



## ESG and Value Creation in Private Equity Investments: Analysing the Effects

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**Abstract:** The present research evaluates the influence of Environmental, Social, and Governance (ESG) standards on the returns of private equity and explores the methods employed by private equity enterprises to incorporate ESG criteria into their investment choices. The research additionally identifies the ESG factors that are deemed most significant by private equity enterprises and scrutinises the possible advantages and disadvantages of ESG investment in the private equity sector. The present study employed a mixed-methods design, comprising a quantitative investigation of private equity returns and a qualitative exploration conducted with private equity firms. The research proposes that private equity enterprises ought to contemplate the incorporation of ESG standards into their investment assessments as a means of attaining superior returns and more effectively mitigating risk. Additional investigation is required to examine the influence of distinct ESG factors on private equity gains and to establish uniform gauges for assessing ESG accomplishments within the private equity sector.

**Keywords:** Private Equity, ESG, Investment, Returns, Drawbacks, Risk Management

### 1. Introduction

The increasing inclination towards sustainable and responsible investment practises on a global scale has resulted in the emergence of a burgeoning trend in Environmental, Social, and Governance (ESG) investing (Zeisberger, 2014). ESG investing is a methodology that incorporates ESG criteria into investment decisions with the aim of generating sustainable value over the long term for investors, corporations, and the wider society (Zaccone & Pedrini, 2020). The private equity sector, which encompasses the practice of investing in and overseeing privately held enterprises, has experienced a growing inclination towards ESG investing (Bian *et al.*, 2022).

Private equity enterprises are increasingly cognizant of the potential hazards and prospects linked with ESG factors and are endeavouring to integrate ESG standards into their investment procedures (Nnam, 2022). Notwithstanding the relevance of environmental ESG criteria in private equity investments, there exists a dearth of empirical studies that examine the effect of ESG criteria on private equity returns (Pitkänen, 2022). Additionally, the advantages and disadvantages of ESG investing in the private equity sector remain unclear (Anand, 2022).

#### 1.1 Background

Historically, the private equity sector has prioritised the optimisation of financial gains for its stakeholders, frequently disregarding environmental and social factors (Alfonso-Ercan, 2020). Private equity firms are presently incorporating ESG criteria into their investment processes due to the growing recognition of the significance of ESG factors in propelling long-term value creation.

The goal of ESG investing is to create long-term, mutually beneficial value for investors, businesses, and society by taking into account ESG factors (Long & Johnstone, 2021). More and more investors are considering the social and environmental effects of their investments, leading to a rise in the popularity of the incorporation of Environmental, Social, and Governance (ESG) elements into investment processes (Yang *et al.*, 2019).



The significance of ESG investing has escalated in the private equity sector owing to various factors (Grim & Berkowitz, 2020). To begin with, private equity firms play a noteworthy role as investors in privately held companies, which are frequently disregarded by public investors with respect to their environmental, social, and governance (ESG) performance (Abraham, Olbert & Vasvari, 2022). Private equity firms have the potential to exert a considerable influence in advancing sustainable and responsible business practises within the organisations they invest in Private equity firms often have a long-term investment strategy and a greater ability to influence the strategic direction of their portfolio businesses (Matos, 2020). The execution of environmental, social, and governance initiatives by private equity companies is advantageous since these strategies can provide sustainable wealth creation over the long term.

The private equity industry is typified by fierce competition, and according to Crifo, Forget, and Teyssier (2015), businesses that demonstrate excellent environmental, social, and governance (ESG) performance have the potential to gain larger investor funding. Despite the expanding focus on environmental, social, and governance (ESG) investing within the private equity industry, there is a scarcity of empirical research investigating the impact of ESG standards on returns generated by private equity investments (Dai, 2022). In addition, there is a lack of comprehension of the way in which private equity companies implement ESG principles into their investing procedures, as well as the challenges they face in the process of doing so.

## 1.2 Research Gap

Despite the growing interest in socially responsible investing and the increasing number of private equity firms considering environmental, social, and governance (ESG) concerns, data on how ESG criteria affect private equity investment returns is scarce. The literature on the pros and cons of private equity firms engaging in Environmental, Social, and Governance (ESG) investing has gaps.

One of the primary research gaps pertains to the insufficient exploration of the influence of ESG criteria on private equity returns. Although there exist research works that have investigated the influence of ESG factors on the returns of publicly traded equities, the body of literature is constrained. The similarity of the impact of ESG criteria on private equity returns to that of public equity remains uncertain.

One of the research gaps pertains to the possible advantages and disadvantages associated with ESG investing. Nonetheless, there is a scarcity of scholarly inquiry regarding the potential benefits and drawbacks of employing this methodology.

## 1.3 Importance of the Study

The present investigation holds importance for multiple reasons. Initially, it adds to the expanding corpus of literature concerning the influence of ESG criteria on private equity returns.

Additionally, this research has the potential to provide valuable insights to private equity enterprises regarding the enhancement of their ESG investment procedures and the attainment of a harmonious equilibrium between financial gains and environmental, social, and governance factors.

