort. Considering the model proposed by Cappucci (2018) of the curvilinear relation between financial performance and extent of integration[23], the mix resulting from the sample should project the companies in the right side of the curve, where ESG costs are off-set with an better investment performance.

Nonetheless the 83,3% of respondent who apply ESG principles agrees with the sentence: "Investing with systematic and explicit inclusion of ESG risk and opportunities in investment analysis can lead to the greatest financial performance". Only Respondent #1 disagree with the statement.



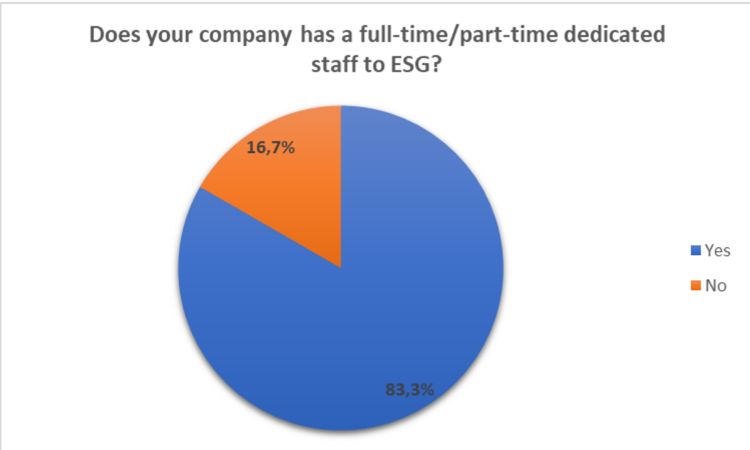
[23] See chapter 2.2.2 The Full Integration Paradox for further details

Is to be highlighted as in voluntary survey like this likely overstate the performance of the average investment manager, as ESG underperformers and skeptics are less apt to respond. (Eccles & Kastrapeli, 2018).

Even if GPs recognize the ability of ESG integration to support higher returns, it cannot be done if there is a sharp dividing line between the portfolio managers, analysist responsible for financial analysis and a separate group of ESG analyst who influence the decisions of managers. ESG integration.

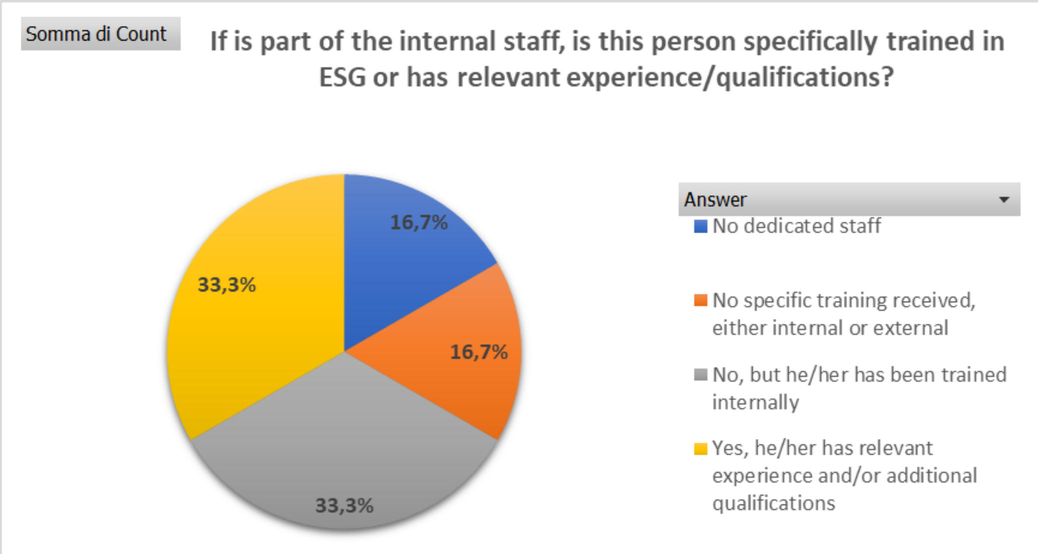
A full ESG integration require a strong internalization of ESG principles and knowledge in doing so.

5 firm out of 6 state to have in place a full-time or part-time staff dedicated to ESG, showing a coherence with the agreement regarding the previous question.



Indeed, the same respondent that declared to not consider a full ESG integration a driver for the greatest financial performance also stated to not have an ESG staff in place.

For the 2 out of 3 firms (66,6%) has a specific trained ESG staff, even doe it can happen in different ways. Some of the firms directly looked for trained employers with an academic or professional path linked with ESG knowledge, while some other firms preferred to train internally some resources to develop an ESG dedicated staff.



