Cash with a Conscience: Developments in the Field of Private Equity

Hanneke Mol and Frank Wildschut

Arcadis NL

Simon Rawlinson

Arcadis UK

Alessandro Casartelli

Arcadis Italia
Abstract

This paper focuses on the differential approach to sustainability adopted by private equity fund managers (general partners, GPs) versus that of their investment partners (limited partners, LPs). To this end, we present the findings of an exploratory study on investors’ criteria for sustainable investments carried out by Arcadis in 2015. The hypothesis of this study was that a mismatch between the approach to sustainability adopted by private equity fund managers and their investment partners would be reflected in the expectation that (1) a small percentage (<25%) of the world’s largest private equity fund managers took steps to demonstrate their ability to measure the sustainability performance of their investments, and (2) a high percentage (>75%) of the world’s largest institutional investors operating as limited partners claim they measure the sustainability performance of their investments prior to acquisition. Here we discuss the findings of this study, after which we explore the observed differences theoretically by drawing on institutional theory, legitimacy theory, and signaling theory.
Non-Financial Disclosure

Against the background of increased awareness of, and attention for, the environmental and social risks and impacts of business activity, the demand for greater corporate transparency on environment, social, and governance (ESG) related issues is growing. However, ESG reporting is characterized by a wide variation in disclosure practices, even when disclosure is regulated or mandatory (De Silva Lokuwaduge & Heenetigala, 2017). Here, our specific interest is with the ESG disclosure practices of private equity funds and investors. In 2013, the Environmental, Social, and Corporate Governance (ESG) Disclosure Framework for Private Equity was adopted by Invest Europe (Invest Europe, 2013). The framework sought to facilitate “a more structured approach to managing environmental, social, and corporate governance (ESG) risks and opportunities” in the private equity sector (De Silva Lokuwaduge & Heenetigala, 2017, p. 1) to address the need for better alignment between general partner and limited partner requirements and expectations vis-à-vis ESG-related policies in the fundraising stage and during the life of a fund.

Based on practical experience and knowledge-exchanges in the field, Arcadis, whose consultancy services include promoting environmental, social and governance considerations in project financing strategies and investment decision making, also had become alerted to a seeming disparity in the commitment to sustainability within private equity (in terms of performance as well as reporting) in comparison to financial institutions and banks (especially those with a more public profile). To gain better insight into this matter, Arcadis conducted a small-scale exploratory study called Cash with a Conscience (CWAC) in 2015, the findings of which we will discuss here. We would like to stress that the present paper is mostly intended as a discussion piece and as an impetus to more systematic and theoretically grounded research.
around how to improve and harmonize ESG reporting in the private equity industry. We describe these reasons in the section below.

The paper is structured as follows. First, we describe the focus, methodology, and main findings of the CWAC study. To address one of the main limitations of the study (the lack of theoretical grounding), we theoretically explore why the observed differences exist. We suggest three theoretical orientations that seem most promising to shed light on the differences in ESG reporting practices in the private equity field (both regionally and between private equity fund managers and limited partner investors). We then propose several corresponding leads for further research that could fill the main knowledge gaps that remain to be tackled for policy makers and regulators to respond to private equity sector ESG transparency and performance with sufficiently tailored measures.

**Cash with a Conscience (CWAC) Study**

The starting point for this paper is an exploratory study on investors’ criteria for sustainable investments carried out in 2015. The study was based on the differential approach to sustainability adopted by private equity fund managers (general partners, GPs) versus that of their investment partners (limited partners, LPs) as had been mentioned but not elaborated on in much detail at the time by initiatives such as the *ESG Disclosure Framework for Private Equity* (Invest Europe, 2013). Arcadis identified a need for more sustained research to help convince GPs and LPs of the need to take on a more proactive approach vis-à-vis their ESG responsibilities.

The *Cash with a Conscience* (CWAC) study aimed to verify whether limited partner investors into private equity funds demonstrated a higher level of transparency vis-à-vis the application of sustainability criteria than the general partners who manage the private equity
funds. The hypothesis was that there is a mismatch between the approach to sustainability adopted by private equity fund managers and their investment partners (LPs), which would be reflected in the expectation that (1) a small percentage (<25%) of the world’s largest private equity fund managers took steps to demonstrate their ability to measure the sustainability performance of their investments, and (2) a high percentage (>75%) of the world’s largest institutional investors operating as limited partners claim they measure the sustainability performance of their investments prior to acquisition. Such a divergence risks undermining the sustainability of the corresponding investments, the reputation and future demand for private equity investments, and the credibility of the ESG monitoring regime.

