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THE CORPORATE SOCIALLY RESPONSIBLE INVESTING CRITERIA IN PRIVATE EQUITY: RELEVANCE AND BUSINESS IMPACT

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Abstract. *When thinking about Corporate Social Responsibility (CSR) approach in the business field it is not usual to refer it to Private Equity (PE). Despite this specialized business could be taken as tester for the development, impact and integration of sustainability into the CEO Agenda of the companies, the grey and dark zones surrounding it and the low degree of knowledge to the public in general left it to a backstage position. In addition, the economic importance of the money flows managed by the companies in the Investment sector is noticing the regulators to consider their importance and increase the restrictions and information requirements to all the stakeholders in the market. Prior to the regulators interest in becoming an active stakeholder in the relation of public finances with private equity, the pure players itself have started to prepare regulations and codes of conduct that are becoming really important to understand the flows of investment as well as sourcing the analysis of the returns of the investments in the economic and non-economic environment. This paper is aimed at analysing the importance of SRI and CSR in the PE field of business, highlight best practices of the main players, learn from the implementations carried out and, eventually, set the basics for an integrated model that could satisfy General Partners and Limited Partners requirements in the quest for capabilities in the wide and non-regulated environment surrounding us. This paper will highlight topics to be covered by research in progress.*

Keywords: *CSR; SRI; Private Equity; ethics; finance; stakeholder theory; GP; LP.*

Introduction

The importance of responsibility in the investment process has been extensively studied throughout the academic and practitioners economic research in recent years, mainly due to the growing importance since its inception in the sixties in countries of Anglo-Saxon culture. Not only financial aspects are relevant, but also social or environmental. The objective is not only to exclude "bad practices" from the investment management, but also to include and empower those considered as positive to the market.

The formalization of the concept of responsible investment in the sector of *Private Equity* (PE) is, however, more recent and has come to consolidate the restructuring effort undertaken by listed companies and public institutions over recent years. Some self-regulatory initiatives that have sought to bring order such as In USA the *Private Equity Council* (PEC) *Responsible Investment Guidelines* (2009); in UK the guidelines for responsible investment by GP promoted by the *Brititsh Private Equity & Venture Capital Association* (BVCA) (2008); or the standards of the *European Venture Capital Association* (EVCA) about this subject.

Several factors have delayed the full implementation of the principles of responsible investment in PE (e.g. info to provide useful to competitors, risk of negative impact of the information provided, or interference in decision-making or management). However, the positive factors have asserted their ability to gain ground allowing *Socially Responsible Investment* (SRI) to be useful, for example, in reducing risk through better control, improving operational efficiency and to promote continuously

sustainable growth for a long-term. Specifically, the *Principles for Responsible Investment* (UN PRI) outline the investor's commitment based on six elements: incorporation of investment principles Environment, Social & Government (ESG) to capital management policies; active participation in management and decision-making to ensure compliance; information and transparency of proceedings; promotion of the application of the principles; effectiveness of implementation; and implementation of the principles in each report.

To have an idea of the relevance of this subject, it is possible to observe a direct correlation of SRI with both the size and the internationalization of a company (Cumming, 2006). The more responsible the company is, the bigger and international appears. These considerations in the field of PE (referring to Limited Partners –LP– who are investors in portfolio companies & General Partners –GP– who are mostly manager of others' resources) are fuelling changes in how investments are analyzed and managed by the different stakeholders. Whereas some few consider it as part of the due diligence prior to investment, others are incorporating it into their information systems or are scheduling systematic audits about all these aspects. The model is not unique. As a consequence the usefulness of academic analysis to assist in the formalization process could be justified.