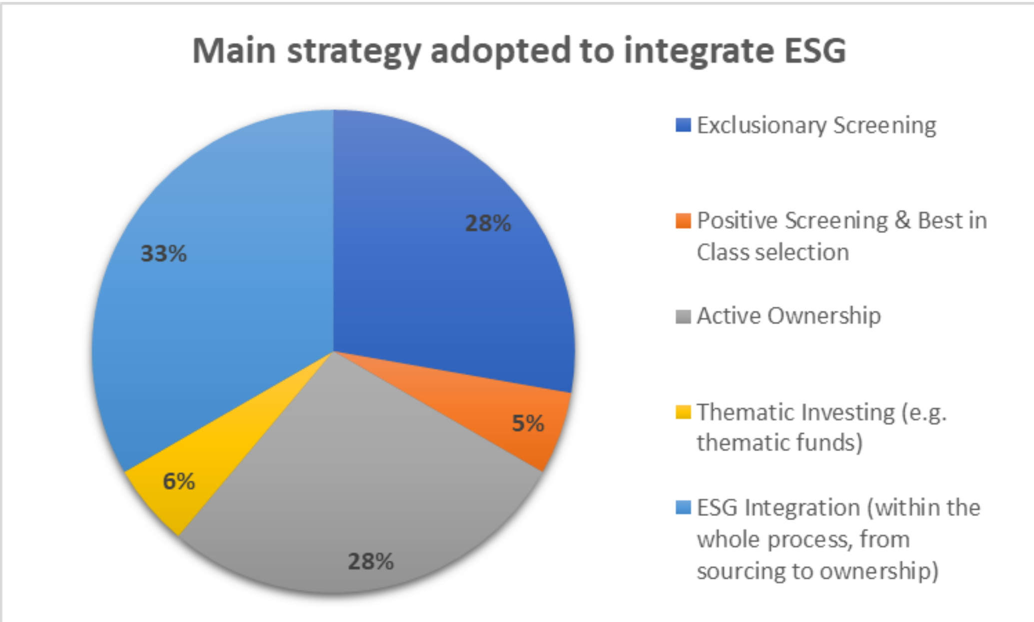
The ESG integration through the hire of a dedicated staff can vary his strenght depending from the position covered by the employers. It is clear that a junior resources dedicated to ESG cannot have the same influence into the investement process respect to a CIO or a member of the board. (Cumming & Johan, 2007)

I decided to ask which position was covered by ESG-specialized employers within the organization to understand the relative influence that these resources can exercise.

As can be seen from the graph above the 50% of respondents report to have an ESG Manager that contribute to the assessment of ESG principles within the investment process. That's relevant since the existence of an ESG Manager/Head of ESG implies the creation of a specific ESG office, specialized in ESG framework and their integration. This evidence confirms another time as ESG is more than a mainstream activity, but a reality in which investment firms are investing time, effort, and capital.

The absence of a CIO or CEO with a specific training in ESG surely negatively affect the influence that socially responsible activities may have within the organization but must be kept in mind that ESG became relevant (and sponsored) only in the last decade while partners of PE firms usually have greater experience, most of it matured in years without pressure arise from ESG integration.

As detailed in chapter 2.2.1 "The new paradigm of investors" ESG integration may differs depending to the strategies used. Therefore, I asked which strategies were mainly used by GPs, each respondent could select more than one alternative.

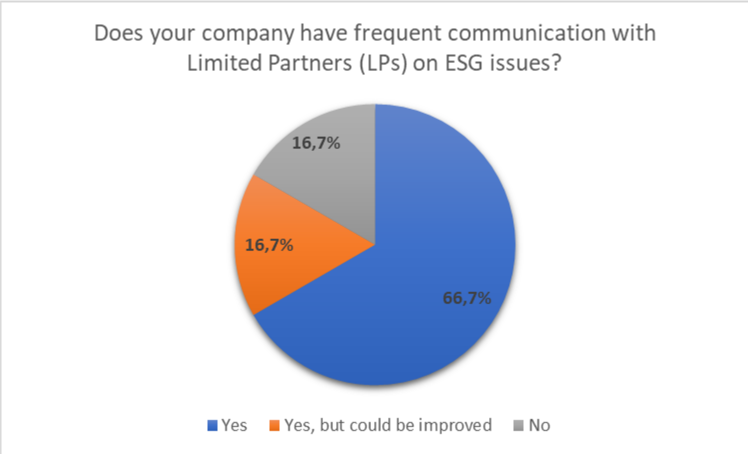


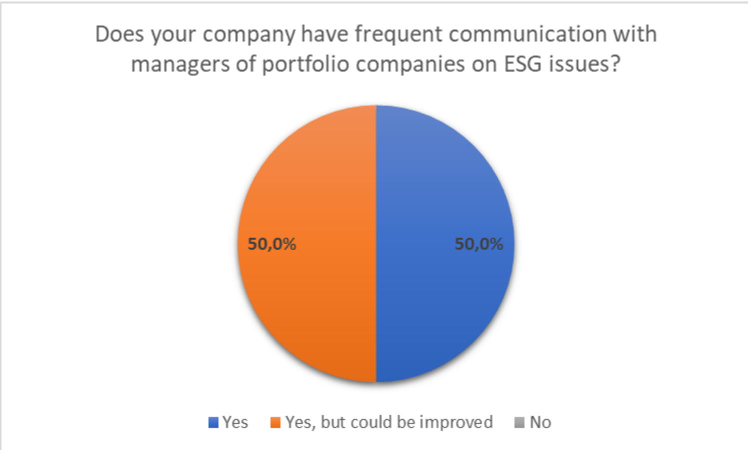
Considering the use of negative and positive screening, the two most common and easy strategies to apply, is reported a greater use of the former, confirming the results obtained by Falch (2016).

ESG integration in the whole process (full integration) is the most used strategy, a result that is consistent with previous analysis. As report by the survey of Amir Amel-Zaheh and George Serafeim (2017), conducted using a population of senior investment professionals from conventional investment manager not explicitly used to SRIs, full ESG integration was considered the best ESG strategy to outperform a market benchmark.

As analyzed in Chapter 2.2.2 The Full Integration Paradox, higher ESG intensity is related to the best performance for the investments. A poor ESG integration, for example with the sole application of negative screening lead the investments “in the valley of low returns”. (Cappucci, 2018)

These considerations regarding ESG integration lead to a further question: How GPs communicate their activities and strategies with investors and portfolio companies?