A web-search based research project was therefore set up, to assess the level of transparency of private equity GPs and LPs with regard to the application of ESG criteria. By contributing to enhanced understanding of best practices in standardization and transparency of ESG reporting in the private equity industry, the study underscores the need for private equity fund managers to shift to a more transparent ESG-reporting approach.

Method

A small-scale, exploratory study was conducted by reviewing the websites, annual reports, and sustainability reports of some of the world’s largest private equity fund managers, private equity limited partners, and debt financing organizations. The focus on the latter was introduced to provide more depth and contrast to the analysis. We summarized and categorized references to sustainability criteria for investments on these organizations’ websites and analyzed the terminology, the use of formal sustainability criteria, and the existence of a managed process of ESG monitoring and reporting in their most recent annual and sustainability report.
Sampling took place on the basis of a purposive sampling method informed by two ranking overviews elaborated by Private Equity International, listing the world’s largest private equity investors and funds at the time of the study. Of the 50 limited partners and 50 general partners included in the study, within each group, 33 were headquartered in North America, 14 in Europe, and three in the Asia-Pacific region. In addition, 31 lenders were included in the sample, representing the largest banks by capitalization.

**Key Findings**

We observed a significant difference between the ESG transparency levels of debt financing in comparison to private equity. Of the lenders included in the sample, 90% regularly monitored and reported on their ESG-performance; 70% of lenders were aligned to the GRI Framework; and 61% published their ESG report on the GRI database.

We did not find a similar level of transparency from private equity firms. It was observed that the reporting and disclosure practices of general partners lag considerably behind those of limited partners. Annual sustainability reporting levels by LPs, for example, far exceed the reporting levels of GPs; whereas nearly 80% of LPs produce an annual sustainability report, among GPs the rate of firms that report annually on ESG is slightly more than 30%. However, while a bigger proportion of LPs compared to GPs report on sustainability, it should be added that both perform quite poorly when it comes to sustainability investment reporting: 45% of LPs and 55% of GPs do not report on sustainable investment. Moreover, in their reports, neither GPs nor LPs use measurable criteria that allow for the tracking of ESG performance. Instead, both tend to use only generic statements and/or case studies. Lastly, less than 30% of LPs and little over 10% of GPs publish their ESG reports on the GRI database.
In short, it appears that debt financing comes with more of a ‘conscience’ than private equity, with banks demonstrating greater ESG maturity and disclosure transparency than equity investors do. Most crucial for this discussion is the observed difference with reference to private equity financing between the reporting and disclosure practices of general partners versus limited partners. These findings confirm the imbalance between GP and LP approaches to sustainability that (in part) informed the ESG Disclosure Framework for Private Equity.

With regard to regional differences, due to the small sample size and uneven regional distribution of the sample, findings cannot be taken as conclusive and are indicative at most. When it comes to visibility on LPs and GPs’ websites, LPs headquartered in North America are most likely to have a link to their sustainable investment policy on their homepage (18% versus 7% in Europe). In terms of more general visibility (i.e., not limited to firms’ homepages but also including their websites more broadly), LPs and GPs headquartered in Europe make reference to sustainable investment policies more often than their counterparts in North America (near 80% for GPs and over 90% for LPs, versus 45% and 55% in North America). Firms in the Asia-Pacific region did not refer to their sustainable investment policies. However, we must reiterate that the sample size is too small to be taken as representative. Lastly, GPs and LPs in Europe are substantially more likely to be signatories to the United Nations Principles for Responsible Investment (UN PRI) reporting framework, although this difference is more evident for GPs (86% in Europe and 24% in North America) than for LPs (79% in Europe and 45% in North America).

Limitations

There are several limitations that may restrict the strength of the conclusions drawn from the CWAC study’s main findings. To begin with, the findings may be somewhat dated. The
study was conducted in 2015, which means that the reporting and disclosure practices that were assessed correspond to the year 2014 and older. Developments in ESG reporting and disclosure standards and requirements are fast evolving; consequently, a narrowing of the gap between the ESG commitments and transparency of GPs and LPs cannot be ruled out.