The importance of PE has been widely analysed in the academic literature (Prowse, 1998; Blanc, Goldet & Hobeika, 2009; VV.AA, 2010). Its origins date back to 1946 when professors at MIT, Harvard Business School and a group of businessmen decided to capitalize those technological developments achieved during the World War II (McKinsey & Co., 2001). However, the first society was formally constituted in 1958 by Draper, Gaither and Anderson with a limited investment objective focused on small businesses and corporations with a risk guaranteed by the federal state. In 1979 it was allowed the investment by pension funds in this kind of businesses what was a decisive factor for the development of PE as it provided liquidity to the market that hitherto did not exist. After turbulent 80's, the 90's accounted for change and consolidation through increased professionalism of the business that could be considered as the germ of the present activity.

A few advantages of the investment market development brought by the PE should be highlighted at this point (Davis, 2009; Spindler, 2009; Hulser, 2008), especially before introducing SRI in the analysis. By mean of the PE investment the invested company may be positioned out of public direct scrutiny; the ownership model may result in a faster timing for implementation of reorganization processes or launching new products; it is easier the acquisition of new businesses allowing faster non organic growth; and it allows streamlining the process of disinvestment when required.

SRI as a pillar of social development

It is difficult to address the evolution of the concept of SRI without considering the influence of Christianity in this development in terms of economic analysis or social impact (Schwartz, 2003; Heilbroner, 1993; Kinder & Domini, 1997; Mackenzie, 1998). Nevertheless, it is more appropriate to focus the analysis in recent times, especially from the 80's, as it was then when the concept was formalized (Schwartz, 2003) due to the investor concerns about environment, labour, oppressive regimes, security of the products manufactured…; to the growing importance of business ethics and corporate responsibility movement; to the creation of indexes that only incorporated sustainability investments considered as ethical; or to the creation and activity of national investment companies.

In 1998 the UK law makers incorporated a new element in the development of ethical funds by announcing in July that year that pension funds should be obliged to inform if they were adopting ethical principles in their investments. After that, Stephen Timms, Pensions Minister, coined the term *Socially Responsible Investment* (SRI) that has evolved untill the present time.

The development of procedures for ethical investment, considered in some cases an innovation aimed at increasing the portfolio of potential investors, has been used by opponents of Cowton, Anderson et al. (cited in Sparkes, 2001), to demonstrate that this new category, really answered to a need expressed by investors:

> *"(…) But that does not mean what they are doing has a right to be labelled "ethical" with the at least occasional implication that other investments are unethical.... This Report suggests that their own investments might variously be accurately labelled "investments reflecting investors' opinions", "investments reflecting fashionable causes", "scrupulous investments", "ethically simplistic investments"... the overall objection to ethical investment codes is their aggressive simplicity ... a simplicity which ill fits them for their ethical work... there is no reason why the various investment institutions should not continue to serve (their customers) and their preferences. The only objection this Report makes is that they should not describe what they are doing as "ethical" investment."*

The differential factor of SRI lies then in its combination of social and environmental financial objectives targeted at obtaining an economic return on market conditions. It implies that the character of socially responsible does not necessarily result in a reduction of the return on investment. The return must be understood so broadly as return to shareholders and stakeholders and it has not been possible to justify a correlation, either positively (Cummings, 2000) or negative (Fernandez-Izquierdo & Matallin-Saez, 2007), between investment ethics, responsibility and profitability.

The economic literature is undergoing a process of analysis of whether ethical investment is a benefit or a cost to the return on investment. On the one hand, the existence of higher transaction costs and management fees according to Luther et al. (1992), Munnell (1983) and Lamb (1991) comes to the conclusion that SRI is a financial sacrifice in line with the theory of Friedman (1962). On the other hand Waddock and Graves (1997), Davis (1999) and Domini (1989), argue that ethical investment is a premium for the generation of intangibles not directly quantifiable in economic value. Finally, Becchetti and Fucito (2000) use simulations to show that active trading strategies do not result in passive portfolio returns significantly higher or lower.

When analyzing the ethical basis of the investment (Stanley, 1990; Dembinski et al., 2003; Hofmann et al., 2009) it is possible to identify four types of ethical concerns (Dembinski et al., 2003; Hofmann et al., 2009) to consider: ethics based on the value, oriented to profitability, aimed at obtaining a result and aimed at the creation of discrimination criteria.

