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Perceived Factors of Importance influencing Environmental, Social and Governance (ESG) Performance Indicators in Private Equity, South Africa.

Applied Research Project

submitted by

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Declaration

I, Galelekile Cecilia Makhathini, declare that this research is my work except as indicated in the references. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration in the Wits Business School, University of the Witwatersrand, Johannesburg. It has not been submitted before for any degree or examination in this or any other university.

Galelekile Cecilia Makhathini



Signed at Johannesburg
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Abstract

Background: Private equity investment managers rely on Environmental, Social and Governance (ESG) risk and performance indicators to understand and measure ESG impacts in order to make decisions that will improve the positive ESG impacts and minimize the negative ESG impacts of their investments. Private equity investment managers assess for ESG risks and impact in order to safeguard the assets that they invest in on behalf of their investors. However, currently applied ESG risk and performance indicators do not divulge the true reflection of material issues associated with investments and these indicators do not encompass the main criteria/factors that investment managers should thoroughly understand regarding a firm's ethical impact and sustainable practices.

Objectives: The purpose of this research study is to understand the perceived factors of importance influencing ESG risk and performance indicators used by private equity investment managers during the investment screening and due diligence phases for investment decision making purposes. Subsequently, assist investment managers to consider ESG risk and performance indicators that divulge the true reflection of material ESG impacts associated with the potential investment company during the investment screening and due diligence phases to avoid reputational and financial risks that ultimately reduce investor confidence in private equity firms.

Methods: The research methodologies included research paradigm, research propositions, reliability and validity of instruments and the study, data collection, research participants, participants description and data analysis. Thematic analysis was used to identify, analyse and interpret themes from the collected qualitative data.

Results: The results indicated that perceived factors of importance influencing ESG performance indicators in Private Equity during investment screening are predominantly focused on sound corporate governance practices because business ethics enable participants to assess the potential investment for compatibility to the investment mandate and exclusion list. Such understanding enables the participants to avoid investing in activities which contravene the mandate and ethical approach of the investment mandate and exclusion list.

The findings highlight that the perceived factors of importance influencing ESG performance indicators in Private Equity during investment due diligence are predominantly focused on environmental and social factors because according to the

participants, understanding labour and working conditions, environmental commitment and communities investing determines the investment company's social image and ultimately its reputational and financial risks. The overall results indicated that pre-investment, most participants want to mainly understand the ESG aspect associated with Corporate Governance, Labour and Working Conditions, Environmental Commitment and Communities Investing. The perceived factors of importance influencing ESG risk and performance indicators that the participants want to understand pre-investment are triggered by Political, Economic, Societal, Global, Environmental and Legislative issues (PESGEL) and internal Strengths, Weaknesses, Opportunities and Threats issues (SWOT) considerations.

Conclusion: The perceived factors of importance frameworks derived from this study provide a holistic framework, which investment managers can adopt to inform decision making during investment screening and due diligence. The ESG perceived factors of importance identified in this study may be useful to private equity investment managers in order to divulge the true reflection of material ESG impacts associated with the potential investment. Therefore, it can be concluded that this proves the research proposition, P1, that perceived factors of importance influencing ESG risk and performance indicators that are predefined are likely to be more effective for decision-making purposes than perceived factors of importance influencing ESG risk and performance indicators that are not predefined.

Keywords: ESG risk and performance indicators; investment decision; investment screening, investment due diligence, investment committee, private equity, limited partners

Perceived Factors of Importance influencing Environmental, Social and Governance (ESG) Performance Indicators in Private Equity, South Africa.

1. Introduction

1.1. Purpose

The purpose of this research study is to understand the perceived factors of importance influencing Environmental, Social and Governance (ESG) risk and performance indicators used by private equity investment managers during the investment screening and due diligence phases for investment decision making purposes.

Currently, ESG risk and performance indicators do not divulge the true reflection of material issues associated with investments. Given the fact that private equity investment managers have a good reputation, which they have to uphold with Limited Partners (investors), concerning responsible investing, failure to detect the material ESG impacts is therefore intolerable (Abdullah Al-Hassan, 2013). This is due to the fact that failure to detect material ESG impacts often leads to reputational risk (associated with irresponsible investing) for both the investment managers and their investors (Inderst & Stewart, 2018). Ultimately, the reputational risk impacts the profit generated from the investment portfolio, decreasing the attractiveness of the private equity investment firms and eventually decreasing investor confidence in the private equity investment firms (Buniamin & Ahmad, 2018; OECD, 2017).

The significance of this qualitative study is that it will contribute to the body of knowledge that will assist investment managers to consider ESG risk and performance indicators that divulge the true reflection of material ESG impacts associated with the potential investment company during the investment screening and due diligence phases to avoid reputational and financial risks that ultimately reduce investor confidence in private equity firms. The study is also vital for investment managers since the importance of applying ESG risk and performance indicators that divulge the true reflection of material ESG impacts associated with the potential investment company is considered the ability to thoroughly screen potential investments for both risks and opportunities and manage reputational risks (OECD, 2017).

1.2. Context of the study

ESG refers to the three central factors ideal in measuring the sustainability and ethical impact of an investment using ESG risk and performance indicators (Sherwood & Pollard, 2018). Complementary, ESG risk and performance indicators focus on the triple bottom line consequences of long-term risks and opportunities. These consequences are associated with environmental management, occupational health and safety, labour standards and working conditions, corporate governance and community health and safety considerations amongst other ESG factors (Kuosmanen & Kuosmanen, 2009; Sultana, Zulkifli, & Zainal, 2018).

It is for this reason that private equity investment managers rely on ESG risk and performance indicators to understand and measure ESG impacts in order to make decisions that will improve the positive ESG impacts and minimize the negative ESG impacts of the investments as well as to safeguard the assets that they invest in, on behalf of their investors (Chartered Financial Analyst [CFA] Institute, 2015; OECD, 2017;). This process is critical because private equity investment managers are aware that all organisations have ESG impacts, therefore, understanding both the positive and negative ESG impacts become paramount during the investment screening and due diligence phases (Inderst & Stewart, 2018).

Globally, ESG remains in its relative infancy, with investors and private equity investment managers continuously looking for ways to integrate and implement ESG for investment management (United Nations Principles for Responsible Investment [UNPRI], 2019). Focusing at the Europe, Middle East and Africa (EMEA) markets, corporate governance is currently the most incorporated ESG element into the investment process of Private Equity firms. ESG integration is more developed in the Netherlands compared to the other EMEA markets. Islamic finance in the Arabian Gulf region complements ESG as it advocates for good stewardship towards society and the environment. The United Kingdom is one of the most advance markets when it comes to ESG integration in the investment process (UNPRI,2019).

In Switzerland, private equity investment managers are the most advanced when it comes to ESG integrated because they embedded ESG in their valuation models. According to the UNPRI (2019) report, private equity investment managers go as far

as adjusting their valuation models and tools in order to consider ESG issues. Risk management seems to drive ESG integration in all the markets, particularly in France, despite the barriers associated with the limited understanding of ESG issues and the concerns about investment benefits of ESG integration. In all markets, the main barrier to ESG integration is often the result of limited understanding of ESG issues, lack of comparable historical data and a lack of ESG culture at the investment firms (UNPRI,2019).

Despite the barriers, ESG integration not only assists private equity investment managers as a tool for risk management and with being consistent with the World Bank's Equator Principles, IFC Performance Standards, IFC Environmental Health and Safety (EHS) Guidelines, the United Nations Principles for Responsible Investment and the International Labour Organization (ILO) amongst other government regulations and standards. However, ESG integration also enables private equity investment managers to be socially responsible investors. This is why private equity investment managers view ESG risk and performance indicators as multiple factors that can be considered as a prerequisite for investment approval by the investment committee during the investment analysis and decision-making process (Dočekalová, Marie Kocmanová, Alena Šimberová, & Koleňák, 2018; Nelson, 2017).

Notwithstanding the successes associated with ESG incorporation into the investment screening process, improving ESG risk and performance indicators for making better investment decisions in private equity is still paramount (Dočekalová et al., 2018; Efimova, 2018; Syed & Ntim, 2017). Hence, non-traditional and innovative ESG risk and performance indicators such as formalising the employee interview process and liaising with government department officials to gain insight on the company's performance with regards to labour relations should be a standard operating procedure during the investment screening process (Cini & Cicci, 2018).
For such reasons, improving and quantifying the ESG risk and performance indicators for making better investment decisions in private equity, will have significant benefit for the investment screening and due diligence phases (Sultana et al., 2018).

1.3. Research Problem Statement

ESG implementation and compliance is a fundamental policy goal for governments worldwide and private equity offers a feasible option towards the actualisation of this goal (Kell, 2018; Organisation for Economic Co-operation and Development [OECD], 2017). Currently, as stated by Jain, Zengdi & Domen (2018) private equity investment managers use the consistently applied ESG performance indicators, which include inter alia:

- Environmental indicators (i.e. environmental management system, greenhouse gas emissions, water consumption, electricity consumption, fuel consumption, hazardous substances usage, waste generation and management, etc.),
- Social indicators (i.e. working conditions, employee health and safety, human capital management, labour relations, community health and safety, product, customer-related social impacts, stakeholder management etc.), and
- Governance indicators (i.e. board effectiveness, corporate conduct, political lobbying and politically exposed persons, anti-money laundering and anti-corruption, board diversity, etc.).

These indicators are often based on ESG standards and regulations such as International Finance Corporation (IFC) Performance Standards, UN Principles for Responsible Investment, International Labour Organisation, International Organisation for Standardisation (ISO) and host country laws etc.

However, despite being based on internationally recognised standards and regulations, these indicators do not encompass the main criteria/factors that investment managers should thoroughly understand regarding a firm's ethical impact and commitment to sustainability (Syed & Ntim, 2017). Granted, the issue is not the internationally recognised standards and regulations but partially due to the lack of a universally accepted standard for defining ESG risk and performance indicators.

Since there is no universally accepted standard for defining ESG risk and performance indicators, investment management firms often establish their own set of ESG performance indicators, that are to be considered as a prerequisite based on their discretion and experience (OECD, 2017). Hence the investment screening process that influences decision making becomes subjective instead of being objective and

often does not allow for better understanding of material ESG related risks and opportunities before the investment approval (OECD, 2017).

