Capital with a Conscience: Navigating ESG in Private Equity

A Qualitative Study of the Underlying Drivers of ESG Integration, its Challenges, and Fundraising Implications in Leveraged Buyout

---

Elin Carlberg
Sofia Rosenblad

Stockholm School of Economics | Department of Finance
Master thesis, 30 credits | M.Sc. Finance
Fall 2024



Abstract

The private equity industry has undergone a transformation in recent years, shifting from a narrow focus on financial returns to a broader commitment to aligning financial objectives with sustainability goals. This thesis aims to investigate the impact of ESG integration on leveraged buyout funds through three key research questions: 1) What are the primary drivers of integrating ESG into private equity investment decisions? 2) What effect does ESG integration have on private equity fundraising outcomes? and 3) What are the main challenges with ESG integration and their practical consequences? The study employs a qualitative approach, drawing upon insights from 19 interviews with General Partners (GPs), Limited Partners (LPs), and independent ESG Advisors in the Nordic private equity market. We find that ESG integration is motivated by a mix of internal and external factors. Internally, ESG is viewed as a key value-creation tool as well as a risk mitigator, although the risk aspect is more pronounced by LPs than GPs. Externally, institutional investors in general, and Nordic pension funds in particular, have established minimum ESG standards in the market, largely driven by regulatory requirements shaping their mandate. Despite ESG integration gaining traction, we conclude that the correlation between ESG and fundraising success is non-negative or neutral, with ESG disclosure constituting a baseline requirement rather than a competitive advantage. However, GPs managing Article 9 funds report that they see their SFDR classification as a valuable differentiator when attracting capital. The study also highlights the main challenges associated with ESG integration, primarily related to EU sustainability regulations and difficulties in quantifying impact. This paper contributes to the understanding of ESG dynamics within the Nordic leveraged buyout market, shedding light on its drivers, challenges, and implications for fundraising.

Key Words: Private Equity, Nordic Leveraged Buyout, ESG, Sustainability, ESG Integration

Supervisor: Jan Starmans, Department of Finance, Stockholm School of Economics

Authors: Elin Carlberg[*] and Sofia Rosenblad[**]

Acknowledgments: First and foremost, we thank our thesis supervisor, Jan Starmans, for his constructive feedback and support. Moreover, we would like to express our gratitude to all General Partners, Limited Partners, and independent ESG Advisors who contributed to our thesis with their time, knowledge, and insights.

[*] 24713@student.hhs.se
[**] 24697@student.hhs.se

Abbreviations

CAPM = Capital Asset Pricing Model

CSR = Corporate Social Responsibility

CSRD = Corporate Sustainability Reporting Directive

E&S = Environmental and Social

ESG = Environmental, Social, Governance

EU = European Union

FMP = Financial Market Participant

GP = General Partner

IRR = Internal Rate of Return

KPI = Key Performance Indicator

LP = Limited Partner

PAI = Principal Adverse Impacts

PE = Private Equity

PRI = Principles for Responsible Investing

SFDR = Sustainable Finance Disclosure Regulation

SRI = Socially Responsible Investing

UN = United Nations

WTP = Willingness To Pay

Table of Contents

1 Introduction 1

2 Background 4
2.1 Incentive Mechanisms in Private Equity 4
2.2 EU Sustainability Regulations 5

3 Theoretical Framework and Literature Review 6
3.1 Integrating ESG Into Private Equity 6
3.2 Stakeholder Theory 7
3.3 The Underlying Drivers Behind ESG Integration 8
3.3.1 ESG as a Means to Drive Value 9
3.3.2 ESG as a Means to Reduce Risk 10
3.3.3 ESG as a Means to Achieve Dual Objectives 12
3.3.4 ESG as a Means to Increase Employee Engagement 13
3.4 ESG and Fundraising Effects 13
3.5 Challenges to ESG Integration 15