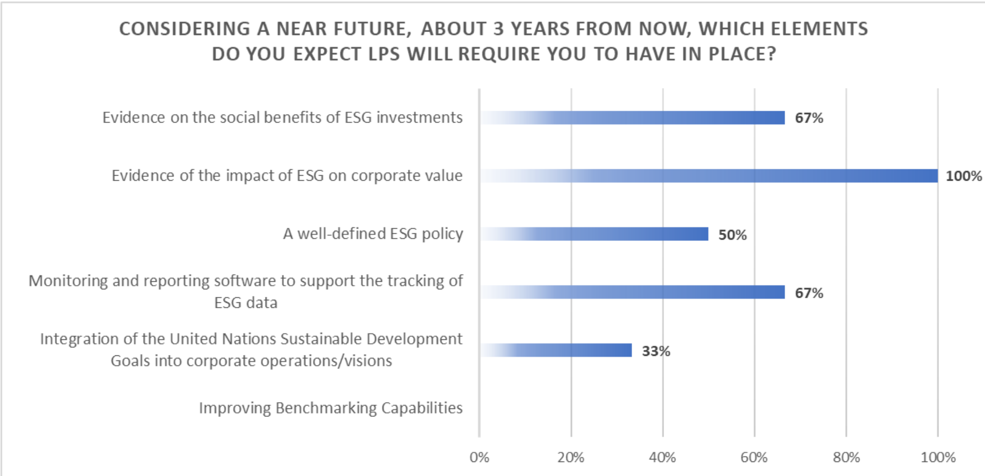
Most of respondent shows to have a frequent communication with both sides of investment chain, LPs and portfolio companies. An impressive evidence is the number of answers reporting that the communication is frequent but can be improved: regarding the communication with LPs only 1 firm report that, while when considered the interaction with portfolio companies half of the companies suggest it’s not optimal. This asymmetry may imply that LPs interests may not be completely aligned with activities undertaken at portfolio levels.

Communication with LPs and GPs is also linked with the short-term expectations of the ESG trend. GPs should understand the future development of the environment and start to introduce or allocate resources in ESG related activities and tools that LPs expect to have in place in a near future.

Consequently, I investigated the expectations regarding the ESG trend for LPs and resources to be allocated.

The results confirm my expectations. Indeed, all the respondents expect ESG will continue develop in short term. ESG consideration by LPs and consequently resource allocation at portfolio level is expected to increase, showing that it is not a temporary phenomenon but a new investment feature in continuing growth.

Focusing on the growth of resource allocation in ESG activities, I explored in detail which elements LPs will require PE firms to have in place, considering as alternatives the considerations of UN PRI (2018).



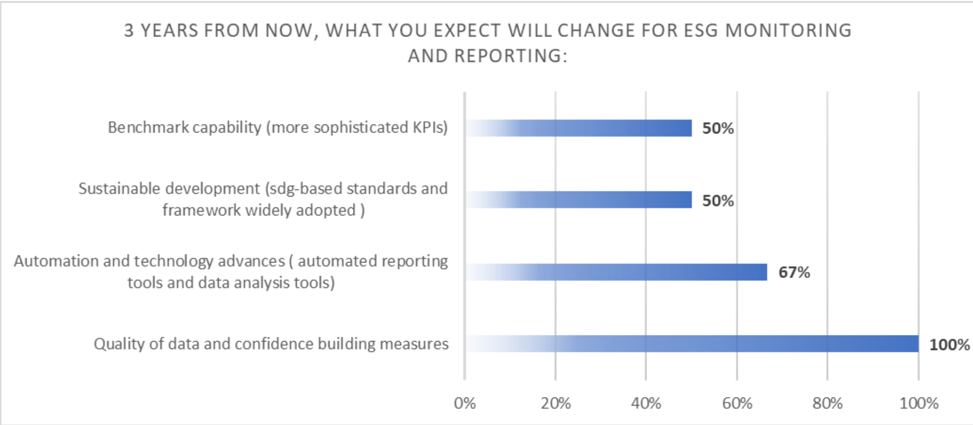
100% of the respondents expect LPs will require evidence of the impact of ESG on corporate value while the 67% expect the request of evidence of social benefits. This finding may lead to two different considerations:

- LPs care both financial return and social impact, weighting more financial return of the investments. This evidence pictures them as the “New Paradigm” investors described in chapter 2.2.1.
- Nowadays is difficult to obtain evidence of value/social impact of ESG and GPs will need to allocate resources to cover this lack, improving the process of measuring and elaborating the raw ESG data.

Despite the expectations regarding the impact of ESG policy on corporate value and therefore the financial performance of investments today only 1 out of 3 companies actually measure it. As before, that may be linked to inadequate tools and high costs to improve them and evaluate such impact. This finding confirms the results obtained by Falch (2016), where 60% of companies reported to not measure the ESG activities’ impact on financial performance.

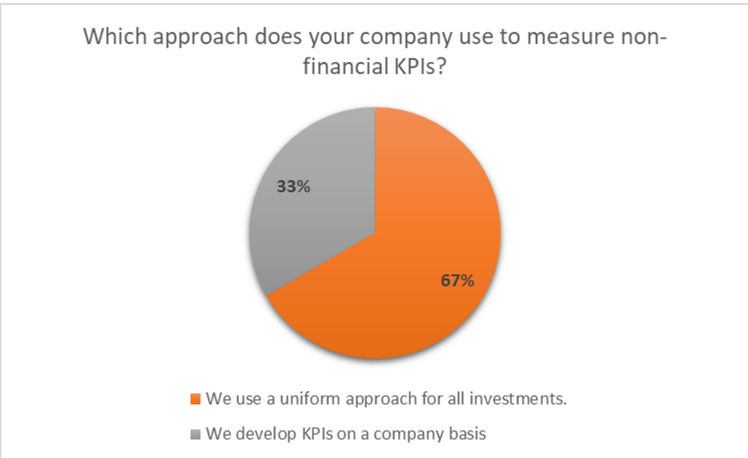
To effectively measure the relation between ESG and value creation are required reporting standards and high-quality data that indeed are expected to be required by 67% of respondent in the next 3 years.