1.4. Research Questions

- **Research Question 1:** What are the perceived factors of importance influencing ESG performance indicators used by private equity investment managers during the investment screening/ pre-investment and due diligence phases?
- **Research Question 2:** What is the priority ranking of the perceived factors of importance influencing ESG risk and performance indicators in Private Equity?
- **Research Question 3:** What are the gaps that are associated with the lack of a universally accepted and predefined ESG risk and performance indicators applied for investment screening and due diligence phases?

1.5. Significance of the study

The study aims to understand the gaps that are associated with the lack of a universally accepted and predefined ESG risk and performance indicators applied for investment screening and due diligence phases to understand ESG risk and impacts of potential investments in Private Equity.

This study will be a practical contribution to the private equity investment screening and due diligence phases, enabling private equity investment managers to make better-informed investment decisions. The study shall provide an approach to improve the screening and due diligence assessments through incorporating the perceived factors of importance as part of the ESG performance indicators that can also be used as a baseline for developing a universally accepted standard for defining ESG risk and performance indicators.

1.6. Delimitations

- The study will focus on the South African private equity market, specifically private equity investment managers in Gauteng.
- Predefining the perceived factors of importance influencing ESG risk and performance indicators: As mentioned above, most investment managers tend

to establish their set of ESG performance indicators, based on their discretion and experience since there is no universally accepted standard for defining ESG performance indicators, making it difficult to improve ESG risk and performance indicators that are not standardised (OECD, 2017).

1.7. Assumptions

– The reference of ESG risk and performance indicators throughout the documents equates to the consistently applied ESG performance indicators.
– Participants during the interview process have private equity experienced, particularly investment screening and due diligence experience.

2. Literature Review

In 2017, four hundred and forty (440) investments were made by private equity investment managers worldwide according to the Global Private Equity Report 2018, most of which were screened using ESG performance indicators (African Venture Capital Association [AVCA],2018). This is conducted to examine how each company Performs as a steward of nature and to assess how each company manages relationship its various stakeholders such as its employees, suppliers, customers and neighbouring communities (AVCA, 2018; Crowther & Aras, 2008). According to the CFA Institute ESG Survey, 2017, nearly 73% of investment professionals worldwide consider ESG factors during the investment process. This further illustrates that ESG risk and performance indicators are increasingly being incorporated in the assessment of investments as well as to measure the ESG performance business/ investment (CFA Institute, 2018; Dočekalová et al., 2018).

2.1. Defining ESG in Private Equity

Research reveals that the adoption of ESG risk and performance indicators to screen companies or industries that do not embrace ESG standards and principles continue to gain prevalence in the investment decision, particularly following the global financial crisis (Amel-Zadeh & Serafeim, 2017; Bos, 2014). Other events such as the BP oil spill and accounting scandals associated with big auditing firms and other ongoing concerns about the environment (climate change, water scarcity and the depletion of natural resources) have contributed to the increased attention on ESG (Amel-Zadeh & Serafeim, 2017; Bos, 2014). Accordingly, the recent years have seen increasing attention focused on ESG particularly by private equity investment managers (Amel-Zadeh & Serafeim, 2017; OECD, 2017; Sultana et al., 2018; UNPRI, 2016).

Syed & Ntim (2017) examined the inclusion of ESG criteria in the managerial decision-making process while Efimova (2018) investigated the impacts of integrating ESG factors into the decision making process. According to Syed & Ntim (2017), ESG criteria are a new dimension of Socially Responsible Investing (SRI). The authors explained SRI as an ethical approach that advocates for the exclusion of certain type of industries from one's portfolio based on certain moral or ethical grounds (Syed & Ntim, 2017). There seems to be a common belief between Efimova (2018) and Syed & Ntim (2017) about ESG being an effective tool for better managing of investment

risks (Efimova, 2018; Syed & Ntim, 2017). Both Efimova (2018) and Syed & Ntim (2017) seemed to agree that ESG is emphasised more by institutional investors such as private equity firms and that even though investors interest in ESG data has grown rapidly over the recent decades, positive ESG screening methods or indicators are still rarer.

On the other hand, authors such as Cini & Cicci (2018), Sultana et al., (2018) and van Duuren, Plantinga, & Scholtens (2015) believe that ESG is not necessarily exclusive to institutional investors but particularly used in most industries for red-flagging and risk management. Stanley (2011) also noted during the study on the private equity market interest nonfinancial information that equity investors have more interest in nonfinancial information than fixed-income investors. According to Stanley (2011) equity investors place more emphasis on ESG disclosure and climate change data. Stanley (2011), noted that in contrast, fixed income investors place more weight on governance data. Based on the investigation by Buniamin & Ahmad (2018) on the moderating effects of corporate life cycle on the relationship between primary stakeholders' attributes and ESG disclosure, equity investors continue to place more emphasis on ESG disclosure compared to fixed income investors.

According to the UNPRI (as cited by Ferrando, 2019), "To ignore ESG factors is to ignore risks and opportunities that have a material effect on the returns delivered to clients and beneficiaries". Acknowledging that the adoption of ESG guidelines should thus be of interest to all financial actors because it has to do with the good financial performance of the investments and the satisfaction of the managers' mandate. Ferrando (2019) is of the opinion that the idea that ESG accounting and disclosure will automatically improve the global economy while making finance actors more resilient is imperfect and must be rethought and improved.

Literature also indicates that thus far, very little attention has been given to discussions concerning the majority of the consistently applied ESG risk and performance indicators (Sultana et al., 2018). Hence, there is still insufficient background of theoretical sustainability in the field of the effectiveness of the consistently applied ESG risk and performance indicators (Sultana et al., 2018).

2.2. Importance of ESG in Private Equity

In the South African context, regulation drives ESG incorporation as government regulation and listing standards are more explicit about ESG disclosure and compliance requirements. This is one of the fundamental reason why ESG is deemed to be important in Private Equity (UNPRI,2019).

Apart from government regulations, institutional investor requirements for private equity investment managers to integrate ESG data into their investment process in order to understand the non-financial aspects of a firm's performance have been the fundamental driver (UNPRI,2019).

Hence, ESG is important in Private Equity because it enables private equity investment managers to account for the non-financial aspects of a firm's performance, for instance, the firm's operational impact on the natural environment, social wellbeing of employees as well as the society at large and operational impact corporate governance. Currently, ESG, especially screening and due diligence phases, is driven by product stewardship and ethical considerations (Amel-Zadeh, 2017). Importance of ESG for investment is also driven by relevance to investment performance, operational efficiencies, and concerns about data reliability (Amel-Zadeh, 2017).

Another reason ESG integration is viewed as an important aspect in of investment screening and due diligence is the ability of ESG risk and performance indicators to assess a company's performance. According to the International Integrated Reporting Council (IIRC), an increasing percentage of an entity's market value can be attributed to intangible assets and ESG risk and performance indicators provide ways to measure the performance of these intangible assets (BRS, 2012). This is why governance indicators are systematically incorporated into the private equity investment process more than 50% of the time compared to social and environmental indicators, which are incorporated approximately 25% of the time (UNPRI,2019). According to the UNPRI (2019) governance indicators are mostly incorporated and assessed because of the direct impact governance indicators have on a company's share price, reputation and ability to access capital.

Research also shows that investors perceive strong ESG risk and performance indicators as a gauge for good risk management and strategic planning hence the importance of ESG in private equity. According to private equity investment managers, companies with strong ESG performance have a higher capacity to adapt to change, lower their capital constraints and lower their costs of capital (Amel-Zadeh & Serafeim, 2017). The importance of ESG information is also associated with the value and predictive nature of ESG performance indicators for gauging firms' future financial performance (Amel-Zadeh & Serafeim, 2017).

Hence, the neutral to the positive relationship between strong ESG risk and performance indicators and long-term financial performance is the driving force for the materiality and importance of ESG to private equity investment managers (Zhao et al., 2018). Furthermore, using ESG risk and performance indicators that divulge the true reflection of material ESG impacts associated with the potential investment company, enables investment managers to develop ESG strategies that provide a positive impact on long-term investment performance, improving the risk-adjusted returns (Stanley, 2011; Syed & Ntim, 2017).

2.3. ESG Incorporation in Private Equity

Research indicates that there is a growing interest from investors and both public and private investment organisations to integrate ESG into the investment process (Yan, Ferraro & Almandoz, 2019). Private equity investment managers inter alia asset managers, insurance companies pension funds and sovereign wealth funds are reported to be pioneers in terms of integrating ESG across their investment portfolios (Allman, 2015; Yan et al., 2019). This is due to their long term liabilities and fiduciary duty to their various stakeholders, particularly since investors believe that ESG integration improves the financial performance of investment portfolios (Allman, 2015; Yan et al., 2019).

Eurosif (2014) as quoted by van Duuren et al., (2015) in the study for ESG integration and investment management process, defines "ESG integration as the explicit inclusion of ESG risks and opportunities into the traditional financial analysis and investment decisions based on a systematic process and appropriate research sources". According to Amel-Zadeh & Serafeim (2018) in their study why and how

investors use ESG information, they indicated that most investment organisations integrate ESG into their investment process to ensure that ESG risks and impact are considered and fully integrated into every stage of the investment process and decision making processes. According to Amel-Zadeh & Serafeim (2018), ESG integration to the investment process is typically implemented and adopted by most investment organisations as shown in Table 1 below. As illustrated in Table 1 below, ESG integration requires the resources who will be responsible for executing the various ESG appraisals, at every stage of the investment process, in order to achieve the ESG Outputs.

Investment Process	ESG Appraisal	ESG Output	Responsibility
i. Identification (deal-flow evaluation)	• Apply Exclusion List • Check national ESIA requirements[1]	• Decline if investment activity is included on the exclusion list • Indicate whether ESIA is required by law	• Deal Team
ii. Initial briefing session (discussion document)/ Transaction Forum evaluation (draft Transaction Proposal)	• ESG risk categorization • Client commitment, capacity & track record check • Identify initial risks and opportunities	• Risk categorization tools completed and on file • ESG comment in Transaction Proposal including information on due diligence requirements	• Deal Team • Categorisation check by ESG Officer • ESG Officer check Transaction Proposal
iii. Due diligence ("DD")	• E&S due diligence (determined by risk category)	• Review ESIAs/Audits and/or complete DD checklists • Distil findings into ESG DD Report • Action Plan to close performance gaps • Identify KPIs for ESG reporting	• Deal Team • ESG Officer check DD report

[1] Different jurisdictions will differ in their Social and Environmental Impact Assessment ("SEIA") regulations.