4 Methodology 16
4.1 Research Design 16
4.2 Data Collection 16
4.3 Research Quality 19

5 Results 21
5.1 The Underlying Drivers Behind ESG Integration 21
5.1.1 ESG as an Attractive Business Case 21
5.1.2 ESG as a Risk Mitigation Tool 24
5.1.3 The Potential Trade-Off Between ESG and Financial Returns 25
5.1.4 ESG and Secondary Benefits 28
5.1.5 The Key Actors Driving ESG Integration 28
5.2 ESG and Fundraising Effects 31
5.3 Challenges to ESG Integration 33
5.3.1 EU Sustainability Regulations 33
5.3.2 Greenwashing 35
5.3.3 Quantifying Impact 36

6 Discussion 39
6.1 The Underlying Drivers Behind ESG Integration 39
6.1.1 ESG as an Attractive Business Case 39
6.1.2 ESG as a Risk Mitigation Tool 40
6.1.3 The Potential Trade-Off Between ESG and Financial Returns 41
6.1.4 ESG and Secondary Benefits 42
6.1.5 The Key Actors Driving ESG Integration 43
6.2 ESG and Fundraising Effects 44
6.3 Challenges to ESG Integration 45

7 Conclusion 48

7.1 Concluding Remarks 48
7.2 Limitations and Future Research 49

1 Introduction

The private equity (PE) industry, once characterized by its reputation as corporate raiders with a narrow focus on financial returns and little consideration for broader stakeholder impacts, is increasingly embracing the integration of ESG factors (Harvard Business Review, 2022). Globally, the Principles of Responsible Investment (PRI) reports that the number of General Partners (GPs) committing to the PRI has increased fourfold over the past years, with nine of the top ten largest GPs having signed the principles (ibid). In addition, a survey by the Institutional Limited Partners Association and Bain & Company (2022) found that 68 percent of Limited Partners (LPs) expect to increase their ESG investment allocation in the coming years. In the Nordic region, this shift is exemplified by pioneers like Summa Equity and Trill Impact, representing a new wave of private equity firms committing to aligning financial returns with sustainability goals. By channeling capital into portfolio companies that contribute to positive societal and environmental outcomes, such firms have redefined the role of PE as a force for positive change. More traditional PE firms have followed along by launching impact- or climate-designated funds, marking a significant departure from many PE firms' historical investment focus.

The ESG transformation is reflected across financial markets, with global sustainable assets totaling almost USD 3.1 trillion in Q2 2024 (Morningstar, 2024) compared to USD 841 billion in Q1 2020 (Morningstar, 2020). Moreover, the acknowledgment that companies have responsibilities beyond generating profits is increasingly gaining traction, as made evident in 2019 when the Business Roundtable, an association of chief executives from leading U.S. companies, revised its Statement on the Purpose of a Corporation (Business Roundtable, 2019). The new statement asserted that businesses should focus on maximizing stakeholder value rather than solely prioritizing shareholders. Furthermore, the EU has implemented new sustainability regulations that target the financial sector with the aim of reorienting capital flows towards sustainable finance (European Union, 2019). Despite ESG investing gaining traction in private markets, there is scarce knowledge on the drivers behind this shift and to what extent it creates value. Therefore, there is much to be understood regarding the underlying mechanisms, impacts, and challenges of ESG integration within the private equity space, which warrant further research.

This thesis aims to explore the underlying drivers behind ESG integration in leveraged buyout funds, hereafter referred to as private equity firms, focusing on identifying the rationales and key market players influencing the adoption of sustainable investment strategies. It further seeks to explore the impact of ESG integration on fundraising, particularly considering the role of ESG disclosure and the implications of EU sustainability regulations. Additionally, the study examines the challenges associated with implementing ESG principles in private equity, shedding light on the practical and operational consequences faced by market participants. In order to narrow the scope

of this study and facilitate access to participants, we have chosen to focus on the Nordic leveraged buyout fund market. This geographical focus also provides a valuable lens through which to study ESG integration due to the region's high level of ESG consciousness. The objectives of this thesis are captured in the following three research questions:

1. What are the primary drivers of integrating ESG into private equity investment decisions?

2. What effect does ESG integration have on private equity fundraising outcomes?

3. What are the main challenges with ESG integration and their practical consequences?

We provide empirical findings from 19 interviews, targeting GPs, LPs, and independent industry participants. Firstly, we conclude that two main internal forces drive the integration of ESG in private equity - ESG as a business case and risk mitigator - with GPs emphasizing the former, while LPs attribute more value to the latter. Furthermore, both groups view the pursuit of dual objectives as a fundamental prerequisite for ESG integration rather than as a mere incentive. Additionally, our findings highlight regulation and LPs as most influential in furthering ESG integration, establishing minimum thresholds that shape market standards. In contrast, the development of Article 9 funds, dedicated to impact, appears to have stemmed internally from specific GPs managing such funds. Secondly, our findings indicate that while ESG integration does not have a strong positive effect on fundraising success, a non-negative or neutral relationship is observed. Not meeting the industry baseline requirements for ESG threatens GPs' ability to raise capital, while exceeding these standards does not seem to significantly increase the chances of a successful funding round. However, Article 9 GPs have a different view, believing that their SFDR classification serves as a competitive advantage when attracting capital. Finally, the paper identifies the primary challenges to ESG integration as stemming from the implementation and interpretation of EU sustainability regulations, namely the Sustainable Finance Disclosure Regulation (SFDR) and the Corporate Sustainability Reporting Directive (CSRD). On the one hand, GPs are concerned about the heavy administrative burdens imposed by the CSRD. On the other hand, LPs highlight challenges related to the SFDR's vague definition of a sustainable investment and the broad scope of Article 8.

This thesis expands on and contributes to earlier research in multiple ways. First, while several scholars have studied ESG within the financial sector, much of the existing research focuses on public markets, often utilizing quantitative approaches (e.g., Pástor, Stambaugh, and Taylor, 2021; El Ghoul et al., 2011). Similarly, although research on ESG integration in private equity is emerging, the majority of these studies are also quantitative in nature, with limited empirical

insights from industry professionals (e.g., Crifo et al., 2015; Bellon, 2020; Abraham et al., 2024). This research instead takes a qualitative stance, diving deeper into the perspectives of both GPs and LPs within the Nordic private equity market. It focuses on the incentives driving ESG integration, assesses its implications for fundraising success, and examines its associated challenges. Second, it fills an existing research gap regarding the internal and external forces advancing ESG integration in leveraged buyout funds. Through in-depth interviews with GPs and LPs, this thesis addresses this gap by uncovering historical and current drivers. Third, given the ongoing implementation of EU sustainability regulations, this research contributes knowledge of how industry participants view the current and future impact on ESG disclosure and investment strategies. Lastly, we add insights to the ongoing debate about the potential trade-offs between financial performance and sustainable investments, expanding on work by authors like Gompers et al. (2003) and Hong and Kacperczyk (2009).

The remainder of the paper is structured as follows. Section 2 provides contextual information on private equity and EU sustainability regulations. Section 3 outlines previous research and theory, which form the basis of the subsequent research and analysis. Section 4 describes the methodology and study design, including a discussion on research quality. In section 5, we present our empirical results and briefly connect these back to our initial hypotheses. Section 6 digs deeper into the findings and discusses these with existing research and theory as a frame of reference. Finally, we summarize our concluding remarks, limitations, and suggestions for future research in section 7.

2 Background

2.1 Incentive Mechanisms in Private Equity

To analyze ESG integration in private equity, it is necessary to first understand the incentives driving GPs. Their compensation structure, consisting of management fees and carried interest, influences GPs' decision-making priorities, aiming to balance short-term returns with long-term value creation (Metrick & Yasuda, 2010). Examining these incentive mechanisms, therefore, provides relevant context to this thesis.

The GP manages the fund and its investments and, in return, receives a management fee of circa 2 percent per annum as well as carried interest, typically 20 percent of the fund's profit. The management fee and carried interest create incentives for the GP managing the fund in multiple ways. Firstly, part of the GP's incentive stems from maximizing deal profits, thus receiving carried interest. A fund's profit arises at the time of exiting a portfolio company where the price of the sale, and ultimately the fund's profit, depends on the future economic viability of the company. This incentivizes the GP to not solely focus on short-term profits, as this would affect the portfolio company's long-term value and, in turn, the fund's profit (Sorensen & Yasuda, 2023).