As a consequence, the ethics underlying the investment may arise in different ways that would not mean a single, or uniform, approach to responsible investment formulas. The active role played by the investor, the individual's will and its ability to condition any decision-making approach is a restriction that has to be considered in every proposal. Similarly, when the relevance of SRI in the case of Europe is observed, it has been possible to conclude that legislation has constrained the development of the concept (Gainet, 2010). As a consequence it is not possible to clearly define the problem and propose a solution as if it were a mathematical equation. From the point of view of the subject that makes the investment, or for the one that will manage it, the same need that it is tried to clarify (the future development expectations and even the degree of certainty about the future impact of the decision that could be taken) is relevant for a few factors that should be deeply considered: who is responsible, to whom and how the relationship model works.

There are several strategies or execution formulas that allow us to characterize the SRI attending to its fundaments (De Graaf & Slager, 2009). Firstly as financial foundation: considering it when social and financial objectives coexist under non-binding basis. This strategy wants to take full advantage of market inefficiencies. This is the example of the thematic funds based on a portfolio that includes leader investments / companies. Secondly as ethical foundation: The social objective determines the main path; financial objectives are restrictive but not binding. The objective is to invest and manage according to the values of the beneficiaries. This is the case of ethical funds with assets exclusion criteria in their investment policy. And finally attending to the creation of value: Strategies that engage with companies incorporating environmental, social or government (ESG) aspects in the analysis itself.

The implementation of these strategies may be differently applied according to each of the typologies and criteria considered. As a consequence, the process of adopting an alternative strategy has different operational implications according to the main driver considered:

Table 1. Models of implementation of the ISR (De Graaf & Slager, 2009)

	Product	Definition	Investment horizon	Examples
Based on value	Exclusion	Sectors or companies are excluded based on certain criteria or standards (e.g. PRI)	no horizon	KLD – Index
	Best in category	Values that best meet certain criteria	Depending on the mandate	FTSE4Good
	Thematic ISR	With specific reasons (water, construction ...)	Typically long-term	
Financial foundation	ESG stock selection	Stocks cherry picking	> 1 yr	Goldman Sachs, Citigroup
	Involvement	Stance as active shareholder	3 to 5 yrs	
	Alternative investments	New products	3 to 5 yrs	Issuing Rights
	Shareholder vote	Use tools of corporate governance	3 to 5 yrs	Hermes Focus Fund
Value assurance	Type of industry	Improving government standards	No time limit	Adjust for every country

The development of the investment vehicles has been also a consequence of the increasing importance of responsible investment (Cabie et al., 2011) resulting in the creation of: Solidarity Funds, investment funds with negative criteria, thematic fund and Multisource ESG funds. Nevertheless, the truth is that the market situation is better described when considering an absence of criteria. Only self-regulation efforts offer a common framework for comparison and future development and, as a consequence, each investor sets its choice and relative weight allowing some common aspects such as purpose, principles, practice and measurement of responsibility (Spiller, 2000; Jayne & Skerratt, 2003). In consequence, the development of these criteria is the answer to the expectation to formalize the interactions between different stakeholders with impact for risks and opportunities as they are associated with the implementation.

Transparency and disclosure of basic information are parts of the common ground for investments. But the frequent asymmetries are an obstacle to let all the agents in the common traffic share the same information and interpret it in a similar way (Rhodes, 2010; Angel & Rivoli, 1997) making viable the comparison. Professionalization of the channels of information has made easier for an institutional investor to apply responsible investment criteria considering few common criteria normally shared. Despite the fact that not all the investors have access to this detailed information by one or other reason (Mackenzie & Lewis, 1999). Fortunately, the development of Corporate Responsibility Reporting gradually reduced the difficulty of access to information, but the training and experience necessary for its interpretation are not always available. It also arises one risk related to the commoditization of the information about responsibility making it ineffective once every business requires certain degree of personalization.