To further investigate this expectation, I asked what GPs expect will change regarding monitoring and reporting requirements



All respondents expect that the quality of data will be an important feature that will change in a near future, and together with a technological development, as consequence will help to cover (or partially cover) the future need.

As of today all the firms report to measure the non-financial KPIs in their investments but the approach is variable: some companies use the same approach with all the investments while others determine such indicators ad-hoc for each portfolio company.



In the former case KPIs may not fit with all the investments and therefore the analysis of such data may lead to an incomplete understanding of the performance of ESG, on the other hand results may not be comparable at portfolio level and the overall ESG performance. This may lead to discrepancies in the evaluation of non-financial performances.

4.3.3 Drivers for Integration and Obstacles

The last part of the survey is aimed to explore the motivation that push GPs to undertake ESG activities.

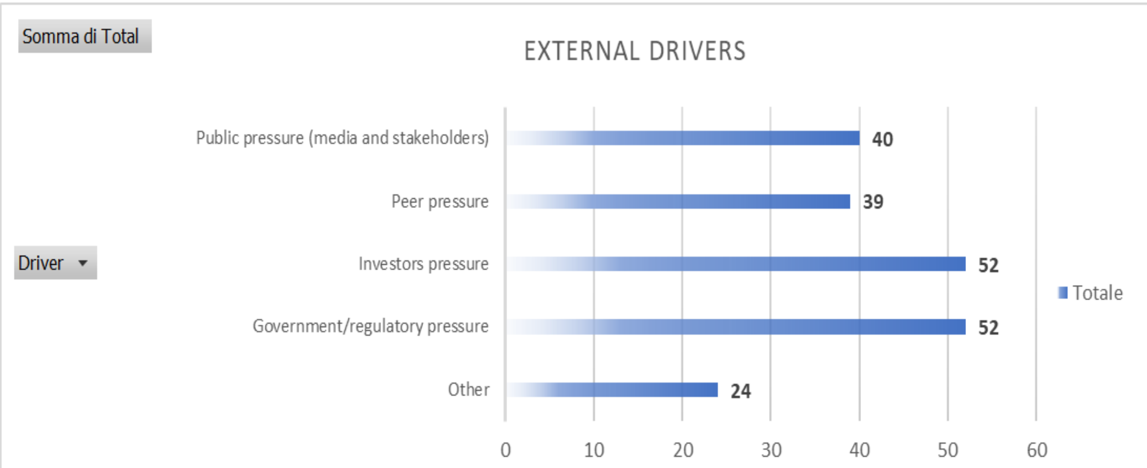
I investigated both external and internal drivers. External drivers represent a pressure coming from outside the organization, as stakeholder, competitors, LPs or government.

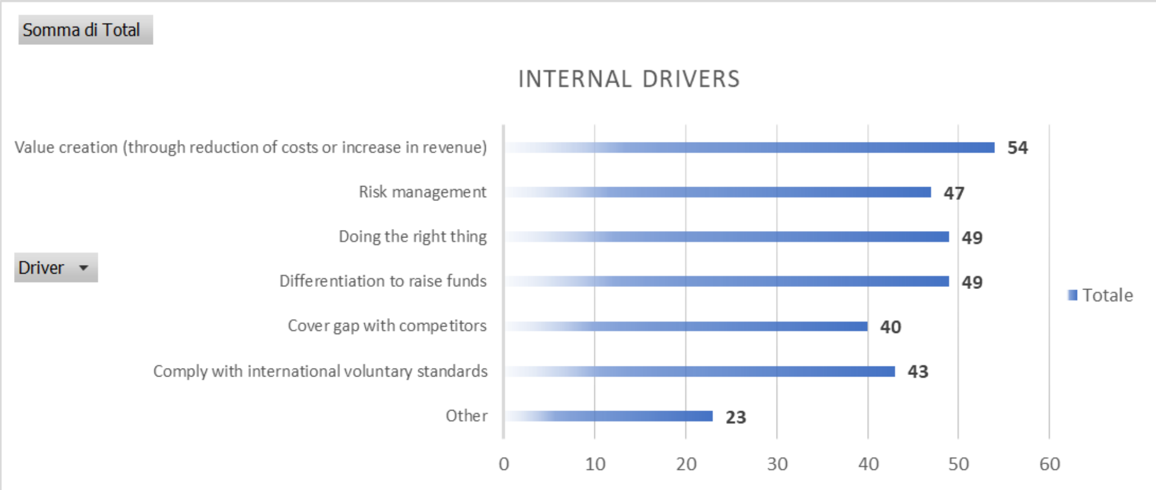
Internal drivers arise inside the organization and their nature can vary widely. The alternatives proposed in the survey represent the motivations most considered in papers, articles and previous surveys (Crifo & Forget, 2012; Falch, 2016; Zaccone & Pedrini, 2020).

To evaluate the strength of each driver I exposed the question using a Likert scale, asking to respondent to give a score from 1 to 10 to each driver. A more detailed evidence of responses obtained regarding internal and external drivers can be found in Appendix, *Tables B.3* and *B.4.*

The results reveal that internal drivers are on average stronger than external (7.3 vs 6.9).

GPs agreed that government/regulatory pressure and investors pressure are by far the most important external drivers, in line with the results obtained by Falch (2016). Differently pressure from social media and stakeholder has less impact on GPs, a possible explanation can be that these factors impact the PE company only indirectly by for example affecting the public opinion. LPs and government pressure instead, impact the firm directly by affecting its capacity to raise funds and regularly exercise its activity.





Value creation represent the most important driver that push PE/VC companies to integrate ESG principles in their activities. They definitely recognized the ability of ESG integration to lead to a better financial performance and therefore increase the value of their investment.

