Finance 701

Literature Review

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1 Abstract

This paper explores academic literature across multiple theoretical frameworks to inform the following research question: Does socially responsible outcomes contribute to the generation of excess returns in private equity-backed investments? Corporate social responsibility (CSR) is the main theoretical framework underpinning this research. A methodological approach establishes the taxonomy. The literature investigates the relationship between CSR and corporate governance, the contention in private equity performance, CSR's growing influence in private equity and the methodology underpinning the construction of the investor sentiment index. The mitigation of research design issues is satisfactory. The literature sets a foundation to explore the research question.

Contents

2 Introduction

This paper reviewed research associated with Corporate Social Responsibility, Private Equity (PE) performance and impact on CSR and ESG. The purpose of this review is to gain a more comprehensive understanding of the body of literature surrounding the associations above and their relation to the research question: **Does socially responsible outcomes contribute to the generation of excess returns in private equity-backed investments?** This question broadly sits within the theoretical framework of Corporate Social Responsibility (CSR), a self-regulatory model helping a company remain socially accountable. CSR is achieved by practising corporate citizenship, managing the impact the entity has on all areas of society.

Private Equity (PE) continues to influence global capital markets and conventionally takes one, or a combination, of the following forms: Venture capital for early-stage companies. Growth equity for growth-stage companies or Buyout for late-stage companies. These are forms of investment vehicles usually identified by four characteristics. Firstly, funds organised privately, pooling capital from several parties. Secondly, professional investment managers administer the fund, incentivised by performance-based compensation and significant carry in the fund. Thirdly, they are inaccessible to the public. Lastly, they operate externally to securities regulation and registration requirements. A general partner(s) (GP) manage fund operations and make investments using capital contributed by limited partners (LP). LPs make passive investments with little to no control in the operations of the fund. Funds typically charge a 2% annual fee and 20% performance fee on the fund's annual return. They raise capital through private offerings and pursue investment strategies in private assets to generate returns for investors (Brav, Jiang, Partnoy, and Thomas, 2008).

The role of private equity in CSR activity is receiving increased attention from stakeholders. The analysis supports the increased demand by institutional investors for contributions towards CSR from the willingness to sacrifice returns for activist-related causes and ESG-related outcomes from both demand and price perspectives. However, the measurability in CSR-related activity and transparency in outcomes is complex at best. Private equity also may invest in a subset of industries that deliver financial returns but may deliver poor outcomes in alternative metrics within CSR contexts.

The research intends to achieve the following outcome. Firstly, devise a more transparent methodology in evaluating CSR-related activity in the form of socially responsible outcomes (SRO). Secondly, determine the performance incentives for private equity by contributing to these outcomes to improve society. Thirdly, the outcomes' alignment to the United Nations Sustainable Government Goals (UNSDG). In summary, the intention is to determine whether the delivery of socially responsible outcomes generates excess returns for private equity investors using a more rigorous, quantitative methodology.

The nature of this research is new, encompassing several interrelated frameworks and little historical context. Subsequently, this literature review covers the intersection of CSR, legal origins and corporate governance, CSR and value creation, the historical performance of private equity, private equity's impact on CSR and ESG and an empirical methodology detailing the construction of a socially responsible outcome-related index from underlying proxies.

As a caveat, the lack of historical context opens opportunities for new research. Firstly, expand on existing CSR-related proxies by exploring and designing new rigorous quantitative proxies for socially responsible outcomes. Secondly, investigating the relationship between socially responsible outcomes and the returns generated by private investors. Lastly, the feasibility for these socially responsible outcomes to help achieve the United Nations' Sustainable Development Goals.

3 Theoretical Framework(s)

Corporate Social Responsibility (CSR); Corporate Governance; Environmental, Social, Corporate Governance (ESG); Private Equity

4 Empirical Research Studies

This section uses a methodological approach to assess corporate social responsibility and private equity-related literature. Research design issues integrated into these empirical research studies.