In order to guarantee a coherent interpretation the figure of the referee arises as potential solution. He is of particular interest as guarantor of the settlement of disputes and, eventually, the valuating the fulfilment of reporting requirements and performance of investments and entities related to them (Gootjes, 2009). As the referee cannot be considered an oracle certain boundaries have to be considered due to the restrictions that impact in the analysis such as metrics, diversification, diluted ownership and inadequate interpretation of fiduciary duties or questionable business models (Wong, 2010). The figure of the referee, with limited interest to the scientific literature when compared with the interest of the investment process, does not offer a complete solution to the need of common criteria for SRI but it

helps to coordinate the understanding of it. As a result in USA and UK a codification process has been proposed in order to share a common understanding of the concept for its evaluation and future considerations. It has been done with a proactive approach in the willingness of give a few steps. But this process is not closed. The existing codes will eventually evolve in the coming years (by mean of the evolution of self-regulation or by the inclusion of the States where investments take place in the regulatory process) and this is a clear opportunity for standardization in order to achieve global objectives in a common framework.

Private equity as lever of social investment

The application of SRI criteria for PE is described in an interesting form when analyzing an institutional investment noting that the application of criteria of social responsibility was more frequent among those investors paying more attention to accounting standards and having a centralized system for managing the investments (Cumming et al., 2010). This situation was a consequence of the importance of setting portfolio practices; and motivated by the variability of perceptions about legal factors, investment decisions, perception of risk; or mere direct concerns of investors.

It is striking that the degree of interest in the responsible application of criteria differs depending on the market in which investments are made. For example, while portfolio investment assets domiciled outside the Netherlands in more than 10% increased between 1 and 2% frequency of concern or interest in the development of SRI in the case of investors with interests in the United States this percentage increased to 5 and 6%. It is important to note that this example could be more probably associated with self-regulation and national attention to the development of accounting principles related to them than with other SRI aspects. In other example, the centralization of the investment process, either in investment managers or centralized committees, resulted in increases by 40 - 50% the trend to apply responsible investment criteria assuming the same effect on profitability. When analyzing the specific impact for PE investments the increase was higher expecting a higher return on investment as well (Cumming, 2007).

The problem arises when trying to standardize the treatment of responsible investment across different institutions. Although few codes have been formalized, their generalist approach should be personalized when applied by every investor in order to fine tune the scope and impact management (Social Investment Forum Foundation, 2010). There won't be better or worse but different implementations being useful to define a standard base for comparison purposes. For example, it is common to observe criteria of "negative assessment" or "best practice" trying to filter unsuitable behaviours or trying to strengthen and encourage those practices regarded as "worth pursuing" and differential in the market. The ultimate goal in those situations is to create shareholder value and the value of their participation in business is understood in a relative manner in each case. As a result, good practices are spread as a way of reducing problems and improving management in order to prevent large corporations from exporting negative practices in their globalization processes (McInerney, 2005) more than a source of value creation.

Different problem is observed when considering the fuzzy limit of the real nature of PE investors as a result of the tough economic situation that has arisen since 2008. In this context the GP have begun to diversify and disaggregate their investment decisions. This has resulted in a segregation of investment boutiques that have decided not to invest only in equity of the companies but to invest in other investment segments as debt trying to maximize the return on investment. Investment in equity and public debt creates a conflict of interest not only among the GP and LP, but also between different GP in the same PE consortium and between shareholders and private investors in the process of maximizing the value of a given formula of investment (Birdthisle & Henderson, 2009).

Generally, the fund manager (usually a GP) has a fiduciary duty to the investor (often an LP) which implies that the GP is legally obliged to focus their efforts on obtaining the maximum return on a specific investment. This is commonly agreed in the Limited Partners Agreements (LPA) securing commitments and obligations of the GP and LP together. A very important element of reflection is then the degree of independence that exists in a particular investment portfolio that can maintain opposing profitability

positions given investments in equity and debt of the same company. The less you pay the debt vs. the face value the greater expected return for the investor. It implies lower value of the company hurting the investor in it. Thus, limiting the participation of the GP in opposed character investments seems reasonable to preserve the interests of the LP.