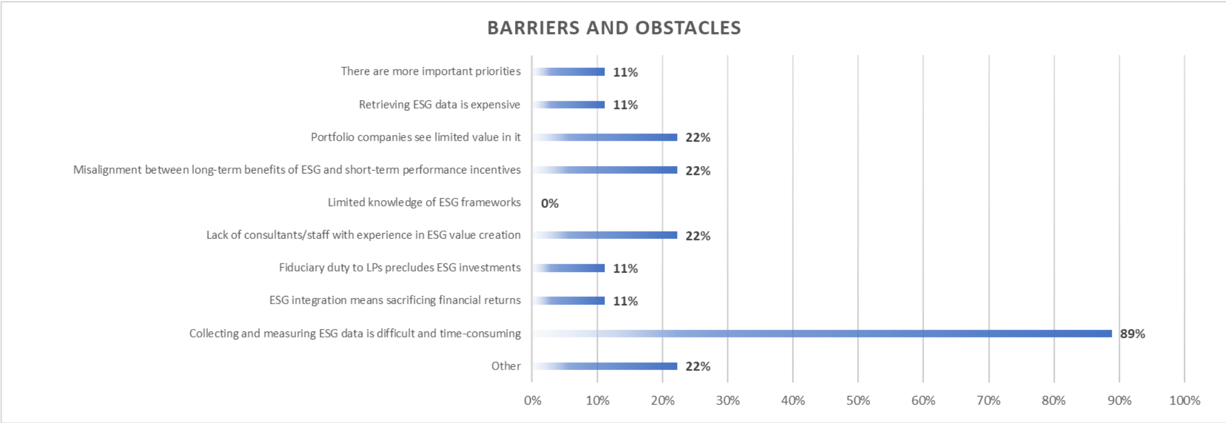
As seen in Chapter 3.1 Value Creation as a strategic driver the value creation is usually obtained through with top-line growth and creation of new markets, employee productivity uplift and investment optimization.

The former represents the easier to assess for PE companies, a portfolio companies that is engaged in a strong ESG participation is facilitate in create new markets and or innovate existing ones.

Value creation and external drivers sometimes are linked, for example when a company is compliant with regulation (external driver) and trusted by authorities can easily access to approvals or licenses that can lead to new product or market, leading to new opportunities for growth and value creation (internal driver).

A strong ESG participation also allows funds to differentiate themselves and capture LP's preferences. PE companies recognized the importance of this driver, the second most important together with "doing the right thing", especially now that the number of funds is increasing year over year. By integrating ESG principles PE firm can offer a more attractive investments opportunities that can be financially sound for value creation and consequently attracts mutual funds, pension funds, insurance companies or individual investors.

The 33% of respondent initially report to not consider ESG in their activities, in order to understand the motivation of such lack and to confirm some hypothesis previously exposed I asked to all the respondents which are the most relevant barriers that obstacle the integration of ESG factors into the investment process.



For further detail see Appendix, *Table B.5 Barriers and Obstacles.*

As can be seen from the table above most of PE companies agreed that the real barrier for ESG integration is represented by the number and quality of ESG data, since are difficult to obtain (especially with an assurance) and measure them is indeed time consuming and costly.
Despite actual technology allows to retrieve high quality raw ESG data, one of the primary concerns is related to the lack of standardization of these data that lead to difficulties to elaborate them and incorporate the analysis into the investment decision process.
Considering sustainability reporting the lack of standardization leave a high degree of discretionarily on which ESG factor are material to the business performance and which to disclose to investors, creating difficulties by GPs in evaluating them.
Measure, collect, elaborate and analyze data is a difficult process, costly and time consuming. For lot of PE firms, especially small ones without lot of resources (human and technological) this represent the absolute biggest barriers, since its overcome would involve an important change in the organization and therefore a high cost to pay.

To be noticed the low agreement regarding the 3 “traditional” barriers of ESG investing: ESG integration means sacrifice financial returns, fiduciary duty with LPs precludes ESG investing, and investors performance expectation are too-short term to fully obtain the positive effect of ESG performance.
These barriers, that obtained preferences between 11% and 22%, few years ago were some of the most important obstacles perceived respect to ESG integration. The low rate of preference obtained in this survey reveal as these barriers are almost disappear and are lower than commonly believed, according with the study of Eccles and Kastrapeli (2018).

An interesting result is the low agreement regarding the alternative “there are more important priorities”, that in the survey of Falch (2016) reported the highest rank of importance between obstacles and barriers to integration.
Even if the sample considered hugely differs (e.g. number of respondent, countries analyzed) the results in my opinion is still significant. Considering the time gap between the two surveys, around 6 years, it described as the ESG is now a priority, and no more a sideline activity. A big takeaway by GPs.

Chapter 5

5. Conclusions

Private Equity as an asset class is confirming is primary role in the world economy as stated by the steadily increasing of asset under management exhibited after the financial crisis of 2008. New trends arose, among them ESG integration. Starting from an addition at portfolio level and ending as an established mainstream activity.

Social and environmental problems shift the attention of companies from stakeholder to shareholder, helping give birth to new business models and investments approaches that are no more focused solely on financial performance but also in a “wider” impact of the investment. Therefore, the character of the “traditional investors” focused exclusively on earnings evolved in new paradigm of investor focused not only on earnings, but also in having an impact at societal level.

Lots of organization, such as United Nations, helped in this transition by promoting several initiatives aimed to emphasize the importance of sustainability and social problems.

Academics help motivate this new trend by analyzing the effect of ESG on investment process and it is quite clear as an introduction of ESG approach into the investment process leads to a better positive performance. Data tells us the increase in performance is not as huge as some people may think but it’s a starting point to motivate traditional-minded investors in initiate a new investment approach.