4.1 Corporate Social Responsibility

4.1.1 CSR, Legal Origins and Corporate Governance

The evolution of corporate social responsibility commitments continues to influence investment decisions. Liang and Renneboog investigate the role legal origins plays in cross-country variations in corporate social responsibility. Their assessment of CSR using proxies across the global business community found strong correlations between legal origins and CSR scores (Liang and Renneboog, 2017). The findings are relevant on both macro and micro levels. Firstly, the relationship explored between CSR and legal origins contribute to the broader body of literature covering the role legal origins plays in investor protection rights, financial and economic outcomes examined by La Porta et al. (Porta, Lopez-deSilanes, Shleifer, and Vishny, 1999). Furthermore, there is a greater understanding of CSR engagement and CSR compliance drivers on a global level. These findings are relevant for the research question as private equity operations and commitments to socially desirable outcomes cross borders. Previously, the academic community contest that investment through acquisition in assets with corporate social responsibility initiatives creates a dichotomy in value creation: Acquisitions either maximise value for shareholders or stakeholders at the expense of shareholders. These relationships are articulated in one of two ways: 'doing well by doing good' ((Dowell, Hart, and Yeung, 2000),(Orlitzky, Schmidt, and Rynes, 2003),(Guenster, Bauer, Derwall, and Koedijk, 2011)) and 'doing good by doing well' (Hong, Kubik, and Scheinkman, 2012).

4.1.2 Dichotomy of Value: Stakeholders or Shareholders

One paper finds evidence to resolve this contest and the accompanying dichotomy of thought. The maximisation of stakeholder value view predicts high CSR firms complete mergers to benefit other stakeholders. The acquisition impact improves stakeholder satisfaction benefiting shareholders. In contrast, the opposing view is acquisitions reduce shareholder wealth. The paper finds merger activity by high CSR acquirers, in comparison to low CSR acquirers, creates several benefits. Firstly, a higher announcement of stock returns for both acquirers and value-weighted portfolios of the acquirer and target. Secondly, significant increases in long-term operating performance and stock returns. Lastly, higher likelihood and shorter duration of deal completion. Subsequently, the integration of various stakeholder's interests in operations complete investment enhancing long-term profitability and efficiency. These improvements are in favour of stakeholder value maximisation, enhancing shareholder wealth and corporate value. The empirical analysis is rigorous and robust, similar to most articles in this literature review, invalidating research design issues. Endogeneity issues, for example, high-quality management driving profitable mergers and more excellent CSR investment, are addressed using supplementary 2SLS regression analyses with instrumental variables considering religious and political factors, strengthening internal validity. The measurement of CSR is thorough, drawing extensive methodologies using the KLD database implemented in prior research Lev, Petrovits, and Radhakrishnan, 2010, Waddock and Graves, 1997, Jiao, 2010 This database ensures external reliability. Seven major dimensions measure social performance: community, corporate governance, diversity, employee relations, environment, human rights, and product quality and safety. These dimensions may inform the construction of socially responsible outcomes. Several empirical tests investigate the robustness of the statistical significance and magnification of abnormal stock returns, validating research design. In particular, the CSR measures are statistically significant on the 1% level for determining abnormal stock returns on value-weighted portfolios returns (Deng, Kang, and Low, 2013).

4.2 Private Equity Performance

Private equity has a reputation as a lucrative asset for generating returns. however, academics continue to contest the relative performance of private equity in comparison to other asset classes. Several academics juxtapose this ideology by examining returns from different datasets.

An investigation of a commercially available dataset of individual fund returns and cash flows collected over a sample period between 1980 to 1997 found average fund returns, net of fees, generated approximately the same level of returns as the S&P5 500. Additionally, venture funds outperform the S&P 500 while buyout funds underperform when weighted by committed capital. However, both types of funds expect to generate returns above the S&P 500 (Kaplan and Schoar, 2005). There are a few issues associated with this research. Firstly, a lack of control for market risk and sampling bias invalidate these findings, creating replication design issues. Additionally, the VE dataset is not as comprehensive as the datasets subsequently discussed.

One paper further developed the concept of private equity funds generating returns above the market. The analysis of 1400 U.S private equity (buyout and venture capital) funds, which utilised a new dataset sourced from over 200 institutional investors via Burgiss Systems, discovered U.S Buyout funds outperformed the S&P 500 20% to 27% on average over the life of the fund. The performance correlates to 3% per year, highlighting the lucrative nature of private equity in this first instance. Firstly, the results are similar with different proxies for the market. Determining a market proxy is often highly subjective. Secondly, the statistical methods used to determine the results are rigorous, with samples tested across multiple commercial datasets, ensuring to mitigate the likelihood of positive selection bias (Harris, Jenkinson, and Kaplan, 2014).