		• Identify ESG conditions to the investment agreement	
iv. Investment Forum initial approval (final Transaction Proposal)	• ESG conditions and covenants	• ESG comment in the Transaction Proposal along with Action Plan • ESG conditions included in the investment agreement	• Deal Team • ESG Officer check action plan and ESG conditionality
v. Investment Committee final investment approval	• ESG conditions and covenants	• Revisions to ESG Conditions and Action Plan if required	• Investment Committee
vi. Deal execution (closing binder)	• Include ESG documentation in a closing binder	• ESG Conditions and Action Plan for closing binder	• Deal Team
vii. Investment management	• Monitoring portfolio performance • Identifying ESG improvements and opportunities	• Progress reports against Action Plan	• Portfolio Team
viii. Monitoring and reporting	• ESG monitoring and reporting	• Review portfolio reports and investor reports • Annual ESG report	• Portfolio Team
ix. Exit	• ESG preparation for divestment	• External audit (where required) • Report on ESG matters to be addressed before exit	• Portfolio Team

Table 1: ESG incorporation into the investment process

According to Amel-Zadeh & Serafeim (2018), ESG integration starts at the investment identification and deal flow evaluation as illustrated in Table 1 above. Early consideration of ESG by investment organisations enables the investments managers to assess the potential investment for compatibility to the investment mandate and exclusion list to avoid investing in activities which contravene the mandate and ethical approach of the investment mandate and exclusion list (Kotsantonis, Pinney &

Serafeim, 2016). Concurring to the Amel-Zadeh & Serafeim (2018) point of view concerning ESG integration, Kotsantonis et al.,(2018) agreed that private equity investment managers integrate ESG into their investment process as a form of undertaking a more detailed ESG due diligence to ensure that prospective investments comply with the ESG standards and regulations. Schramade (2016)

Adestam & Husberg (2010) assessed the importance of integrating ESG -post-investment and their opinion were that integrating ESG -post-investment assists with developing and communicating ESG performance standards that portfolio companies will be expected to meet within an acceptable time frame, including incorporating such provisions into legal agreements as considered relevant. In line with Adestam & Husberg (2010, Schramade (2016) conceded that integrating ESG -post-investment assists private equity investment managers with working in partnership with portfolio companies to help them unlock value from ESG implementation through addressing linkages between material issues and company strategy in a way that generates commercial benefits. Additionally, Schramade (2016) stated that integrating ESG -post-investment assists ensuring that appropriate ESG disclosure by underlying investments as required by government regulation and best practice standards such as King IV on ESG aspects is achieved. Furthermore, Schramade (2016) stated that ESG is integrated until the Exit process begins in order to maximise the financial contribution that sound ESG performance can generate when negotiating with potential investment buyers and ultimately maximise the return on investment.

This is one of the reasons why ESG integration is viewed by the majority of investment organisations as an integral part of doing business and adhering to the highest standards of conduct intended. Additionally, as explained by Amel-Zadeh & Serafeim (2018) the majority of investment organisations incorporate ESG to avoid the appearance of negligent, unfair or corrupt business practices or practices within their investment process (Amel-Zadeh & Serafeim, 2018). Furthermore, most investment organisations also integrate ESG to measure and report on ESG issues for each investment, using such information to inform investment analysis processes and decision-making. (Allman, 2015; Amel-Zadeh & Serafeim, 2018). Hence, studies continue to show that ESG integration is further along in the Private Equity market than it is in other investment markets.

2.4. Effects of ESG on Profits

According to the latest results of the 2018 McKinsey & Company Global Private Equity Review and the RisCura-SAVCA South African Private Equity Performance Report, which tracks the performance of a representative sample of both global and South African private equity funds, private equity continues to outperform listed equity markets across all three listed benchmarks over the 3-years and 5-years periods. Empirical and theoretical reviews link this performance to the integrated approach provided by the private equity model, which in addition to providing capital, improving market presence and access to new markets, prioritizes the strengthening of ESG performance in order to enhance the overall business growth (Avery, Lyudvig, & Maritz, 2018; Deloitte, 2018; Zhao et al., 2018).

To understand the economic performance of a company in relation to ESG performance indicators, Kocmanová & Dočekalová (2012) conducted a study in search for a way of measuring the economic performance of the company in relation to ESG indicators. Empirical research was conducted by (Kocmanová & Dočekalová, 2012), which concluded that the integration of ESG and economic performance indicators results in sustainable value and economic value. However, the study does not clearly indicate ways/methods discovered for measuring the economic performance of the company in relation to ESG risk and performance indicators (Kocmanová & Dočekalová, 2012). The study only proposes that ESG KPIs which can assist companies plan and manage their ESG and economic priorities should be established (Kocmanová & Dočekalová, 2012).

Similar to Kocmanová & Dočekalová (2012), Adedeji, Ong, Rahman, Odukoya, & Alam (2019) examined the relationship between the financial performance, corporate governance and sustainability initiatives. Adedeji et al.(2019) found that corporate governance and sustainability initiatives enable firms to enhance their social image and minimise reputational risks. Corporate governance and sustainability initiatives also enhance goodwill for their companies in the marketplace, resulting in higher sales, employee attraction, loyalty and retention (Adedeji et al., 2019). This is why (Adedeji et al., 2019) concluded that corporate governance and sustainability initiatives enhance corporate performance since they minimise the costs of doing business and increase profits.

Since most studies that examine the relationship between ESG and financial performance confirm that the ESG performance of companies has a positive impact on financial performance, it is therefore important that effective ESG risk and performance indicators that divulge the true reflection of material ESG impacts associate with the potential investment company are established to effectively quantify the impact (Zhao et al., 2018).

2.5. Consistently Applied ESG Risk and Performance Indicators Constraints

Focusing on the analysis of the set of ESG performance indicators, Chvátalová & Šimberová (2013), conducted a study for the analysis of a set of ESG risk and performance indicators for the development of improved methods for measuring corporate performance. The study was built on their previous publication on the analysis and identification of joint performance measurement indicators: social and corporate governance issues Chvátalová & Šimberová (2012), but in broader and more complex contexts. As a result, Chvátalová & Šimberová (2013), produced a very relevant list of ESG performance indicators, most of which are still applicable. However, the authors did not introduce weightings for each/ group of the developed ESG risk and performance indicators (Chvátalová & Šimberová, 2012, 2013).

Additionally, the proposed KPIs for measuring of the economic performance in relation to the ESG risk and performance indicators were established based on the results of empirical research did not take into consideration/ refer to the IFC Performance Standards, an international benchmark for identifying and managing ESG risk (Kocmanová & Dočekalová, 2012). This is concerning as the IFC Performance Standards have been adopted by many organisations as a key component and benchmark of their ESG risk management (Kocmanová & Dočekalová, 2012).

Furthermore, other reviewed authors have pointed out that the majority of the consistently applied ESG risk and performance indicators are a sometimes limiting and contribute to the constraint that restricts investment managers from understanding the material ESG risks and impacts before investing (Cini & Cicci, 2018; Kuosmanen & Kuosmanen, 2009; Stanley, 2011; van Duuren et al., 2015).

In conclusion, the important and material constraints to the use of ESG information are the lack of standardisation in relation to the consistently applied ESG risk and performance indicators (Amel-Zadeh & Serafeim, 2017).

3. Methodology

3.1. Introduction

The research methodology included the following subsections research paradigm, followed by the research propositions, research participants, data collection, reliability and validity of instruments and the study, participants description and data analysis.

As cited by Mackenzie (2006), the methodology is both "the collection of methods or rules by which a particular piece of research is undertaken" and the "principles, theories and values that underpin a particular approach to research. Mackenzie (2006), also stated that other authors argue that methodology is the frame of reference for the research which is influenced by the "paradigm in which our theoretical perspective is placed or developed". This means that methodology is essentially the systematic procedures or tools essential for collecting and analysing data (Mackenzie, 2006).

The importance of the research methodology is that it is the blueprint of how the research itself will be executed. It is fundamental as it details the steps on how the problem statement will be addressed.

3.2. Research Paradigm

The qualitative methods of research used included comparative analysis, graphical illustration methods, descriptive statistics and benchmarking with international best practise (Sultana, Zainal, & Zulkifli, 2017).

The study also adopted the interpretivist paradigm, which is underpinned by observation and interpretation, to observe is to collect information about events, while to interpret is to make meaning of that information by drawing inferences or by judging the match between the information and some abstract pattern (Aikenhead, 1997; Kawulich, 2012). This paradigm relies heavily on naturalistic methods (interviewing

and observation and analysis of existing texts). Reeves and Hedberg (as cited by Antwi & Kassim, 2015), noted that the “interpretivist” paradigm stresses the need to put analysis in context. The interpretive paradigm is concerned with understanding the world as it is from the subjective experiences of individuals. The method uses meaning (versus measurement) oriented methodologies, such as interviewing or participant observation, that rely on a subjective relationship between the researcher and subjects (Antwi & Kassim, 2015;Robert Wood Johnson Foundation [RWJF], 2008). The interpretivist paradigm method ensures an adequate dialogue between the researchers and those with whom they interact in order to collaboratively construct a meaningful reality (Kawulich, 2012; RWJF, 2008).

3.3. Research Propositions

P1: Perceived factors of importance influencing ESG risk and performance indicators that are predefined are likely to be more effective for decision-making purposes than perceived factors of importance influencing ESG risk and performance indicators that are not predefined.

P2: Perceived factors of importance influencing ESG risk and performance indicators that are not predefined are likely to be more effective than perceived factors of importance influencing ESG risk and performance indicators that are predefined.

3.4. Research Participants

The research participants consisted of South African private equity investment managers in Gauteng who have encountered including those that are currently encountering challenges as a result of the consistently applied ESG performance indicators. These managers were selected based on who can best inform the research objectives and enhance understanding of the phenomenon under the study. This essentially means that investment managers were selected intentionally across the possible types of investment managers to capture all possibilities (Sargeant, 2012). This selection method was preferred as it ensured that responses and experiences of all private equity investment managers are taken into consideration (Sultana et al., 2017).

3.5. Data Collection

Primary data was sourced through the face to face and telephonic interviews, where participants of private equity investment managers based in Johannesburg were urged to be participants (Sultana et al., 2017). Open-ended and semi-structured interview questions were utilised and completed telephonically and through personal interviews where necessary, to various private equity investment managers (Sultana et al., 2017).

The interviews were aimed at eliciting information on key ESG factors that inform decision making during investment screening and due diligence including the key ESG matters that private equity investment managers want to understand about potential investments that were not detected through using the consistently applied ESG performance indicators. The interviews were also aimed at eliciting information on ESG risk and performance indicators that investment managers envisage as a feasible solution (main ESG risk and performance indicators that investment managers can adopt to understand a potential investment concerning the ethical impact and sustainable practices) or alternative to the consistently applied ESG risk and performance indicators (Bunjamin & Ahmad, 2018).