Secondly, private equity firms are partly incentivized by their future deal flows. A large share of a private equity firm's success is contingent on its ability to make future investments, which in turn is dependent on access to high-quality deals. Maintaining a good reputation as a reasonable investor can help secure future deals. Thus, sacrificing short-term profits by turning down a deal can still be profit maximizing in the long run, as it may help enable future portfolio company acquisitions (Sorensen & Yasuda, 2023).

Lastly, the GP's core incentive stems from its focus on maximizing its cumulative management fees and carried interest from its past, current, and future funds. Chung et al. (2012) suggest that around half of the GP's incentive compensation comes from current fund performance and, in turn, its ability to raise future and larger funds. The second half comes from the current funds carried interest (ibid). According to Metrick and Yasuda (2010) and Chung et al. (2012), successful buyout fund managers enhance their compensation primarily by increasing the size of follow-up funds rather than by increasing their compensation per dollar under management. The capital for the funds is supplied by LPs. Therefore, private equity firms should consider whether their investment decisions align with the priorities and preferences of their LPs and how these actions support the firm's ability to raise future funds (Sorensen & Yasuda, 2023).

2.2 EU Sustainability Regulations

Although the private equity industry has traditionally been exempted from mandatory ESG disclosure and lacked standardized frameworks, EU regulations are significantly reshaping the reporting landscape. Effective from January 2023, the CSRD aims to enhance transparency by providing investors and other stakeholders with comprehensive information on companies' social and environmental impacts, as well as to help investors assess the financial risks and opportunities related to sustainability factors (European Union, 2022). While the CSRD is gradually phased in, starting with larger public entities before extending to smaller private enterprises, it will indirectly impact the private equity sector, as PE firms will require their portfolio companies to comply with CSRD standards to meet their own SFDR reporting requirements (PwC, 2024). This will significantly increase ESG transparency in the private equity industry, aligning reporting requirements more closely with those in the public market. Additionally, the shift will necessitate PE firms' portfolio companies to establish or enhance processes for tracking, measuring, and reporting ESG data. These requirements will likely result in higher initial operational costs, but over time, they may offer substantial benefits, including improved access to capital and enhanced reputation. This regulatory shift will also provide investors with more tangible and standardized KPIs, making it easier to compare and evaluate ESG practices across private firms (ibid).

Complementing the CSRD, the SFDR, effective from 2021, requires financial market participants (FMPs), including PE firms, to apply both product and entity-level sustainability disclosures (European Union, 2019). At the product level, funds are classified into three categories based on their sustainability ambition, namely Article 6, 8, or 9. Article 6 funds have no explicit sustainability objective, Article 8 funds promote environmental or social characteristics, and Article 9 funds have sustainable investments as their primary objective. These classifications determine the level of sustainability-related disclosures that the FMP must undertake (ibid). At the entity level, FMPs are to disclose how they integrate sustainability risks into investment decisions and to report on the principal adverse impacts (PAIs) their investments may have on sustainability factors (European Union, 2019).

The SFDR and CSRD are closely interlinked, with the SFDR relying on CSRD-compliant reporting from portfolio companies to ensure robust sustainability disclosures (Deloitte, 2022). For PE firms, this creates a dual imperative of enhancing internal ESG integration strategies and ensuring portfolio companies adhere to rigorous reporting practices. For LPs, this, in turn, enables more informed investment decisions aligned with their sustainability preferences, as they can clearly differentiate the ESG focus of various funds (ibid). This alignment drives accountability and supports the EU's broader goal of attracting private funding to help Europe make the shift to a net-zero economy (European Union, 2019).

3 Theoretical Framework and Literature Review

3.1 Integrating ESG Into Private Equity

Since this thesis aims to explore ESG integration in PE, this section outlines why the PE model is well-positioned to adopt an ESG approach and explores the importance of ESG within private equity.