Conversely, another article published in 2020 offered an alternative perspective. Analysis on PE fund performance across three datasets derived average net multiple on money (MoM) metric range of 1.55 to 1.63. These findings implied an 11% per annum return, consistent with relevant public market proxies calculations. Carry calculations to help determine the net multiple of money calculations used the same dataset as the previous article. The article identifies the potential for agency conflicts to arise based on the existing fee and carry structure. (2% per annum on AUM and 20% on return). Additionally, the statistical analysis is lacking empirical rigour (Phalippou, 2020). Subsequently, the article raises design and methodology issues.

In summary, private equity does generate favourable returns from investors equal to or above the market.

4.3 Private Equity, CSR and ESG

There is an increased interest in CSR and ESG-related activity in the private equity industry based on published literature.

4.3.1 Impact Investing, Utility and Willingness to Pay

Impact investing offers an alternative perspective on investing for performance alone. The article investigated insights on an investors utility/willingness to pay, showing how investors derive non-pecuniary utility from investing in dual-objective venture capital funds. Random willingness-to-pay models indicated investors were willing to accept 2.5 - 3.7 percentage points lower internal rate of return from an impact fund than a traditional venture capital fund. The analysis found impact funds earn an internal rate of return 4.7 percentage points ex-post lower than traditional venture capital funds (Barber, Morse, and Yasuda, 2021). Funds analysed were organised into five industry groups: Information technology and business services. Diversified and consumer discretionary. Health care. Media and communications. Others (energy, industrials, infrastructure, food and agriculture, materials, real estate etc.). The internal rate of returns found in regressions for impact funds was statistically significant on at least the 5% level for the first four of five industry groups. The random utility of the willing-to-pay model, logit specification adoption given the unobservable nature of utility and expected returns formulation are rigorous. Additionally, the model formulation for willingness to pay across every logit model varied for limited partner controls is statistically significant at the 1% level for both homogenous and heterogenous expected returns forecasts. Investor categorisation unpacks issues with heterogeneity. Regression and logit analysis strengthen the statistical validity and rigour of the empirical research design. This article provides some interesting insights. Firstly, a subset of investors in the private equity industry is willing to sacrifice returns to invest in the causes of impact funds. The same effect may occur for socially responsible outcomes. Secondly, the exact derivation of willingness to pay models, logit regressions and performance models may influence the empirical design required to solve the research question. Thirdly, the grouping exercises may inform the methodology for constructing socially responsible outcome categories for exploration.

4.3.2 ESG in Demand

ESG disclosures and demands from investors emphasise additional factors to accompany performance are gaining traction. One paper provides evidence institutional investors, limited partners in various private equity funds, push for stronger environmental and sustainability around the world. The empirical analysis informs investors are demanding environmental and social outcomes with firms delivering (Dyck, Lins, Roth, and Wagner, 2019). Institutional investors have often limited partners in private equity funds. It is plausible these institutional investors may influence general partners to make investments in assets that are driving socially responsible outcomes.

4.3.3 The Price of ESG

The price of environmental, social and governance practice disclosures about professional private equity investors contributes to the growing field of sustainable entrepreneurship and the role in driving socially responsible outcomes. The paper addresses the role socially responsible and irresponsible financing has on private equity financing (Crifo, Forget, and Teyssier, 2015). The paper derives an exciting method to determine the marginal impact of valuation on investors when given ESG-related information, assessed by good and bad outcomes based on market thresholds. The positive or harmful nature of three qualities (soft, hard, impact) for each factor (environment, social and governance) creates an aggregate marginal sign effect on firm valuation. This methodology informs one null and three alternative hypotheses: No effect. Mispricing. Asymmetrical impacts. Irresponsibility risk premium. The hypotheses inform the impact of ESG disclosure on firm valuation. The methodology expressed in this instance may inform the incorporation of ESG disclosure requirements in socially responsible outcomes for the research question. This approach provides an alternative qualitative approach to assessing socially responsible outcomes compared to the other methods explored in this paper. The variation in case studies and the small sample size of private equity investors raises concerns regarding experimental design. However, several methods improve validity. Firstly, soft and hard practices are tested in conjunction to test the accumulated implications of both. The testing procedures were consistent and structured amongst participants, with each given the same sets of data and process. Additionally, investor profiling approaches control for heterogeneity. These implementations mitigate the threats to reliability by addressing errors and biases for both participants and researchers. The approach finds subsets of ESG disclosures are statistically significant at the 5% and 1% level on firm valuation and investment decisions. Additionally, the predictive margins of good and bad ESG practises are statistically significant at the 1% level, impacting investment decisions, highlighting the strength of this study. Conversely, this analysis shows the impact of ESG disclosure on private equity investment, not how disclosures inform returns. Nonetheless, this analysis may frame how to construct quantitative variables from qualitative information related to socially responsible outcomes.