Essentially the interview questions enabled the gathering on the perceived factors of importance influencing ESG risk and performance indicators that inform decision making. The interview questions required the participants to rank several proposed ESG risk and performance indicators using the four-point Likert scale with one indicating “low priority” and four indicating “high priority” (Sultana et al., 2018).

Additionally, the qualitative interview sessions were extended to Limited Partners (investors) to gather their views regarding the impact of ESG in their current investments (Sultana et al., 2018).

Secondary data was also gathered from various sources including the findings of other research conducted locally and outside South Africa, journal articles, South African Venture Capital and Private Equity Association (SAVCA), UNPRI EMEA reports, and other literature and internet sources (Buniamin & Ahmad, 2018; Sultana et al., 2018; Zeisberger, 2014).

For ethical considerations, the following process as stated by Mouton (2000) was applied:

- Informed consent: consent was obtained from the primary research participants;

- Privacy and confidentiality: protection and sensitivity to the participants' confidentiality was exercised;

- Fabrication and falsification of data: fabrication and falsification of data was avoided to ensure authentic reporting; and

- Faulty data gathering methods: no faulty data gathering methods were applied to prevent inaccuracy in reporting.

3.6. Reliability and validity of instruments and the study

The extent to which tests or procedures for assessing the quality of the study was managed through internal consistency (a measure of the precision of the measuring instruments used in a study) (Lameck, 2013). This type of reliability assisted with interpretation of data and predicting the value of scores and the limits of the relationship amongst the variables (Lameck, 2013).

According to Lameck (2013), interrater reliability assists in assessing the consistency of how the rating system is implemented. Hence, data validity was also considered for this study to ensure that the study accurately reflects or assesses the ESG risk and performance indicators for improvements. Face validity was also be used to ensure that reasonable ways to gain information are used (Lameck, 2013).

3.7. Participants Description

A total of 20 participants were interviewed, 17 participants were interviewed in the form of face to face interviews with 3 participants being interviewed in the form of telephonic interviews. 14 of the participants are females and 6 are males. 15 of the participants are investment managers and 5 of the participants are DFI representatives. 16 of the participants have master’s degree, 3 of the participants have degrees and 1 of the participants has a diploma. 4 of the participants have more than 10 years working

experience and 16 have more than 5 years but less than 10 years industry working experience.

Participants Description			
Total respondents	20	**Sector**	
Females	14	Investment managers	15
Males	6	DFIs	5
Qualifications			
Masters degree	16	**Experience**	
Degree	3	> 10 years of working experience	4
Diploma	1	> 5 but < 10 years working experience	16

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Figure 1: Description of participants to the study

3.8. Data Analysis

The data was summarised and analysed using the thematic analysis, which emphasises identifying, analysing and interpreting themes from the collected qualitative data (Buniamin & Ahmad, 2018; Sultana et al., 2018; Zeisberger, 2014). Braun and Clarke (2006) define thematic analysis as “A method for identifying, analysing and reporting patterns within data”. As stated by Braun and Clarke (2006) thematic analysis allows for a detailed description of data as it is compatible and flexible to be applied to any theoretical framework. The thematic analysis also allows for data to be arranged systematically, while getting familiar with the data (Mortensen, 2020).

4. Research Results and Analysis

The interview questions were structured to enable the gathering of information key ESG matters that private equity investment managers want to understand about potential investments and on key ESG factors that they perceive to be important for decision making during investment screening and due diligence. The results were structured in the following manner:

- Findings related to key pre-investment ESG matters that they want to understand pre-investment
- Findings related to the perceived factors of importance influencing ESG risk and performance indicators in Private Equity
- Priority ranking of the perceived factors of importance influencing ESG risk and performance indicators in Private Equity

4.1. Findings related to key pre-investment ESG matters that they want to understand pre-investment

When the participants were questioned in order to elicit information on the key ESG matters that they want to understand about potential investments that were not necessarily detected through using the consistently applied ESG performance indicators. Thematic analysis was applied to identify repeated concepts or themes and more apparent factors of importance from the data collected during face to face and telephonic interviews. Similarities and relationships between the collected data were explored to identify repeated themes (Mortensen, 2020).

Visual analysis was applied to categorise the data into evident themes namely Labour and Working Conditions, Corporate Governance, Environmental Commitment and Communities Investing. Essentially pre-investment, most participants responded that they want to understand the following about a potential investment:

- Labour and Working Conditions: (Presence of certain risk groups e.g. temporary workers, migrants, minors, women, disabled persons and impacts within the supply chain and low wages)
- Corporate Governance: governance of sustainability issues and business ethics, commitment, compatibility of investment to investment mandate and exclusion list, capacity and track record of the portfolio to manage ESG impact and risks.

- Environmental Commitment: (environmental risks to the business and its supply chain such as climate change and resource constraints e. g. consumption of resources, use of hazardous materials, effluents, emissions, wastes, hazardous working conditions, location site and potential impacts of operations on sensitive areas including impacts on biodiversity etc.)
- Communities Investing (interested and affected communities e.g. physical or economic displacement, impacts on social and economic infrastructure, community health and safety, vulnerable groups).

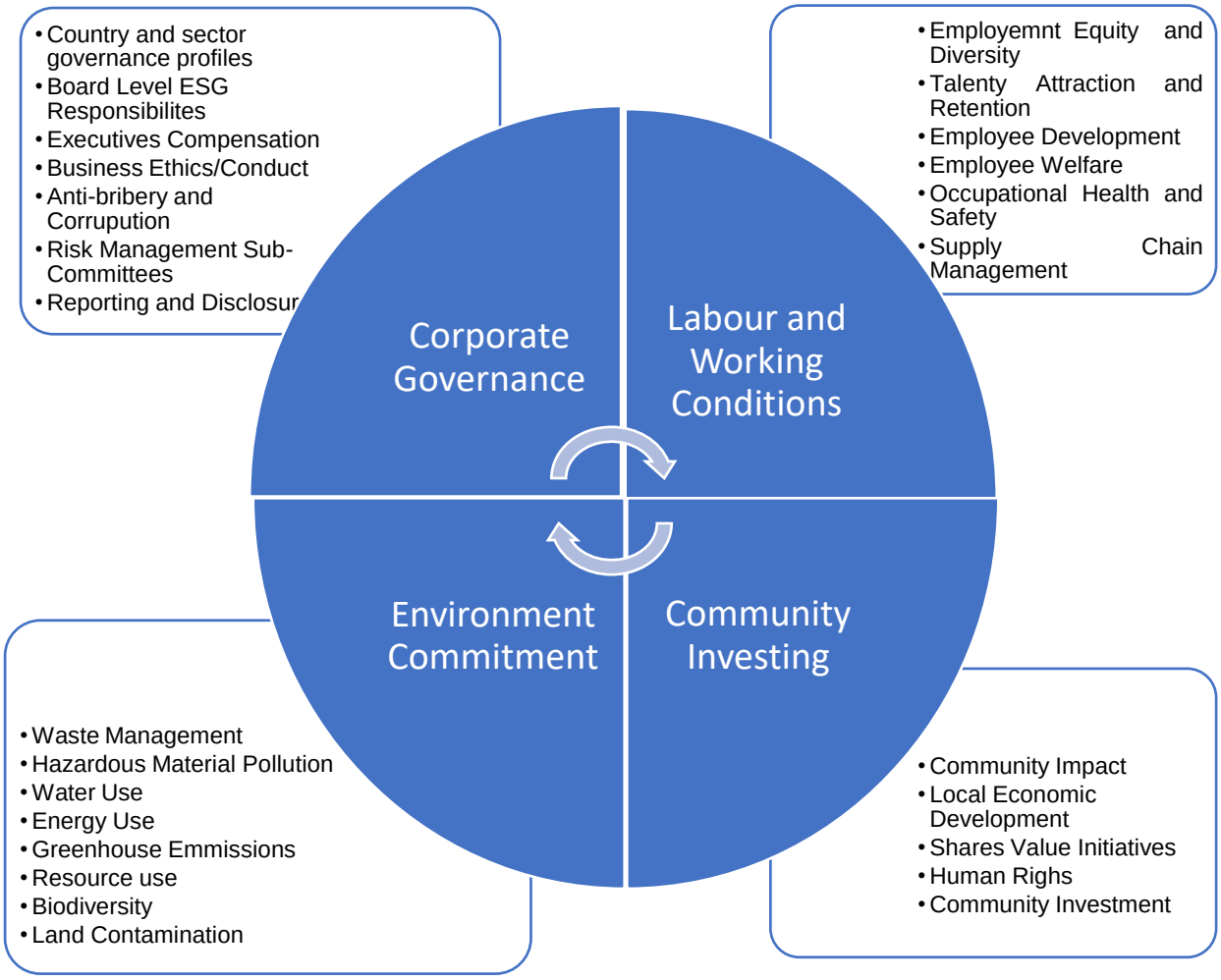


Figure 2: Breakdown of the ESG matters that private equity investment managers want to understand pre-investment

According to the participants, understanding these ESG matters enables them to identify potential exposures and key ESG issues that may be of concern, particularly those associated with the breakdown in Figure 2 above. Understanding these ESG matters enables them to establish specific obligations such as a condition precedent to the transaction or as requirements to be incorporated into the shareholders'

agreement and addressed post-investment. According to most participants, understanding these ESG matters enables them to rate the commitment, capacity and track record of the portfolio to manage E&S impact and risks. This is an important aspect to understand, according to most participants, as a portfolio with a low level of commitment and capacity and a high or medium risk business activity presents a greater overall potential risk than a portfolio that understands their E&S impacts and has well-established management systems to address them. These findings are in support of the literature, which indicates that there is a growing interest from investors and both public and private investment organisations to integrate ESG into the investment process (Yan, Ferraro & Almandoz, 2019).

Most participants indicated that understanding these ESG matters also enables them to evaluate the potential investment company's ability to mitigate these risks post-investment. This is in line with the literature conducted by Crowther & Aras (2008), which states that private equity investment managers assess how each company performs as a steward of nature and how each company manages relationships with its various stakeholders where it operates. These results also confirm (Amel-Zadeh, 2017) opinion that ESG, especially screening and due diligence phases, is currently driven by stewardship and ethical considerations.