The primary aim of an investment is the creation of value that allow to an exit strategy at a price higher than the price paid to acquire the targeted firm. Academics and associations described as an ESG approach can help empower the value creation process through the creation of new business opportunities, productivity uplift and asset optimization.

Moreover, an ESG focus help improve the risk management of a company, that not only consider traditional financial factors but also introduce concern about sustainability that reduce tail-risk in the medium-long run.

An ESG optimization can also help target company to better face the new strict regulations arose in these years in developed economies, especially in “sensitive” sectors as food or natural resources.

The consequent reduction of operating costs and indeed the costs of capital is also suitable for small enterprises to help them develop their business and collect capital.
To understand the characteristics of Italian Private Equity, and their perception and extent of ESG integration, I conduct a survey which results are summarized below.

- In Italian PE/VC industry there is an overrepresentation of small and medium companies, and most of them are located in north Italy. Such situation may be linked to the maturity of the sector, that is lower respect to other European countries.
- Between E, S and G, Governance issues are valued more, followed by Social and Environmental issues respectively. Governance issues are considered more material since their resolution can lead to the best increase in financial performance and therefore value creation. ESG trend has not reached its maturity and there is not a unique normative approach. There are different framework and guidelines used by PE/VC companies and the context is fragmented. Moreover, at European level, the focus of regulation is mainly respect to the Environmental issues (the less valuable for GPs), while PE companies consider more Social and Governance in their investments.
- All respondents expect the interest by investors and portfolio companies in ESG and ESG integration will increase in 3 years. Investors will require new elements to have in place and companies must invest to cover these lack. Most of the firm already have specific ESG team or are developing them, whose member are internally trained or have an adequate professional or academic background. These new employers will help the company to cover the transition.
- PE companies recognized the ability of ESG to create value and improve the financial performance of the companies. They already adopt strategies to integrate them into the investment process, most of the time during the Due Diligence and Ownership phase. The full integration of ESG principles is the most common strategies adopted since can lead to the highest improvement of performance, followed by active ownership and exclusionary screening. Despite the recognition of the improvement of financial performance only 1 firm out of 3 measure it. This misalignment is due to a lack of standardization of raw ESG data that entails difficulties for PE/VC companies in process and analyze the information and integrate them into the investment decision process.
- On average internal drivers for ESG integration weight more than external drivers, demonstrating that the integration of ESG is voluntary and mainly related to value creation opportunity. External drivers, as investors or government's pressure, are

therefore minors but relevant drivers that accompany and speed up a process that would be in place anyway.

While writing this thesis I have gained insights into the Private Equity Industry and ESG integration, considering different features and trends. Despite I believe this work may give an overall view of the ESG integration in PE industry, there are few areas where I want to add some considerations.

It is important to represents the literature sources I used. The field of research is new and have been investigated largely by researchers only in the last 10-15 years, with only few academic studies regarding Italian PE industry. Therefore, could be bias given to a more "enthusiastic" view of the field by researcher, due to the newness trend.

Regarding the results obtained I want to add some further considerations.

It's important to underline as the full ESG integration is becoming an important tool used by companies to comply with ESG standard and market. Most of the companies thought the introduction of ESG can lead to the best financial performance and therefore are improving the ESG effort inside the company. It's actually easy to find an ESG Office in a PE/VC firm and specific employers with an adequate instruction and experience in the field. Most of the time, especially in countries like Italy where the culture of Private Equity is less deep-rooted, the competencies and skill of these employers are developed internally, but due to the increase of sustainability related university course the engagement of employers with an external instruction is becoming easier.

The adaption process that are experiencing PE firm is also an effect of the relationship with their investors, the Limited Partners. Most of the company report a frequent but sometimes insufficient communication with LPs, and it should be increase in order to better align the interests and the level of fiduciary duty of investors.

As of today, is certain for PE firm that the relative importance of ESG will increase in the next 3-5 years and these firm will have to adapt to it as new requests by LPs and an improvement in the asset and technologies deployed in ESG related activities.

Investment companies expect that LPs will mostly require evidence of the effect of ESG in both value creation and social benefit of the investment undertaken. Despite these trends Italian firms appear partially misaligned with LPs expectations since most of them did not has a proper policy to measure the financial impact of ESG activities and the related value creation. The difficulties of obtain this kind of analysis is rooted on the quality of data. Despite technologies allow to retrieve raw ESG data these information are usually not standardized, and therefore

difficult to process and analyze by PE companies, implying a costly and time-consuming integration.
ESG understanding in terms of causality and medium-long term impact on financial performance is complex and require a deep knowledge of the field. Nonetheless, lots of studies are pointing out important insights on the ESG integration and the relative effects on investments, and PE companies are putting lot of effort to be aligned with these trends and LP's interests.

This thesis and the empirical analysis mainly considered soft data, as opinion, feeling or individual observation. It would be more effective to use hard data as financial characteristics regarding increase in financial performance (e.g., ROI, IRR etc.) or ESG impact to back up the hypothesis provided in the literature review with relevant numbers. However, this kind of approach would be hard to perform, due to the actual difficulties of PE companies of measuring such impacts and the possible distrust of provide this kind of information. In next years I expect there will be a better understanding of the field and better tools to measure such impacts.
As consequence, a suggestion for future research could be to introduce this kind of analysis based on hard data to effectively measure the effect of the ESG integration in the financial performance of PE companies.

The focus of this thesis lay on PE companies in general and the overall investment approach. It would be interesting to explore more how differs the ESG integration between VC and PE companies, or regarding the size of the companies. Due to the small sample this kind of analysis has been difficult to perform.
Another suggestion for future research is the introduction of a link with the cultural aspect of a country and how they can affect the ESG integration, I find that could be interesting to see if a country is more inclined to innovation and sustainability, how it can affect the integration of ESG in investments of their companies respect to a country less inclined to innovation.