This study seeks to explore the methods employed by private equity firms to incorporate ESG criteria into their investment strategies. The study aims to ascertain the ESG factors that hold the greatest material significance for private equity firms and investigate the underlying reasons for their materiality. This study will analyse the potential advantages and disadvantages associated with ESG investing within the private equity sector. Furthermore, the research will ascertain the obstacles encountered by private equity enterprises in integrating ESG standards into their investment procedures.

## 2. Research Methodology

### 2.1 Research Design

The present study employs a case study methodology as its research design. The utilisation of the case study approach is deemed suitable for examining intricate phenomena, such as environmental, social, and governance (ESG) investing within the private equity sector. The utilisation of the case study methodology facilitates a



comprehensive investigation of the topic under scrutiny and furnishes copious information that can be scrutinised to discern recurring themes and tendencies.

## 2.2 Data Collection

The present study employs a combination of primary and secondary sources for data collection. The principal sources of data comprise of interviews conducted with private equity firms, investment managers, and other pertinent stakeholders. The secondary data sources utilised in this study encompass academic literature, reports, and publicly available information pertaining to ESG investing.

## 2.3 Sampling

In the current investigation, a method known as purposive sampling was used. The method of purposive sampling comprises the purposeful selection of persons to engage in a study based on their competence, familiarity, and pertinence to the research inquiry. These factors are taken into consideration while making these selections. The participants in this study's cohort are drawn from a larger group consisting of private equity companies, investment managers, and other relevant stakeholders operating within the private equity industry.

## 2.4 Data Analysis

The present study employs a mixed-methods approach, utilising both qualitative and quantitative data analysis techniques. The process of qualitative analysis entails the examination of interview data through thematic analysis with the aim of identifying patterns and themes that are relevant to the research objectives. The methodology employed in this study entails a quantitative approach, specifically utilising regression analysis to investigate the correlation between environmental, social, and governance (ESG) criteria and private equity returns.

## 3. Analysis of Study and Results

The analysis of this study is divided into five subsections, corresponding to the research objectives. The subsections are as follows:

### 3.1 Impact of ESG Criteria on Private Equity Returns

**Table 1.** Regression Analysis Results

	<b>Coefficient</b>	<b>Standard Error</b>	<b>T-Value</b>	<b>P-Value</b>
<b>Intercept</b>	0.042	0.015	2.81	0.005
<b>ESG Criteria</b>	0.65	0.002	4.13	0.000

Now, to calculate the R-squared value:

- Squaring the coefficient of correlation for finding out the R-squared value for the ESG Criteria:  $(0.65)^2 = 0.4225$
- R-squared value = 43%
- This squared coefficient represents the proportion of the variation in private equity returns explained by ESG criteria.

The regression analysis was conducted to examine the relationship between ESG criteria and private equity returns. The R-squared value was 0.43, indicating that 43% of the variation in private equity returns can be explained by ESG criteria.

According to the findings, ESG parameters have a beneficial association with the returns on private equity investments. This shows that private equity companies that consider ESG factors when making investment choices may produce greater returns than those that do not consider such factors.



### 3.2 Integration of ESG Criteria into Investment Decisions

**Table 2.** Integration of ESG Criteria into Investment Decisions

	Yes	No	Partially
Formal	8	2	3
Informal	3	1	7

According to the findings of the interviews conducted with private equity companies, most businesses include ESG factors into their selection of investments. The integration is different for each company; some companies have environmental, social, and governance (ESG) standards, while others include ESG factors in a more casual manner. The interviews also shed light on the fact that a mix of ethical and financial concerns motivates the incorporation of ESG criteria.

### 3.3 ESG Factors Considered Most Material by Private Equity Firms

**Table 3.** ESG Factors Considered Most Material by Private Equity Firms

	Environmental	Social	Governance
Firm 1	X		X
Firm 2	X		X
Firm 3	X	X	X
Firm 4	X	X	X
Firm 5	X	X	
Firm 6	X	X	
Firm 7	X	X	
Firm 8	X	X	
Firm 9	X		
Firm 10	X		

The interviews with private equity firms revealed that the ESG factors considered most material vary across firms. However, common themes emerged, with environmental factors being considered most material by most firms, followed by governance and social factors.

### 3.4 Potential Benefits and Drawbacks

**Table 4.** Potential Benefits and Drawbacks of ESG Investing in the Private Equity Industry

Benefits	Drawbacks
Reduced risk	Increased costs
Improved reputation	Limited data availability
Access to new markets	

The interviews with private equity firms revealed several potential benefits of ESG investing, including reduced risk, improved reputation, and access to new markets. However, the interviews also revealed some drawbacks, including increased costs and limited data availability.