4.2. Findings related to the perceived factors of importance influencing ESG risk and performance indicators in Private Equity

To understand the key ESG factors that the participant perceive to be important for decision making during investment screening and due diligence, participants where engaged on the material ESG factors that they use to assess a potential investment company during the investment screening, due diligence and investment committee processes. Their responses were also analysed using thematic analysis was to identify repeated concepts or themes and more apparent factors of importance from the data collected during face to face and telephonic interviews. Similarities and relationships between the collected data were explored to identify repeated themes.

Visual means of analysing the collected data were applied to identify similarities and relationships in the data. Visual analysis was conducted by going through the data

collected during the interviews and highlighting important environmentally, socially and governance-related sections that are relevant to identifying the perceived ESG factors of importance. The identified similarities and relationships were then organised based on which items are environmentally, socially and governance-related and according to the number of times the response was repeatedly given by the interviewed participants (Mortensen, 2020).

This comprehensive review of the collected data enabled the connection of the repeated concepts and more apparent factors of importance to existing theme and patterns within the existing literature on ESG. To address the research problem statement, the perceived factors of importance influencing ESG risk and performance indicators in Private Equity, have been categorised for each stage of the investment process, predominantly, Investment Screening, Investment Due Diligence and Investment Committee. The findings are as follows:

Investment Screening:

The perceived factors of importance during investment screening, according to the number of times the response was repeatedly given by the interviewed participants are illustrated in Table 2, Table 3 and Table 4 below:

Environmental Factors
Publicly Available Information about the company's Environmental Commitment
Compliance with host country environmental management agency requirements
Compliance with host country bylaws for environmental impacts management
Host Country and industry resource efficiency and environmental impacts
Biodiversity impacts including animal welfare for livestock investors
Environmental Convictions
Environmental Liability Directives

Table 2: Perceived environmental factors of importance during the investment screening phase

Social Factors
Company-Specific Human Resource Management
Country and industry forced labour statistics
Country and industry child labour statistics
Country and industry Gender inequality
Country and industry Working conditions

Country and industry Occupational health and safety standards
Country and industry Supply chain management
Publicly Available Information on the company's Community health and safety
Publicly Available Information on the company's land acquisition and involuntary resettlement
Publicly Available Information on the company's Indigenous people impact
Publicly Available Information on the company's Cultural heritage impact

Table 3: Perceived social factors of importance during the investment screening phase

Governance Factors
Country Corruption and Bribery Profile
Sector Corruption and Bribery Profile
Competitors Corruption and Bribery Profile
Senior Management Corruption and Bribery Profile
Country Sanctions
Country, Sector and Competitors Anti- Money Laundering Activities
Politically Exposed Persons

Table 4: Perceived governance factors of importance during the investment screening phase

Table 2 indicates publicly available information about the company's environmental commitments, convictions, fine and compliance with host country environmental management agency requirements including compliance with host country bylaws for environmental impacts management are perceived as environmental factors of importance during the investment screening phase. All of the interviewed responded indicated that they assess the potential investment's environmental commitment in order to ascertain if the company seem to be genuinely committed to understanding and addressing ESG matters that are specific to its sector or business by establishing ESG policies and procedures.

Table 3 illustrates that social factors relating to the country and industry's performance are mostly considered during investment screening. According to the interviewed participants, these social factors are highly considered to ensure that investments are not concluded in countries/industries that are associated with a legacy of social injustice.

According to the responses reflected in Table 4, governance is screened using perceived factors of importance namely, country, sector and competitors corruption and bribery activities including anti-money laundering activities. All of the interviewed responded indicated that companies are essentially screened for business integrity and corporate governance reputation. These findings are in line with the EMEA markets since corporate governance is currently the most incorporated ESG element into the investment process of Private Equity firms in these markets.

All of the interviewed responded agreed that they conduct ESG screening to confirm compliance by ensuring that the investment is aligned with their fund's policy, investment mandate as well as investor requirements. Because most investors generally require that their funds not be invested in prohibited or excluded sectors or activities such as gambling, tobacco, sex industry etc., all of the interviewed responded agreed that investment screening enables them to ensure that their investments comply with the relevant investors' exclusion list. This is accordance with the study conducted by the Ferrando (2019) which stated that acknowledging the adoption of ESG guidelines not only yields good financial performance but also assists private equity investment managers to satisfy both the fund and investors mandate.

All of the interviewed responded agreed that it is during this stage when they also identify inherent ESG risks associated with the sector of their investments that may have a significant impact on their investments. All of the interviewed responded indicated that they depend largely on publicly available about their the potential investments information during this stage since they are still in early discussions with the company owners who might still be reluctant to disclose private company information. Based on these results, the participants' views are aligned with Adedeji et al.(2019) who concluded in their study that corporate governance and sustainability initiatives enable firms to improve their corporate performance, reputation and ultimately their social image.

Investment Due Diligence:

The perceived factors of importance during the due diligence phase, according to the number of times the response was repeatedly given by the interviewed participants are illustrated in Table 5, Table 6 and Table 7 below:

Environmental Factors
Environmental Policy
Processes and procedures for the identification of environmental risks and opportunities
Environmental management programmes
Waste reduction and prevention strategies including hazardous waste management
Energy and water use efficiency
Primary energy and water source
Energy and water costs
Greenhouse gas emissions as a business risk
Mechanisms to manage impacts of climate change on the company's assets
Impact of operations towards climate change including greenhouse gas emissions
Emergency preparedness and response policies and procedures
Environmental liabilities associated with land, water and air contamination
Environmental impacts on local communities (waste, wastewater, air emissions, storage of hazardous materials)
Impacts on ecosystem services used by the community such as water and energy etc.
Risks to biodiversity (forests, wetlands, fauna and flora, natural resources etc.)
Biodiversity Management Plan
Internal capabilities and competencies for managing environmental risks and opportunities

Table 5: Perceived environmental factors of importance during the investment due diligence phase.

Social Factors
Human resource policy
Processes and procedures for the identification of social risks and opportunities
Human resource management programmes
Compliance with national employment regulations and core ILO Labour Conventions

Terms and conditions of employment clearly defined for all employees including employees with special needs, temporary workers, migrant workers and contractors
Specific requirements for the minimum age to avoid child labour, forced labour and discrimination
Compliance to national minimum wage
Freedom of association and collective bargaining principles
Occupational health and safety policies and procedures
Worker productivity and skills development programmes
Employee turnover and procedures for managing retrenchment
Internal Capacity for stakeholders management
Grievance Management mechanisms and policies
Stakeholder engagement programme
Human resource and labour standards
Supply Chain Management Policies and procedures
Security Personnel Management
Involuntary resettlement or economic displacement of people associated with land acquisitions
Impact on the rights of indigenous people
Direct or indirect impact on cultural heritage
Internal capabilities and competencies for managing social risks and opportunities

Table 6: Perceived social factors of importance during the investment due diligence phase.

Governance Factors
Corporate governance or code of conduct policy
Processes and procedures for the identification of governance risks and opportunities
Ethical risks associated with the leadership of the company
Employees familiarity with the Corporate governance or code of conduct policy
Board Charter (board duties and responsibilities, quorum, nomination, succession planning, remuneration, independence and conflicts etc.)
Number of board meetings held and minutes
Board sub-committees for assurance functions and services and sub-committee charters

Responsible corporate citizen efforts for compliance with the Constitution of South Africa, the Bill of Rights, national laws, leading standards etc.
Measures taken to monitor corporate citizenship and its outcomes
Governance of risk (risk management strategies etc.)
Ethical and responsible use of technology and information.
Remuneration policy
Whistleblowing policies and procedures
Transparency and disclosure policy and procedures
Internal capabilities and competencies for managing governance risks and opportunities

Table 7: Perceived governance factors of importance during the investment due diligence phase.

Table 5 indicates that participants perceive a company's environmental position and values as stated in the environmental policy as important. Processes and procedures for the identification of environmental risks and opportunities including environmental management programmes for mitigating the identified risks are amongst the key things that participants evaluate during the due diligence process. Waste reduction and prevention strategies were also highlighted more often than not during the interviews. Participants are also viewing energy and water use costs including energy and water use efficiency models as a factor of importance. Internal capabilities and competencies for managing environmental risks and opportunities are being perceived as one of the important factors.

From a social standpoint, Table 6 indicates that HR policies are an important factor that participants want to understand during the due diligence phase. The results were evidence that the participants eiperceived occupational health and safety policies and procedures to be important factors. Participants perceive terms and clearly defined conditions of employment for all employees as an important factor. Processes and procedures for the identification of social risks and opportunities are also considered as one of the important factors just as human resource management programmes.

Table 7 details the perceived actors of importance concerning corporate governance and these include amongst others: governance of risk (risk management strategies etc.), Corporate governance or code of conduct policy, Processes and procedures for

the identification of governance risks and opportunities, Ethical risks associated with the leadership of the company and Board Charter (board duties and responsibilities, quorum, nomination, succession planning, remuneration, independence and conflicts etc.).

From the data gathered and summarised in Table 5, Table 6 and Table 7 above, it evident that the participants are particularly concerned with potential investment companies risk management capabilities and competencies. Over and the above the mentioned ESG perceived factors of importance considered during the investment evaluation process, the sector specific ESG risks are also considered. The consideration of greenhouse gases as a business risk and impacts of operations towards climate change further supports Stanley (2011) opinion that concluded that equity investors place more emphasis on ESG disclosure and climate change data. Hence, mechanisms to manage the impacts of climate change on the company's assets are being perceived as one of the important factors.

The findings related to the due diligence process further supports the results of the study by Dočekalová et al., (2018) which indicated that ESG risk and performance indicators are increasingly being incorporated in the assessment of investments as well as to measure the ESG performance business/ investment.

Investment Committee:

The perceived factors of importance during the due diligence phase, according to the number of times the response was repeatedly given by the interviewed participants are illustrated in Table 8 below:

ESG Factors
Compliance to Exclusion List
Compliance to investment Fund mandate
Ethical risks associated with the leadership of the company
Board structure and composition (appropriate mix of genders, executives, age, race, knowledge, skills and experience
ESG identified risks and Corrective Action Plan
ESG Costs for Financial Model
ESG Strategy for improvement and value add

Transparency and disclosure policy and procedures
Internal capabilities and competencies for managing ESG risks and opportunities

Table 8: Perceived ESG factors of importance during the investment committee meeting.

Table 8 highlights that the investment committee ensures that the investment managers have assessed the potential investment for compatibility to the investment mandate and exclusion list to avoid investing in activities which contravene the mandate and ethical approach of the investment mandate and exclusion list. This is in line with the opinion of Syed & Ntim (2017) that SRI is an ethical approach that advocates for the exclusion of certain type of industries from one's portfolio based on certain moral or ethical grounds (Syed & Ntim, 2017).