Literature about Italian PE companies and ESG integration is scarce and usually cover only some specific aspects in details. The industry is tricky to investigate, the field is continuously changing and there is a traditional lack of disclosure and transparency by companies. With the expected increase in ESG interest in future years by investors and by other stakeholders I expect the number of papers and research about this topic will hugely increase in next years. Despite the biases reported before I think this study and the conclusions reached with the empirical analysis can contribute to address that lack in theoretical grounding and be useful to provide an overall frame of the integration of ESG principles and activities in Italian PE industry, providing a contribute for future researcher on this field.

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Appendix

A) Questionnaire

1. Does your company apply ESG Principles in its investment process?
   - Yes
   - No

2. Which ESG factors matter in PE's investment decisions? For each ESG issues give a rate from 1 to 10, where 1 represent "not important" and 10 represent "very important"
   Climate change*
   • Diversity and equal opportunities
   • Bribery and corruption
   • Waste management
   • Human capital management **
   • Risk management
   • Air/Water pollution
   • Data Protection
   • Business Ethics
   • Energy Efficiency
   • Supply Chain Management
   • Compliance***
   • Hazardous material
   • Human rights
   • Board composition

   *Including policies to mitigate climate change and the impacts of climate change
   **Including training and education
   ***Including freedom of association and collective bargaining, child labor, forced labor, occupational health and safety, living wage

3. Do you agree with the Statement: "Considering a usual day at work, is ESG an important part of your company agenda?"
   - 1 – Strongly disagree

- 2 – Somewhat disagree
- 3 – Neither agree nor disagree
- 4 – Somewhat agree
- 5 – Strongly agree

4. Does your company have a policy or established standards for Socially Responsible Investments?
   - Yes
   - No

5. Indicate, if any, which international guidelines/framework do you apply in the integration and management of ESG
   - UN SDGs
   - UN PRI
   - B- Corp Certification
   - UN Global Compact
   - Global Impact Investing Network (GIIN)
   - EVCA Invest Europe
   - PEGCC Guidelines
   - Other

6. Does your company participate in ESG-related industry events, including conferences and sponsorship?
   - Yes
   - No

7. How important are ESG aspects in your different investment stages? Give a rate from 1 to 10, where 1 represents "not important" and 10 represents "very important."
   - Sourcing
   - Due Diligence
   - Board Follow-up / Ownership
   - Exit

8. Considering the different phases (Sourcing, DD, Portfolio management, Exit) what does your firm do?

- Evaluation of ESG pilots/use case to be included in vendor DD
- Implement ESG value creation initiatives
- Make sure portfolio companies have ESG policies
- Rank portfolio companies based on ESG indices/checklist
- Asses ESG related value creation opportunities
- Control minimum ESG standards before investing or closing deals
- Exclude non ESG friendly sector/industries from investment opportunities

9. Does your company have a part-time/full-time staff dedicated to ESG?
    - Yes
    - No

10. If it is part of the internal staff, are these people specifically trained in ESG or has relevant experience/qualifications?
    - Yes, he/she has relevant experience and/or additional qualification
    - No, but has been trained internally
    - No specific training received, neither internal nor external
    - No staff dedicated

11. If he/she is part of internal staff which role does him/her cover?
    - Financial Advisor
    - Analyst
    - Portfolio Manager
    - Chief Investment Officer (CIO)
    - Chief Executive Officer (CEO)

12. If he/she is external to organization, does this person cover all environmental, social and governance issues?
    - Yes
    - No

13. Which strategies does your company mostly apply to integrate ESG in the investment process?
    - Exclusionary Screening
    - Positive Screening and Best-in-Class selection

- Active Ownership
- Thematic Investing (e.g. thematic funds)
- ESG Integration (within the whole process, from sourcing to ownership)

14. Do you agree with the following sentence? "*Investing with systematic and explicit inclusion of ESG risk and opportunities in investment analysis can lead to the greatest financial performance.*"
   - Yes
   - No

15. In your opinion, does your company have a frequent communication with your LPs regarding ESG?
   - Yes
   - Yes, but could be improved
   - No

16. In your opinion, does your company have a frequent communication with portfolio company's managers regarding ESG?
   - Yes
   - Yes, but could be improved
   - No

17. Considering a near future, about 3 years from now, which elements do you expect LPs will require you to have in place?
   - Improving Benchmarking Capabilities
   - Integration of the United Nations Sustainable Development Goals into corporate operations/visions
   - Monitoring and reporting software to support the tracking of ESG data
   - A well-defined ESG policy
   - Evidence of the impact of ESG on corporate value
   - Evidence on the social benefits of ESG investments

18. 3 years from now, do you expect ESG focus and commitment among investors will…
   - Increase

- Remain stable
- Decrease

19. 3 years from now, do you expect that the allocation of resources for ESG activities in a company will…
    - Increase
    - Remain stable
    - Decrease

20. 3 years from now, what you expect will change for ESG Monitoring and Reporting
    - Quality of data and confidence building measures
    - Automation and technology advances (automated reporting tools and data analysis tools)
    - Sustainable development (SDGs-based standards and framework widely adopted)
    - Benchmark capability (more sophisticated KPIs)
    - Other

21. Does your company measure non-financial KPIs related to ESG activities in its investments?
    - Yes
    - No
    - Other

22. Regarding KPIs, which approach does your company use to measure non-financial KPIs?
    - They are not measured
    - We use a uniform approach for all investments.
    - We develop KPIs on a company basis
    - Other

23. Does your company measure whether ESG-related activities affect the financial performance of your investments?
    - Yes
    - No
    - Other

24. External Driver - for each driver give a rating from 1 to 10, where 1 represents "not important" and 10 represents "very important"
    - Investor’s pressure
    - Government/regulatory pressure
    - Public pressure (media and stakeholders)
    - Peer pressure
    - Other