These thoughts that conceptually may be reasonable are not easily applied in the normal market practice. One of the common problems associated with the formation of a PE is that investors and managers are people who offer their labour and money as an asset through an advisory scheme in which an entity raises funds from investors and manages the investment and divestment when required. The GP decides the investment (sector and company) that the LP has invested. Thus investors provide resources, not management, and there are normally large financial institutions funding the operations in the background. This situation in which the LP provides financial resources and the GP management resources serves as a breeding ground for a conflict of interest especially relevant in the highly competitive current economic situation.

A significant example of this situation is observed when analyzing the problem of *down-round* (in a negative market situation where proceeds a recapitalization conflicts of interest may arise among investors by the prices at which it is carried out and the impact this has on the overall assessment of the investment). GP's are setting-up funds specialized in the acquisition process of discounted debt managing debt and equity on a portfolio of assets. This investment strategy can have positive implications helping to reduce the risk of buyouts in investments due to the GP knowledge of the managed investments schemes -45% vs. combined. 43% equity exclusively schema (Birdthisle & Henderson, 2009). What is questioned in this circumstance is the responsibility of this type of investments given that a simple policy of diversification could serve to a similar purpose of avoiding the problems of transparency and information to the LP in addition to the obligation the GP has to maximize their profit. In conclusion, the GP would be compromised if holding debt and equity positions simultaneously.

More complex is the situation when contemplating the GP as managers, LP as investors and existing shareholders in the company which in turn may have interests directly or indirectly in any of the above through family offices, vehicles collective investment or direct investment. The situation that arises in this context makes it difficult to give a clear solution (as the case mix is variable).

When proposing a solution to the complexity it is possible to focus the analysis in the agents where the situation is more clear, the GP, defining measures (Birdthisle & Henderson, 2009) to alleviate the tension created between the various actors (investors and managers) in societies. This can be done by using alternatives such as obtaining unanimity among investors, promoting the reduction of participation commitments; developing measures to limit the impact of double taxation and shareholder financial investment or looking for consent and contractual waiver of investors.

There is not clear solution to mitigate conflicts of interest among investors except those already known of more transparency and equal access to investment vehicles for all investors with a potential conflict of interest. Designing and maintaining these matrixes of investment related risks in not an easy assignment. In addition it may imply to incur in additional management costs, not considered in advance, that could represent a disadvantage to the global implementation. But the diversity of businesses related to PE, the variety of interests and the particular requirements for their management (Blanc, Goldet & Hobeika, 2009) promote easier standards of management and investment such as the models of thematic ESG, models based on filtering criteria, and models of community work (collaborative). These entire models have been created trying to standardize the different requirements in a more comparable and stable framework easier to be understood by the different stakeholders. In fact, the models response, in the case of PE, to the high interest existing for increasing the professionalism of the activity and create a structure aligned with a transparent governance process aligned with the legal requirements and the investment and social targets (using ESG performance indicator, increasing the request of information, integrating ESG requirements in the managing practices and, for the case of the LP, incorporating ESG criteria into the RFPs in an appropriate form).

Responsible investment, defined as the incorporation of environmental aspects in the analysis of ESG investment decisions, is a growing discipline that provides opportunities for creating long term value for investors and for society as a whole. In recent years, a growing group of investors around the world has come to believe that this is one of the main developments since the dissemination of proposals on climate change, globalization and social expectations for business transformation (Institute for Responsible Investment, 2007) and, without doubt, its implementation will have a significant role for long-term returns for investors.

This belief has also been reflected in practice in the "mission related investments" (MRI). Those investments in financial products seek to achieve social and / or environmental objectives. Their practice has demonstrated that investment foundations, universities, pension funds, etc., can create long term sustainable wealth taking care not only of profit but for the impact of their investments in the markets they have presence. Responsible investment is not philanthropy, it is mainly investment and this has to be reflected in the behaviour of the investors. In conclusion investing responsibly does not mean earn less, but to earn money considering the social function that is beyond it.