Additionally, Table 8 indicated that the investment committee members perceive companies that exhibit strong ESG performance to be better managed, less risky and capable of delivering better financial returns. This concurs to the view highlighted by Amel-Zadeh & Serafeim, (2017) that private equity investment managers perceive companies with strong ESG performance to have a higher capacity to adapt to change, lower their capital constraints and their cost of capital (Amel-Zadeh & Serafeim, 2017).

According to the participants, the investment committee members have the obligation to ensure that all aspect of ESG compliance and risk are assessed hence Figure 3 below illustrates all factors of importance and checks conducted by the investment committee members. Figure 3 highlights that investment committee members oversee that all the perceived ESG factors of importance have been thoroughly analysed before investment approval is granted.

Deal Phase	Factors of Importance	Checks
ESG Deal Screening	• Compatibility of the potential investment with the fund's mandate • Eligibility against the exclusion list • Evaluate against national legislation requirements • Environmental and social liability and convictions	• Compliance to national legislation requirements • Publicly available information about the company and industry
Due Diligence	Gap analysis that includes the assessment of: • Reputation Risk • Human Rights Risk/Impact • Greenhouse gas emissions • Value Add Opportunities • Pollution Prevention • Labour and Working Conditions • Occupational Health and Safety Environmental and Social Risk • Community Health and Safety • Processes and procedures for the identification of ESG risks and opportunities • Internal capabilities and competencies for managing ESG risks and opportunities	• If ESG categorisation tool was appropriately applied • Identification and categorisation of ESG risks • Identification of ESG red flags and opportunities • Benchmark against national regulatory requirements and ESG reference standards • Assess ESG commitment, capacity & track record to identify and address ESG risks • Whether DD costs were within budget
Investment Committee	• ESG identified risks • ESG Costs for Financial Model • ESG Strategy • ESG Corrective Action Plan • Key ESG conditions included in the investment agreement (key 100-day plan items) • Key ESG investment requirements and covenants • Key ESG performance indicators to be tracked	• ESG Summary in the Investment Paper

Figure 3:ESG factors of importance and checks conducted by the investment committee members

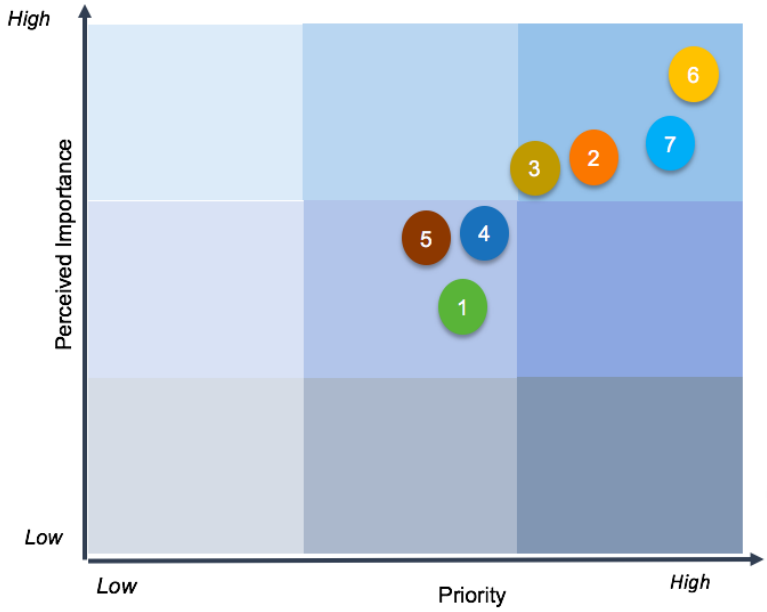
4.3. Priority ranking of the perceived factors of importance influencing ESG risk and performance indicators in Private Equity

The data which was grouped into themes was further ranked in terms of priority to assess which perceived factors of importance must be satisfactory for participants to deem an investment as one that they would want to u pursue. During the interviews, participants were requested to rank their responses with one indicating “low priority” and four indicating “high priority”. The top seven priority factors for investment screening and investment due diligence were considered for the environmental, social and governance themes. Priority findings are as follows:

Investment Screening:

The ranked information in Figure 4, Figure 5 and Figure 6 below illustrated that environmental convictions, publicly available information about the potential investment community impact and country corruption and bribery profile are the priority factors for participants when analysing a potential investment.

Publicly available information about the potential investment environmental commitment, child labour statistics and politically exposed persons are the least prioritised factors. This is due to the fact that 17 of the participants indicated that their investors are most likely to include contractual requirements relating to environmental compliance, community impact and country corruption and bribery profile than those related to child labour statistics and politically exposed persons.



1 **Publicly Available Information about the company's Environmental Commitment**

Company's policy focus on the key E&S risks and opportunities?

2 **Compliance with host country environmental management agency requirements**

Does the company operate in line with the host country environmental management agency compliance requirements

3 **Compliance with host country bylaws for environmental impacts management**

Does the company operate in line with the host country bylaws for environmental impacts management compliance requirements

4 **Host Country and industry resource efficiency**

Resource efficiency status quo at both country and industry level

5 **Biodiversity impacts including animal welfare for livestock investors**

Risks to biodiversity (forests, wetlands, fauna and flora, natural resources etc.)

6 **Environmental Convictions**

Is the company convicted of environmental crime in the host country?

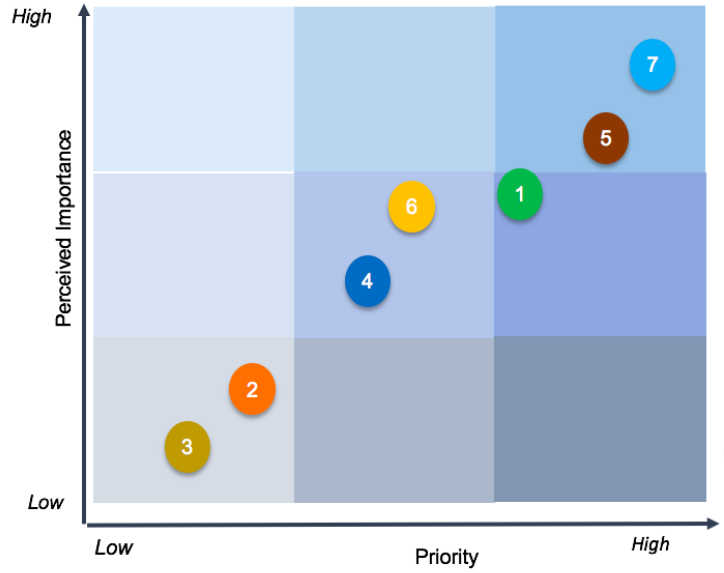
7 **Environmental Liability Directives**

Polluter pays principle where the business pays for the damage done to the natural environment.

Figure 4: Top Seven Perceived Environmental Factors of Importance in terms of priority

According to the participants, compliance with host country environmental management agency requirements and bylaws for environmental management is

prioritised because investors emphasise these compliance requirements as critical in the limited partners' agreement. Essentially, understanding the contextual risk that the participants and investors may be exposed to during the life of the investment informs the screening process over and above the limited partners' agreement.



Company-Specific Human Resource Management:

Effective management of people in the business

Country and Industry Forced Labour Statistics:

Does the company employ mechanisms to avoid forced labour

Country and Industry Child Labour Statistics:

Does the company employ mechanisms to avoid child labour

Country and industry Gender Inequality:

Gender-inclusive and specifically consider women's roles in management positions

Country and industry Working Conditions:

Promote the fair treatment, non-discrimination, and equal opportunity of employees

Country and Industry Occupational Health and Safety Standards:

Provision of a safe and healthy working environment taking into consideration inherent risks in its particular sector and host country compliance requirements

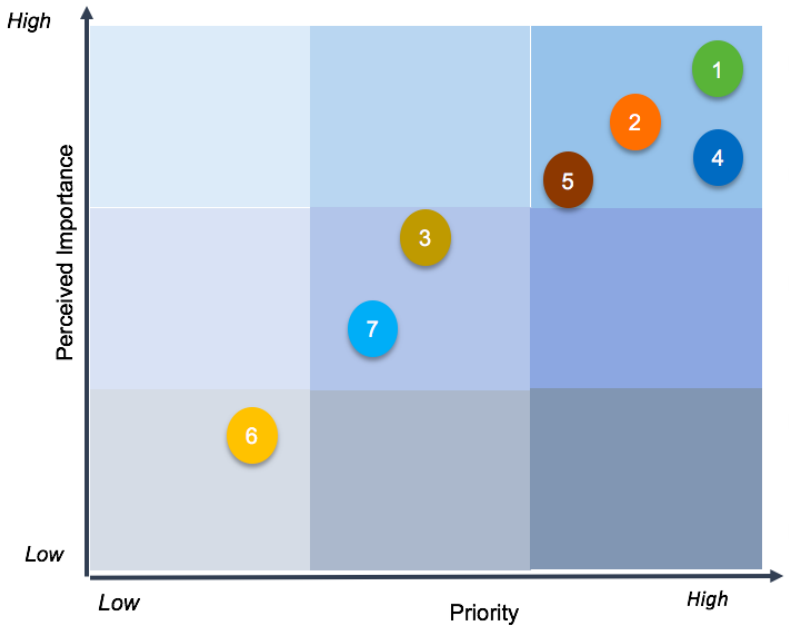
Publicly Available Information on the Company's Community Health and Safety Impact:

Risks and impacts on the health and safety of the neighbouring communities

Figure 5: Top Seven Perceived Social Factors of Importance in terms of priority

Fifteen of the participants indicated that assessing for risks associated with working conditions ensures that they invest in companies that advocate for the fair treatment,

non-discrimination and equal opportunities for all employees. Although important to participants, 14 of the participants ranked forced labour as the least of their priority.



1 **Country Corruption and Bribery Profile**

Is the company active in countries where corruption is prevalent?

2 **Sector Corruption and Bribery Profile**

Does the company operate in sectors known to be prone to bribery?

3 **Competitors Corruption and Bribery Profile**

Are the competitors of the company suspected of actively using bribery in the company's markets?

4 **Senior Management Corruption and Bribery Profile**

Senior management's reputation in relation to corruption and bribery

5 **Money Laundering Activities**

Major stakeholders using a portfolio company to launder money.