Second, there is a selection bias due to the fact that only funds that publish material on accessible websites have been included (e.g., sovereign wealth funds were outside the scope of the study). In addition, the 50 largest private equity funds (at the time of the study) were included, thus insight into variations according to the size of funds is limited.

Third, the CWAC study was designed as a small-scale exploratory study rather than a systematic content analysis of websites, annual and sustainability reports and a thorough examination of the organizational structure and investment profile of the firms included in the sample.

The fourth limitation, which most directly informs the remainder of this paper, is that the CWAC study lacks theoretical grounding. The study was conceived mostly from a commercial and practically inferred basis. The formulation of the hypothesis was neither preceded nor followed up by an extensive literature review and theoretical exploration of the issue at hand. Admittedly, the research design has been constructed on a somewhat thin basis, which makes it difficult to interpret the why and how from here of the findings. Three theories seem to connect best to the observed disparities and will therefore be explored below.

**Differences in ESG Reporting: Theoretical Explanations and Recent Trends**

ESG reporting and disclosure practices have been found to correlate to a wide variety of aspects. These range from board structure (Husted & de Sousa-Filho, 2018), corporate culture, and type of sector (De Silva Lokuwarduge & Heenetigala, 2017), legal regime (e.g., addressing
variations in shareholder, stakeholder and investor protection in civil law versus common law systems), and country-specific institutional factors, cultural values, and perceptions (Feng, Wang, & Huang, 2015). Relevant theoretical perspectives for enhanced understanding of the divergences in ESG reporting and disclosure practices of the private equity industry appear to be insights derived from institutional theory, legitimacy theory, and signaling theory. In what follows, we explore each of these briefly.

Institutional theory emphasizes the importance of the social and political context in which a firm operates. This relates to such things as the influence of legal and regulatory frameworks on corporate behavior and decision-making, monitoring of business practices by civil society organizations and other (public and private) bodies, prominence of labor unions, and cultural configurations within society (Baldini, Dal Maso, Liberatore, Mazzi, & Terzani, 2018). Rather than mere instrumental decision-making, a firm’s ESG policy and reporting practices from this point of view are shaped by the broader social structures within which these firms operate.

The influence of cultural values and perceptions that prevail in a given region or country has been addressed by Feng et al. (2015) who note that CSR tends to be viewed differently in Asian countries compared to Europe and North America,. While cultural variety between and within Asian countries (and recent ESG trends) cannot be sidestepped, overall, Feng et al. note that Asian cultures tend to be more family and in-group focused. This is seen as having important implications for understandings and expectations of corporate social (and environmental) responsibilities. Our finding that firms in the Asia-Pacific region made no reference to their sustainable investment policies seem to corroborate Feng et al.’s analysis of attitudes toward CSR. As a caveat, we once more point to our small sample size. However, the relationship between cultural values and societal perceptions of private sector responsibility for
sustainable business practice on the one hand, and the commitment of private equity firms to report on ESG-issues on the other hand, certainly merits to be explored in more depth.

An interesting contribution that focuses specifically on institutional differences between the US and Europe is Matten and Moon’s (2008) examination of implicit versus explicit CSR. Although contemporary ESG reporting and disclosure trends seem to reflect a rather globalized form of explicit CSR, Matten and Moon note that, historically, explicit claims of CSR were primarily seen in the US. On the other hand, such practices have traditionally been a much more implicit part of the business models and practices of European companies. Matten and Moon explain these cross-national differences with reference to the “historically grown institutional frameworks” that shaped the practices of US and European companies. For example, historical differences exist in the level of corporate oversight and government interference in social and economic matters. Such interference and oversight has tended to be higher in Europe while there is greater corporate discretion in the US. Another difference concerns the primacy of shareholder interests in the US versus a stronger orientation towards stakeholders other than shareholders in Europe. Yet another factor mentioned by the authors is the influence of greater union membership and government-led labour market policies in Europe. However, Matten and Moon note that increasingly companies in Europe have been adopting more explicit approaches to CSR. The last point seems to be supported by our study’s finding that the rate of GPs and LPs signed up to the UN PRI reporting framework is higher in Europe than in North America. While admittedly somewhat speculative, it is not unthinkable that the more restricted scope for corporate discretion that has historically characterized European business practices is more accommodating to evolving expectations and regulatory requirements vis-à-vis ESG reporting. Findings from existing scholarship confirm that the ESG disclosure policies of European firms
are more transparent than those of North American (and Asian) firms, which is thought to reflect stronger standard-setting and regulatory actions in Europe (e.g., Feng et al., 2015).