Initial solution: the responsible investment guides

The drafting of guidelines for responsible investment has been the response of the market to the need to specify how the investment can be assessed and peculiarities of it. This is not an effort exclusive of public or private corporations, but requires global collaboration of most of the stakeholders. In fact, in the case of PE investments, the drafting by the United Nations of the *Principles for Responsible Investment* (UN-PRI) is an answer to common public and private goals of building markets that promote development and reduce poverty; invest in clean and efficient technologies that serve to reduce the progression of climate change due to human action; improve work environments and management practices along the value chain of companies; and incorporate good management practices of corporate governance to reduce corruption.

Ultimately the ESG responsibility issues can be material to investors, especially in the long term, and non-compliance with them could have negative effects. The community aspect and the creation of a line of general opinion is essential to explain the development of the concept. The ulterior application of criteria based on a model of principles is an improvement on the SRI compared with that understood in the traditional model. In order to set a common framework, PRI signatories are committed to (PRI, 2011a) incorporate ESG issues to their procedures as well as promoting the use of these criteria in general improving the reporting skills. The principles are not legally binding so, therefore, it does not imply a penalty for noncompliance. This is important because their failure causes ethical effects but not necessarily economic ones. The signers and developers understand implicitly that compliance offers a yield that would otherwise not be achieved and it belongs to environmental, social or government's values owned by the society with a significant impact on long-term.

The enactment of the principles was grounded in a problem of scale in implementing ESG-related aspects. Sometimes by size and others by complexity it was necessary a comprehensive and affordable approach to the different types of existing investors. Differentiate executive functions in society, protect human rights, fighting corruption or reduce carbon emissions to the atmosphere, needed in most of the cases a coordinated effort between shareholders, regulators and other market players that could not be addressed individually. By working together, the signatories of the principles formalized a single voice in defence of themselves and their effective promotion in society.

Formally, the PRI is collaboration between investors and two institutions: UN Global Compact and UNEP Finance Initiative. In the USA the program is administered under the *Foundation for the Global Compact* in New York whereas London has a branch in two organizations articulated in the *PRI Foundation* and the *PRI Association*. The latter is at present time in charge of most of the operational aspects especially with regard to the growth of the PRI Initiative in Europe.

Conclusions

The survey data that facilitates the PRI and industrial developments verify the trend of a growing interest for SRI aspects of PE investments. The last years have been particularly attractive in terms of market conditions and investors have tried to draw more or less luckily. Doing business in times of crisis does not usually coincide with maximum respect for ethical principles (the misfortune of one can mean the benefit of others), but most important given the PRI and the growing concern of LP and GP on the subject it is expected an interesting process of expansion of existing initiatives.

However, not all findings are positive. The multiplicity of codes, the lack of homogeneity and the growing importance of image of responsible investment measures question if it the right solution is been taken. Advancing sustainability models requires more a cultural change that criteria and that change is much deeper than the enactment of some principles that satisfy a select club. It is essential to further develop the work of formation and extension of best practices. A best practice does not mean subtractions of competitiveness but improve of the attractiveness to investors of the company. What begins to be observed is a selection of binomial nature (meets standards / does not meet criteria), which is increasing competition between the GP in order to attract the LP.

This situation leaves open interesting lines of research that will be developed in the future in a more empirical form. Current developments in USA and UK normalizing the concept have influenced the development of it in Europe, have not yet served for its expansion to the Asian market. The perception is that substantially different profiles exist depending on the territory. Knowing the evolution of the concept in Asia and understanding the impact of these developments in other emerging markets such as Africa and how the SRI of the PE can promote sustainable development are aspects that need to be continued in future research.

As no normalized framework has been established until now, this is an opportunity for proposing an integration model of use under different investment forms providing answers to those questions that PE stakeholders are rising currently for improving professionalization, promoting compliance and spread the word of added value of the ESG in the economic field.

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