6 **Country Sanctions**

Sanctions imposed for significant political and trade reasons backed up by criminal penalties that are rigorously enforced.

7 **Politically Exposed Persons**

Politically Exposed Persons (PEPs) are people who hold or have held (during the previous year) prominent public positions, either domestically or internationally.

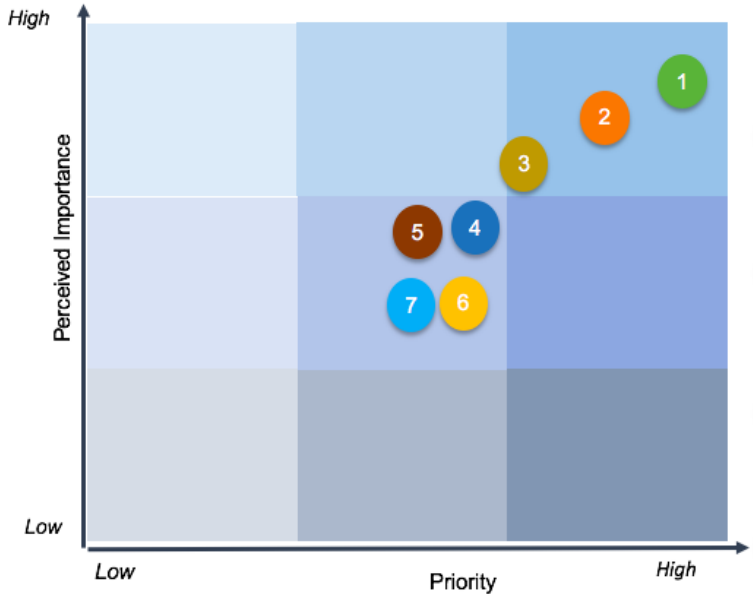
Figure 6: Top Seven Perceived Governance Factors of Importance in terms of priority

In the case of governance, corruption and bribery profiles of both the sector of operation and senior management are prioritised by the participants. This is mainly

driven by the fact that investors believe that companies with healthy financial performance are an attribute of senior managers, together with the sector peers, who have business integrity.

Investment Due Diligence:

Figure 7 below indicates that the participants perceive internal capabilities and competencies for managing environmental risks and impact to be more important over and above climate change, and mechanisms to manage impacts of climate change on the company's assets. This , however, does not mean that climate change is not important to the participants, it means that having sufficient human and financial resources to achieve effective and continuous environmental performance on an on-going basis is more of a priority for investment managers than matters related to climate change.



1 **Internal capabilities and competencies for managing environmental risks and opportunities** Sufficient human and financial resources to achieve effective and continuous environmental performance on an ongoing basis

2 **Environmental management programmes**
Management programs that detail mitigation and performance improvement measures and actions that address the identified environmental risks and impacts

3 **Processes and procedures for the identification of environmental risks and opportunities**
Standard operating processes for identifying the environmental risks and impacts

4 **Emergency preparedness and response policies and procedures**

5 The mechanism to respond to accidental and emergency environmental-related situations in an appropriate manner

Waste reduction and prevention strategies including hazardous waste management

6 Strategies to reduce waste generation, recover and reuse the waste in a manner that is safe for human health and the environment

Energy and water use efficiency

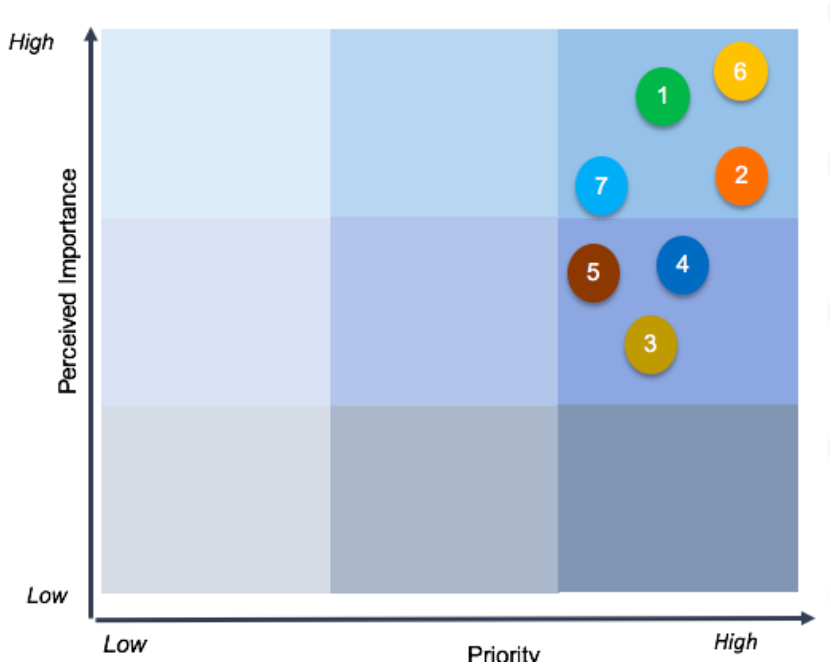
7 Sustainable use of resources including water and energy

Environmental impacts on local communities

Understanding and minimizing the risks and impacts on community health and safety

Figure 7: Top Seven Perceived Environmental Factors of Importance in terms of priority

According to 18 of the participants, understanding the environmental management programmes in place for potential investments is fundamental hence environmental management programmes are perceived as both factors of high importance and priority. Based on the data provided, no environmental factors are of least priority during the due diligence phase.



1 **Processes and procedures for the identification of social risks and opportunities**

Standard operating processes for identifying social risks and impacts

2 **Human resource management programmes**

Human resources policies and procedures appropriate to the size and workforce of the company that set out approaches to managing employees

3 **Terms and conditions of employment**

Evidence of compliance with the host country's basic conditions of employment, as a minimum.

4 **Freedom of association and collective bargaining principles**

Recognizes employee' rights to establish and join employees' right protection organisations without interference

5 **Occupational health and safety policies and procedures**

Commitment to prevent accidents, injury, and provide a safe and healthy work environment

6 **Internal capabilities and competencies for managing social risks and opportunities**

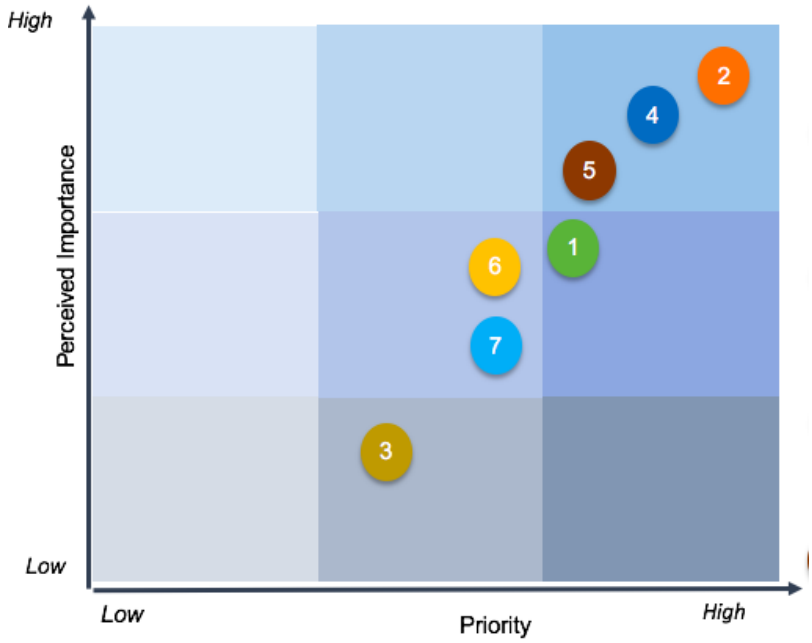
Sufficient human and financial resources to achieve effective and continuous environmental performance on an ongoing basis

7 **Specific requirements for the minimum age to avoid child labour, forced labour and discrimination**

Evidence of no economically exploitative labour practices.

Figure 8: Top Seven Perceived Social Factors of Importance in terms of priority

Although human resource management was presented as a priority for 17 of the participants, evidence of no economic exploitative labour practices where at the least of prioritising for the participants. As communicated by the responded, this is as a result of the stringent measures that have been introduced in most host countries to prevent child and forced labour. Essentially, evidence of compliance with the host country's basic conditions of employment and recognising employees'rights is a priority for all of the participants.



1 **Processes and procedures for the identification of governance risks and opportunities:**

Standard operating processes for identifying governance risks and impacts

2 **Board Charter:**

Board duties and responsibilities, quorum, nomination, succession planning, remuneration, independence and conflicts etc.

3 **The number of board meetings held and minutes:**

Board's commitment to making decisions, set policy, solve problems and to plan and evaluate.

4 **Board sub-committees for assurance functions and services and sub-committee charters:**

Effective management of risk throughout the various departments

5 **Governance of risk (risk management strategies etc.):**

Structured and coherent approaches to identifying, assessing and managing risk

6 **Transparency and disclosure policy and procedures:**

Accurate disclosure regarding all material matters particularly a financial capital, manufacturing capital, human capital, social and relationship capital, intellectual capital and natural capital.

7 **Internal capabilities and competencies for managing governance risks and opportunities:**

Sufficient human and financial resources to achieve effective and continuous governance performance on an ongoing basis

Figure 9: Top Seven Perceived Governance Factors of Importance in terms of priority

Sound corporate governance practices are the priority of all investors hence none of the participants had the least priority concerning governance factors. Even though the participants are interested in understanding the board's commitment to making decisions while setting strategic direction, the data indicates that during the due diligence process that factor becomes the least priority. However, gathering intelligence around board structure, board duties and various board sub-committees become a priority for effective risk identification and management. Essentially, understanding the processes in place to identify risk together with the governance of risk are prioritised.

5. Discussion

The study aims to address a gap that is associated with the lack of a universally accepted and predefined ESG risk and performance indicators applied for investment screening and due diligence phases to understand ESG risk and impacts of potential investments in Private Equity.

The results indicated that perceived factors of importance influencing ESG performance indicators in Private Equity during investment screening are predominantly focused on sound corporate governance practices because business ethics enable participants to assess the potential investment for compatibility to the investment mandate and exclusion list. Such understanding enables the participants to avoid investing in activities which contravene the mandate and ethical approach of the investment mandate and exclusion list.

The findings also highlight that the perceived factors of importance influencing ESG performance indicators in Private Equity during investment due diligence are predominantly focused on environmental and social factors because according to the participants, understanding labour and working conditions, environmental commitment and communities investing determines the investment company's social image and ultimately its reputational and financial risks.