However, the most pressing question that emerges from Matten and Moon’s (2008) exposition is whether there is a difference between the ESG performance of US and European private equity. If significant differences exist in this respect, it would be interesting to explore whether they can be traced back to the historical embeddedness of US and European firms in their respective institutional frameworks. The way in which institutional theory can enhance our understanding of ESG performance and reporting practices in the private equity field certainly merits further examination.

**Legitimacy Theory**

ESG reporting and disclosure are also seen as an instrument of legitimacy-seeking. Legitimacy theory is premised on the notion that there is a relationship between corporate reporting and the expectations of stakeholders. If a company does not enjoy societal acceptance of its business practices, its legitimacy is at stake. In the words of De Silva Lokuwaduge & Heenetigala (2017):

> Legitimacy theory emphasizes that an organization must consider the rights of the public at large, not merely the rights of the investors. Failure to comply with societal expectations may result in sanctions being imposed in the form of restrictions on firm’s operations, resources and demand for its products. (De Silva Lokuwaduge & Heenetigala, 2017, p. 440)

Legitimacy theory cannot be understood in isolation from institutional theory. The legitimacy of business practices (whether business practices are appropriate, desirable, and/or acceptable), is dependent on the set of beliefs, values, and norms held by society (Baldini et al.,
2018) or certain groups within a society. In other words, legitimacy is shaped and influenced by the external environment.

From a legitimacy point of view, a key factor in influencing ESG disclosure is public or social visibility. Visibility can be divided into visibility to investors and visibility to non-investors. Firm size is generally held as a good proxy measure for visibility to non-investors. In keeping with legitimacy theory, a higher visibility of a company’s possible impact on social and environmental conditions tends to result in more effort being directed at disclosure of ESG policies and performance (Baldini et al., 2018). Legitimacy also hangs closely together with public accountability. Van Zijl, Wöstmann and Maroun (2017), in this respect, explain that the high levels of strategy-related disclosure (environmental, social and economic) by the banking, insurance and real estate subsectors, are necessitated by “the need to manage their legitimacy and address adverse selection” in view of a high public accountability and daily interaction with customers. Our study’s finding that the LPs in our sample reported more on sustainability than GPs are in keeping with the assumptions of legitimacy theory.

This also connects well with stakeholder theory, which holds that stakeholder exposure is of important influence on the extent and quality of companies’ ESG disclosure practices (De Silva Lokuwaduge & Heenetigala, 2017). Higher levels of visibility and public accountability are considered to be linked to increased exposure to corporate scrutiny from relatively powerful stakeholders. Employees, for instance, take a growing interest in how their pension funds invest their money. A similar development can be noted with regard to insurance takers and calls on universities to divest from unsustainable or otherwise controversial investments. Pressure from non-governmental organizations’ campaigns and publicity form another source of exposure (e.g., Mighty Earth, 2018; Preesman, 2018).
These dynamics seems to apply to limited partners in particular. In contrast, general partners generally do not experience the same societal pressure, as confirmed by the following statement:

For financial services and investment instrument firms, in particular, the business model is complex and focused on generating returns for a niche group of stakeholders. In addition, these companies have relatively few daily dealings with the general consumer. Consequently, the societal pressure to manage environmental and social issues (as predicted by legitimacy theory) actively is low. This is especially true given that the link between social and environmental issues and the organisations’ business model is only indirect. (Van Zijl et al., 2017, p. 81)

General partners are primarily accountable to their limited partner investors. LPs, in this sense, have an important role to play in enforcing stricter ESG commitment and transparency on part of GPs when negotiate the terms of the fund in which they plan to invest. We close this section by reflecting on this with reference to signaling theory.