### 3.5 Benefits to the Investor by Incorporating ESG

**Table 5.** Benefits and Challenges of Incorporating ESG Criteria for Investors

Benefits	Challenges
<b>Improved risk management</b>	Limited standardisation of ESG metrics
<b>Increased long-term returns</b>	Lack of transparency in ESG reporting
<b>Alignment with personal values</b>	Difficulty in measuring the impact of ESG criteria

According to the findings of the interviews with investors, using ESG factors in investing choices may give a few advantages, including enhanced risk management, greater long-term returns, and personal value alignment. However, the interviews also indicated that there are certain obstacles connected with the incorporation of ESG criteria, including a limited standardisation of ESG measurements and a lack of transparency in ESG reporting.

As per the outcomes, including ESG factors in investment choices pertaining to private equity may have a beneficial effect on returns and provide a few potential advantages to private equity companies and investors. Incorporating ESG standards, on the other hand, might result in a number of complications, such as higher prices and restricted access to data.

### 3.6 Impact of ESG Criteria on Private Equity Returns

The coefficient of ESG criteria was statistically significant, indicating that ESG criteria are positively associated with private equity returns. The R-squared value of 0.43 suggests that 43% of the variation in private equity returns can be explained by ESG criteria. Therefore, private equity firms that incorporate ESG criteria into their investment decisions may achieve higher returns than those that do not.

### 3.7 Integration of ESG Criteria into Investment Decisions

According to the findings of the interviews conducted with private equity companies, most businesses include ESG factors into their selection of investments. The integration is different for each company; some companies have environmental, social, and governance (ESG) standards, while others include ESG factors in a more casual manner. A mix of ethical and financial reasons is pushing the incorporation of environmental, social, and governance standards. Ethical concerns refer to the disposition to direct resources towards businesses that have a positive impact, both socially and environmentally, on the communities in which they operate.

### 3.8 ESG Factors Considered Most Material by Private Equity Firms

The interviews with private equity firms revealed that the ESG factors considered most material vary across firms. However, common themes emerged, with environmental factors being considered most material by most firms, followed by governance and social factors.

### 3.9 Potential Benefits and Drawbacks

The interviews with private equity firms revealed several potential benefits of ESG investing, including reduced risk, improved reputation, and access to new markets. However, the interviews also revealed some drawbacks, including increased costs and limited data availability. The benefits of ESG investing are likely to increase as ESG factors become more important to investors and stakeholders.

### 3.10 Benefits and Challenges of Incorporating ESG Criteria for Investors

ESG investment may lead to enhanced risk management, greater long-term returns, and alignment with personal values, as was found by a review of the advantages and obstacles of implementing ESG criteria for investors. ESG investment does, however, come with its fair share of difficulties, the most significant of which are the limited standardisation of ESG measurements, the lack of transparency in ESG reporting, and the need of balancing material needs with other priorities in life.



## 4. Conclusion

The purpose of this research attempt was to determine whether ESG norms had an impact on the returns on private equity investments. In addition to this, it investigated how private equity companies integrate ESG criteria into their investment choices, which ESG elements private equity firms deem to be the most relevant, the benefits and drawbacks of ESG investing in the private equity sector, and the advantages for investors of incorporating ESG considerations.

According to the findings of the research, private equity companies that consider ESG variables to consider while making financial investments have a greater potential to realise better profits while simultaneously reducing their exposure to risk. Additionally, investors may benefit from integrating ESG criteria into their investing choices by aligning their investments with their personal beliefs, enhancing risk management, and maybe obtaining greater long-term returns. This can be accomplished by incorporating ESG criteria into their investment decisions.

### 4.1 Future Scope

The study suggests several areas for future research, which include:

1. Comparative analysis: Future studies may conduct a comparative analysis of private equity firms that integrate ESG criteria into their investment decisions versus those that do not.
2. Robustness check: Future studies may check the robustness of the findings using different data sets and analytical methods.
3. Impact on non-financial performance: Future studies may investigate the impact of ESG criteria on non-financial performance measures, such as employee satisfaction and customer loyalty.
4. Industry-specific analysis: Future studies may conduct industry-specific analysis to investigate the impact of ESG criteria on private equity returns in different industries.

### 4.2 Suggestions

Based on the outcomes of this study, the following suggestions are made for private equity firms and investors:

1. Formal ESG policies: Private equity firms may consider developing formal ESG policies to ensure that ESG criteria are integrated consistently and systematically into their investment decisions.
2. Standardisation of ESG metrics: Private equity firms may collaborate with industry associations and other stakeholders to develop standard ESG metrics to ensure comparability and transparency.
3. Improved ESG reporting: Private equity firms may encourage portfolio companies to improve ESG reporting to ensure that accurate and comprehensive information is available to investors.
4. Inclusion of ESG criteria in due diligence: Private equity firms may consider including ESG criteria in their due diligence processes to identify potential ESG risks and opportunities.

ESG integration in investment decisions: Investors may consider investing in private equity firms that integrate ESG criteria into their investment decisions to achieve higher returns and reduce risk.

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**Does this article screen for similarity?** Yes

**Conflict of Interest:** The Author has no conflicts of interest to declare that they are relevant to the content of this article.

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