These results also indicate the gaps that are associated with the lack of a universally accepted and predefined ESG risk and performance indicators. Since the results indicate a predominantly focused on sound corporate governance practices during investment screening, this highlights the gap in terms of environmental and social risk

identification during this phase. The results also indicate the possible negligence of governance-related factors during the investment due diligence phase.

In relation to the investment committee, the findings indicate that the investment committee members prioritise the following factors:

i. ESG identified risks
ii. ESG Costs for Financial Model
iii. ESG Strategy
iv. ESG Corrective Action Plan
v. Key ESG conditions included in the investment agreement (key 100-day plan items)
vi. Key ESG investment requirements and covenants
vii. Key ESG risk and performance indicators to be tracked

The results also illustrate that the investment committee members also perceive the Corrective Action Plan to be an important factor as it presents key ESG risks/gaps, mitigation strategies, costs associated with mitigation as well as the priority actions required to close gaps identified in a given time frame. The ESG risks/gaps also provide the foundation upon which Key ESG risk and performance indicators to be tracked are established. According to the participants, the investment committee member conduct checks for the various stages prior to investment as illustrated in Figure 3 above to ensure the potential investment's compliance with the investors' ESG commitments.

Given the data analysis, the perceived ESG factors of importance enable the investment committee members to make an informed decision after getting comfort that the potential investment:

i. is compatible with the investors and fund mandate
ii. complies with all applicable laws as a minimum standard and doesn't expose investors to ESG related reputational risks
iii. has minimal adverse impacts and enhances positive effects on the environment, communities and employees

iv. encourages sustainable and efficient use of natural resources and to protect the environment wherever possible

v. support the reduction of greenhouse gas emissions to mitigate climate change

vi. encourages full compliance with the International Labour Organization (ILO) Core Conventions and Basic Terms and Conditions of Work and with the United Nations Universal Declaration of Human Rights

vii. consistent and fair with all stakeholders of the businesses and, as appropriate, promote the social aspects of the development impact of the businesses.

viii. has internal capabilities and competencies to manage ESG risk and opportunities.

The overall results indicated that pre-investment, most participants want to mainly understand the ESG aspect associated with Corporate Governance, Labour and Working Conditions, Environmental Commitment and Communities Investing. Based on the comprehensive review of the above findings, the framework for perceived ESG factors of importance has been developed applying a holistic view of analysing the information gathered from the participants (Mortensen, 2020). Table 9, Table 10 and Table 11 below illustrate the perceived factors of importance frameworks derived from the comprehensive review of findings.

Perceived Environmental Factors of Importance Framework			
Risk Identification Triggers	**Risk Parent Categories**	**Screening Indicators**	**Due Diligence Indicators**
• Political issues • Economic issues • Societal issues • Global issues • Environmental issues • Legislative issues Teams • Strengths issues • Weakness issues • Opportunities issues • Threats issues	• Compatibility to the investment mandate • Investment exclusion List • Host country environmental laws and regulations	• Publicly Available Information`; • Environmental Commitment • Host country environmental management agency compliance • Host country bylaws for environmental impacts management compliance • Host country bylaws for environmental impacts management compliance • Biodiversity impacts	• Internal capabilities and competencies for managing environmental risks and opportunities • Environmental management programmes • Processes and procedures for the identification of environmental risks and opportunities • Emergency preparedness and response policies and procedures

		• Environmental Convictions • Environmental Liability Directives	• Waste reduction and prevention strategies including hazardous waste management • Energy and water use efficiency • Environmental impacts on local communities

Table 9:Perceived Environmental Factors of Importance Framework.

Perceived Social Factors of Importance Framework			
Risk Identification Triggers	**Risk Parent Categories**	**Screening Indicators**	**Due Diligence Indicators**
• Political issues • Economic issues • Societal issues • Global issues • Environmental issues • Legislative issues Teams • Strengths issues • Weakness issues • Opportunities issues • Threats issues	• International labour laws and regulations • Host country labour laws and regulations	• Company-Specific Human Resource Management • Country and industry forced labour statistics • Country and industry child labour statistics • Country and industry Gender inequality • Country and industry Working conditions • Country and industry Occupational health and safety standards • Country and industry Supply chain management • Publicly Available Information on the company's Community health and safety • Publicly Available Information on the company's land acquisition and involuntary resettlement • Publicly Available Information on the company's Indigenous people impact • Publicly Available Information on the company's Cultural heritage impact	• Processes and procedures for the identification of social risks and opportunities • Human resource management programmes • Terms and conditions of employment • Freedom of association/human rights • Occupational health and safety policies and procedures • Internal capabilities and competencies for managing social risks and opportunities • Specific requirements for the minimum age to avoid child labour, forced labour and discrimination.

Table 10:Perceived Social Factors of Importance Framework.

Perceived Governance Factors of Importance Framework			
Risk Identification Triggers	**Risk Parent Categories**	**Screening Indicators**	**Due Diligence Indicators**
• Political issues • Economic issues • Societal issues • Global issues • Environmental issues • Legislative issues Teams • Strengths issues • Weakness issues • Opportunities issues • Threats issues	• Compatibility to the investment mandate • Investment exclusion List • Host country environmental laws and regulations	• Country Corruption and Bribery Profile • Sector Corruption and Bribery Profile • Competitors Corruption and Bribery Profile • Senior Management Corruption and Bribery Profile • Country Sanctions • Country, Sector and Competitors Anti- Money Laundering Activities • Politically Exposed Persons	• Processes and procedures for the identification of governance risks and opportunities • Board Charter • Number of board meetings held and minutes • Board sub-committees for assurance functions and services and sub-committee charters • Governance of risk • Transparency and disclosure policy and procedures • Internal capabilities and competencies for managing governance risks and opportunities

Table 11:Perceived Governance Factors of Importance Framework.

The risk indication triggers contained in the perceived factors of importance frameworks are informed by the analysis of the findings related to key pre-investment ESG matters that the participants want to understand about a potential investment. These findings are evidently triggered by PESGEL and internal SWOT considerations. The screening indicators were derived from the findings as highlighted by the participants in relation to perceived environmental factors of importance during the investment screening phase in Table 2, Table 3 and Table 4 above. The due diligence indicators were derived from the due diligence indicators that have been ranked in terms of perceived priority as highlighted and ranked by the participants in relation to perceived environmental factors of importance during investment due diligence phase in Figure 4, Figure 5 and Figure 6 above.

The perceived factors of importance frameworks derived from this study provide a holistic framework, which investment managers can adopt to inform decision making during investment screening and due diligence. To a greater extent because the

perceived factors of importance frameworks derived from this study are founded on PESGEL and SWOT, which are generally accepted international best practice techniques. Hence, the perceived factors of importance frameworks derived from this study may be considered as a baseline for developing the universally accepted standard since it contains elements of generally accepted international best practice techniques.

6. Conclusion

The ESG perceived factors of importance identified in this study will enable private equity investment managers and investment committee members to make an informed decision after getting comfort that the potential investment a sustainable and ethical investment. Furthermore, the ESG perceived factors of importance identified in this study may enable private equity investment managers to divulge the true reflection of material ESG impacts associated with the potential investment company during the investment screening and due diligence phases.

Therefore, it can be concluded that this proves the research proposition, P1, that perceived factors of importance influencing ESG risk and performance indicators that are predefined are likely to be more effective for decision-making purposes than perceived factors of importance influencing ESG risk and performance indicators that are not predefined.

Based on the findings, there is a need for further research to address the gap that is associated with the lack of a universally accepted and predefined ESG risk and performance indicators applied for investment screening and due diligence phases. Based on the findings, there is also a need for further research to develop a universally accepted standard, which will be based on internationally recognised standards and regulations, for defining ESG risk and performance indicators that influence ESG decision making in private equity. Further research should also consider methods or tools to quantifying the effectiveness of the universally defined ESG risk and performance indicators.

The perceived factors of importance frameworks derived from this study may be considered as a baseline for developing the universally accepted standard. The universally accepted standard for defining ESG risk and performance indicators, investment management firms will make the investment process more time and cost

effective as investment managers will no longer have to spend time and money establishing their own set of ESG performance indicators for every investment that needs to be evaluated (OECD, 2017).

Developing the universally accepted standard will ensure that the investment screening and due diligence processes that influence decision become objective instead of being subjective and allow for better understanding of material ESG related risks and opportunities before the investment approval (OECD, 2017).

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The author declares that no competing interests exist.

Author's contributions

G.C.M designed the study, collected the data, performed the analysis and wrote the article.

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9. Appendix A: Interview Questions

Perceived Factors of Importance influencing Environmental, Social and Governance (ESG) Performance Indicators in Private Equity, South Africa.

Applied Research Project Interview Questions

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Introduction

The purpose of this research study is to understand the perceived factors of importance influencing Environmental, Social and Governance (ESG) performance indicators used by private equity investment managers or ESG consultancy firms during the investment screening and due diligence phases for investment decision making purposes.

The significance of this qualitative study is that it will contribute to the body of knowledge that will assist investment managers together with ESG consultancy firms to consider ESG performance indicators that divulge the true reflection of material ESG impacts associated with the potential investment company during the investment screening and due diligence phases.

Hence, the interviews questions are aimed at eliciting information on key ESG factors that inform decision making during investment screening and due diligence including the challenges encountered by private equity investment managers post investment that were not detected through using the current tools of assessing ESG risks. The interviews questions are also aimed at eliciting information on ESG performance indicators that investment managers envisage as a feasible solution (main ESG performance indicators that investment managers can adopt to understand a potential investment with regard to ethical impact and sustainable practices).

The interview questions will be categorised in relation to the various pre-investment processes, which include investment screening, investment due diligence and investment commitment.

Investment Process:

1. What key ESG matter do you generally want to understand about a potential investment?

Investment Screening Process:

1. During investment screening, what are the material ESG factors that you use to assess a potential investment company?

Please rank a number of proposed ESG risk and performance indicators on a four-point Likert scale, with one indicating “low priority” and four indicating “high priority”

Investment Due Diligence Process:

1. What are the material ESG factors that you use to assess a potential investment company during the due diligence process?

   Please rank a number of proposed ESG risk and performance indicators on a four-point Likert scale, with one indicating “low priority” and four indicating “high priority”

Investment Committee Process:

1. What would you say are the key ESG factors that inform decision making for investment committee members?

   Please rank a number of proposed ESG risk and performance indicators on a four-point Likert scale, with one indicating “low priority” and four indicating “high priority”