**Signaling Theory**

From recent reports and attempts by the UN PRI to harmonize the ESG commitments of LPs and GPs (Buckley, 2017; PRI & ERM, 2018), it follows that the incorporation of ESG considerations into private equity fund terms and transparency vis-à-vis the operation of private equity funds is still not quite satisfactory:

The 2017 PRI reporting data, based on submissions from 219 LPs and 332 GPs on their responsible investment progress, indicates (i) that 63% of PRI LP signatories consider responsible investment in their appointment of private equity managers, whereas (ii) 39%
of PRI GP signatories are not making commitments to responsible investment in their fund terms, or are not being asked to do so by investors. (Buckley, 2017, p. 10)

The quality and maturity of GPs’ publicly available responsible investment policy has thus been identified as an important indicator of the likelihood that ESG considerations are being incorporated into private placement memorandums or limited partnership agreements. With regard to the potential role of LPs in pushing for enhanced ESG commitments by GPs, Buckley notes that mandating of responsible investment activity through fund terms is at present mostly “an aspirational endeavour” still in the early stages of development (Buckley, 2017, p. 11).

In view of the observed differences in ESG disclosure practices between GPs and LPs and recent efforts towards harmonization, it is interesting to see whether limited partners could gradually become more reluctant to invest into funds managed by general partners that are less prone and transparent about their ESG policies and performance. Drawing on signalling theory, Van Zijl et al. note that “high quality ESG disclosures signal that potentially significant business risks are being effectively managed, reducing information asymmetry and lowering the cost of equity” (Van Zijl et al., 2017, p. 74). Reporting on ESG issues according to this theory may reduce the risk of adverse selection. It is worth investigating whether this logic also holds true for the relationship and investment dynamics between GPs and LPs. If greater selectivity on the part of LPs starts to affect the continuity of financial returns for GPs, in keeping with signaling theory this may function as an important incentive for GPs to shift towards more transparent ESG reporting and disclosure practices. As such, signalling theory’s concern with the link between ESG disclosure and the ability of organizations to generate financial return could offer important insights into future directions of ESG disclosure practices within the private equity industry.
Conclusion and Suggestions for Further Research

Considering the potential for positive leverage by private equity firms on the ESG performance of their portfolio companies and the influence that private equity firms exert across society based on the sheer size of the private equity market, it is vital that both limited partners and general partners demonstrate their commitment to ESG through transparent reporting and disclosure practices. This paper has highlighted some key differences between private equity general and limited partners in regards to ESG reporting by presenting the findings of the CWAC study conducted in 2015 and connecting this study to insights from institutional theory, legitimacy theory and signaling theory.

Perhaps the most urgent conclusion is that more research is needed in this area. To the best of our knowledge, there is a lack of literature and research dealing specifically with ESG reporting and disclosure differences between private equity fund general partner and limited partner investors. While institutional theory, legitimacy theory, and signaling theory all seem to make important contributions to understanding the observed differences, the explanatory potential of each of these theories requires more thorough research and analysis. Recent efforts to harmonize GP and LP approaches to sustainability are steps in the right direction, but the success of such initiatives depends on understanding the underlying determinants of ESG transparency and commitment. The influence of fund terms on GP ESG behavior seems to be an interesting area for further research. The extent to which more explicitly ESG-aligned funds form more attractive business opportunities is another area that warrants more research.

As a final reflection, it is worth emphasizing that ESG information disclosure does not necessarily correspond to good ESG performance (De Silva & Heenetigala, 2017). Therefore, in order to assess whether ESG adds value (economically, socially, and environmentally), the
extent to which ESG disclosure and reporting accurately reflect actual ESG performance must be examined. Important in this regard is that disclosure dynamics are still predominantly driven by the *materiality* of ESG reporting to *investor needs*; environmental and social considerations, as a result, are still largely secondary to financial motives. Arguably, the logic of "corporate social performance" as the driving force behind ESG disclosure and reporting still prevails over the logic of "civil regulation" (Levy, Brown, & de Jong, 2010). Thus, it seems legitimate to question the extent of reporting on the more contested environmental and social dimensions of investments and business activities. Quantitative assessment of ESG disclosure practices as well as the analysis of annual and sustainability reports cannot provide the answers to these more fundamental questions. Multimethod approaches, including ethnographic, qualitative case study research into investment portfolios, are a welcome addition to fill these gaps in the discussion.
References


Endnotes

1 Using the LP50 and PEI300 rankings developed by Private Equity International’s Research and Analytics division (Private Equity International, 2014a, 2014b).

2 In keeping with what has been discussed in terms of visibility and the level of power held by different stakeholders, dominant and powerful groups are better positioned to exert influence on companies. In contrast, for subjugated groups it will be much more difficult to challenge the legitimacy of corporate activity.