4.4 Empirical Methodology: Investor Sentiment Index

The following article does not relate to private equity. However, it identifies a rigorous modelling approach that may inform empirical methods. The article confirms the significance of behavioural finance, diverging from classical finance theory. It is one of the most popular articles in finance-related academic literature, measured by citation frequency and academic recognition. Briefly, investment sentiment influences the cross-section of returns, validated by theoretical arguments, historical accounts of speculative episodes and sets of novel empirical results (Baker and Wurgler, 2006). The research question seeks to investigate how socially responsible outcomes generate excess returns in entities backed by private investors. The investigation will require the construction of a methodology to measure socially responsible outcomes. The article constructs a sentiment index to measure sentiment, a formulation of a composite index from six underlying proxies, including the number of IPOs and average first-day returns. Principle component analysis isolates common components as idiosyncratic and non-sentiment-related. The formulation of the composite index follows:

1. Estimate the principal component of six proxies and their lags to create first stage index with twelve loadings
2. Compute correlations between first stage index and the current and lagged values of each proxy.
3. Define the sentiment index as the first principal component of the correlation matrix of six variables, lead to lag with the highest correlation to the first index while scaling for unit variance.

Panels display modelling characteristics and return drivers, split into subsets including returns, profitability and growth opportunity. Each underlying proxy is statistically significant results at the 1% level when regressed on the sentiment index. A series of empirical tests, including decile sorting, predictive regressions and time-series regressions, were rigorous. The empirical results aligned with market observations increasingly the validity of the experimental design. Subsequently, the research methods and design were intensive, delivering validity, replicability and reliability. Additionally, this research is critically acclaimed, significantly contributing to behavioural finance and recognition for the authors in the form of a Nobel prize for their contributions to the area. This methodology may inform the construction of a socially responsible outcome index. Both firm-specific and industry-specific socially responsible outcome-related proxies may form the aforementioned composite index. These may include churn rates, employee health statistics, insurance policies, emission reductions, income statistics, energy access and water quality. Additionally, firm and industry drivers would assist in the formulation of panel data. These may include returns, growth, profitability and industry classification. The modelling may use multiple modelling techniques: cross-sectional, time-series regressions, probit regressions, dummy variables to control for industry-specific outcomes and private equity-related investment, including but not limited to investment size, follow on investment, stage of investment, board influence and time horizon. This modelling approach may evaluate how socially responsible outcomes contribute to driving excess returns of an entity backed by private equity. The empirical analysis across time could be compared to societal-related events before, during and after PE investment.

5 Conclusion

This paper explores academic literature across multiple theoretical frameworks to inform the research question. Corporate social responsibility underpins the objective of determining if socially responsible outcomes contribute to the generation of excess returns in private equity-backed investments? The academic literature provided several insights. CSR-related activities play an increasing role in corporate governance, further contributing to a critical piece of literature on legal origins, corporate governance and investor protection. The dissection of the dichotomy between stakeholders and shareholders in CSR-related value creation informs CSR-related activity can both generate returns and benefit both parties. The debate on whether private equity generates excess returns above the market is ongoing between investment professionals. However, investors are demanding CSR-related contributions and are willing to pay for them. The expression of socially responsible outcomes is complex and opaque. However, the robust quantitative methodologies in other applications could reduce this complexity and improve visibility behind their relationship with returns. Most empirical methodologies correct for research design issues, providing suitable frameworks to base modelling and analysis. In summary, the literature provides context for investigating the ability for socially responsible outcomes to generate excess returns in privately-backed investments in further research.

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