25. Internal Driver - for each driver give a rating from 1 to 10, where 1 represents "not important" and 10 represents "very important"
    - Risk management
    - Value creation (through reduction of costs and liabilities and/or increase in revenue)
    - Differentiation to raise funds
    - Doing the right thing
    - Cover gap with competitors
    - Comply with international voluntary standards
    - Other

26. Which obstacles and barriers does your company find in applying ESG principles within the investment process?
    - Collecting and measuring ESG data is difficult and time-consuming
    - ESG integration means sacrificing financial returns
    - Fiduciary duty to LPs precludes ESG investments
    - Lack of consultants/staff with experience in ESG value creation
    - Limited knowledge of ESG frameworks
    - Misalignment between long-term benefits of ESG and short-term performance incentives
    - Portfolio companies see limited value in it
    - Retrieving ESG data is expensive
    - There are more important priorities
    - Other

B) Empirical Analysis Details

Table B.1. – ESG issues analysis

Group and related issues	Somma di Respondent #1	Somma di Respondent #2	Somma di Respondent #3	Somma di Respondent #4	Somma di Respondent #5	Somma di Respondent #7	Somma di Totale	Average	Variance
⊟ E	**36**	**37**	**9**	**45**	**32**	**38**	**197**	**32,8**	**128,5**
Air/Water pollution	5	8	1	9	6	7	36	6,0	6,7
Climate change	5	7	2	10	5	8	37	6,2	6,5
Energy Efficiency	9	8	2	9	7	8	43	7,2	5,8
Hazardous material	9	6	2	9	7	7	40	6,7	5,6
Waste management	8	8	2	8	7	8	41	6,8	4,8
⊟ S	**25**	**42**	**34**	**42**	**38**	**38**	**219**	**36,5**	**33,9**
Data Protection	5	9	7	7	9	8	45	7,5	1,9
Diversity and equal opportunities	4	8	7	9	5	6	39	6,5	2,9
Human capital management	8	9	7	8	8	9	49	8,2	0,5
Human rights	5	8	7	10	9	8	47	7,8	2,5
Supply Chain Management	3	8	6	8	7	7	39	6,5	2,9
⊟ G	**38**	**39**	**28**	**44**	**44**	**40**	**233**	**38,8**	**28,8**
Board composition	2	7	7	8	9	8	41	6,8	5,1
Bribery and corruption	9	9	2	10	9	6	45	7,5	7,6
Business Ethics	9	9	7	10	8	9	52	8,7	0,9
Compliance	9	7	7	9	9	8	49	8,2	0,8
Risk management	9	7	5	7	9	9	46	7,7	2,2

Table B.2. – Investment Phases

Investment Phase	Respondent #1	Respondent #2	Respondent #3	Respondent #4	Respondent #5	Respondent #7	Total	Average	*Variance*
Sourcing	5	7	9	8	6	7	**42**	**7,0**	***1,7***
Due Diligence	9	8	9	10	8	8	**52**	**8,7**	***0,6***
Boad Follow-up/ Ownership	9	8	9	8	8	8	**50**	**8,3**	***0,2***
Exit	9	7	9	9	7	8	**49**	**8,2**	***0,8***

Table B.3 – External Drivers

External Driver	Respondent #1	Respondent #2	Respondent #3	Respondent #4	Respondent #5	Respondent #7	Total	Average	*Variance*
Investors pressure	7	9	10	10	8	8	52	8,7	1,2
Government/regulatory pressure	8	9	10	10	7	8	52	8,7	1,2
Public pressure (media and stakeholders)	2	7	8	9	6	8	40	6,7	5,2
Peer pressure	1	8	8	8	6	8	39	6,5	6,6
Other	1	7	1	8	6	1	24	4,0	9,3
Total	**19**	**40**	**37**	**45**	**33**	**33**	**207**	**34,5**	**65,3**

Table B.4. – Internal Drivers

Internal Driver	Respondent #1	Respondent #2	Respondent #3	Respondent #4	Respondent #5	Respondent #7	Total	Average	*Variance*
Risk management	9	6	8	8	8	8	47	7,8	0,8
Value creation (through reduction of costs and liabilities and/or increase in revenue)	10	9	8	10	8	9	54	9,0	0,7
Differentiation to raise funds	9	9	7	9	6	9	49	8,2	1,5
Doing the right thing	7	7	10	10	6	9	49	8,2	2,5
Cover gap with competitors	3	7	8	8	6	8	40	6,7	3,2
Comply with international voluntary standards	2	7	8	10	8	8	43	7,2	6,1
Other	1	6	1	8	6	1	23	3,8	8,5
Total	**41**	**51**	**50**	**63**	**48**	**52**	**305**	**50,8**	**42,5**

Table B.5. – Barriers and Obstacles

Barriers and Obstacles	Respondent #1	Respondent #2	Respondent #3	Respondent #4	Respondent #5	Respondent #6	Respondent #7	Respondent #8	Respondent #9	%
Other						✔			✔	***22,2%***
Collecting and measuring ESG data is difficult and time-consuming	✔	✔	✔	✔	✔	✔	✔	✔		***88,9%***
ESG integration means sacrificing financial returns				✔						***11,1%***
Fiduciary duty to LPs precludes ESG investments	✔									***11,1%***
Lack of consultants/staff with experience in ESG value creation					✔		✔			***22,2%***
Limited knowledge of ESG frameworks										***0,0%***
Misalignment between long-term benefits of ESG and short-term performance incentives		✔		✔						***22,2%***
Portfolio companies see limited value in it	✔					✔				***22,2%***
Retrieving ESG data is expensive		✔								***11,1%***
There are more important priorities						✔				***11,1%***