While ESG investing has gained momentum across various asset classes, several articles and studies argue that the private equity governance model is particularly well-suited to advance investors' sustainability agendas. Although the governance aspect of ESG has long been integral to the PE industry, what Kaplan and Strömberg (2009) describe as "governance engineering", there has been significantly less emphasis placed on the environmental and social components. In interviews with 100 industry professionals globally, including both LPs and GPs, it was revealed that practitioners have been slow to recognize the importance of ESG for the future relevance of the firm, its profitability, and license to operate within the PE market (Harvard Business Review, 2022). Yet, the authors argue that the private equity business model holds significant potential to drive ESG improvements in portfolio companies, offering advantages over public investors in implementing such changes. Firstly, a GP's majority ownership stake provides substantial control over its portfolio companies, including the appointment of one or more representatives to the Board of Directors and considerable influence over the composition of management. Secondly, GPs have access to detailed private information on both financial and ESG performance, unlike other investors who rely on public reports and presentations. Thirdly, GPs have the authority to set executive compensation, which they can explicitly tie to ESG performance metrics if they aim to incentivize such outcomes (ibid). Furthermore, Alfonso-Ercan (2020) emphasizes that the PE sector is strategically positioned to lead the shift towards investment standards that account for ESG impacts. She argues that PE firms can create the tools necessary for greater transparency, better resource management, more effective risk mitigation, and higher returns compared to traditional investment strategies.

Limited Partners have progressively integrated ESG into their investment decisions in recent years, with the development being driven by two main factors (Sorensen & Yasuda, 2023). The first driver is materiality, where LPs believe that a business's ESG practices have a material impact on its future performance (ibid). This reasoning therefore makes ESG integration a part of a GP's scope of fiduciary duties, where the ultimate goal is still maximizing returns. The second driving factor for ESG integration is based on impact investing and the belief that LPs enjoy non-financial gains from generating positive externalities, also called dual objective investing (ibid). The growing emphasis on ESG from an LP perspective is further made evident in a report from the Institutional

Limited Partners Association and Bain & Company (2022), with 70 percent of surveyed LPs stating that their organizations' investment policies include an ESG approach.

3.2 Stakeholder Theory

Combining the facts that LPs are increasingly calling for an investment approach integrating ESG and that GPs have financial incentives to align with investor expectations, one could argue that ESG is relevant to PE firms (Sorensen & Yasuda, 2023). Furthermore, EU sustainability regulations expand the scope of firm responsibilities beyond shareholder returns, requiring ESG-focused investors to also consider and disclose the wider impacts of their actions on all key stakeholder groups (European Union, 2019). Thus, ESG investing, inherently considering stakeholder impacts, can be linked to stakeholder theory.

Stakeholder theory originates from Freeman (1984) and proposes that businesses serve a broader purpose than solely generating profits for shareholders. Instead, they function best and serve the greater good by addressing the interests of all stakeholders, including employees, suppliers, the community, partners, and shareholders (ibid). Clarkson (1995) expands on this by asserting that firms are composed of stakeholders and operate within societal frameworks that provide the legal and market infrastructure necessary for their activities. Moreover, he states that value or wealth creation for stakeholders is the main purpose of firms. The way in which control is exercised within firms is determined by the entire network of informal and formal relations, which is the focus of stakeholder theory (ibid).

Stakeholder theory can be approached from various perspectives. From a normative standpoint, Donaldson and Preston (1995) argue that it reflects ethical principles guiding how organizations should engage with stakeholders. From a practical perspective, Jones (1995) highlights the instrumental benefits of adhering to ethical principles, suggesting that mutual trust and cooperation among stakeholders can create competitive advantages for firms. Clarkson (1995) also links stakeholder theory to corporate social responsibility (CSR), responsiveness, and performance, arguing that aligning a corporation's stakeholder relationships with normative principles enhances its ability to effectively analyze and address these concepts. These two perspectives, practical and normative, may contribute to explaining the relevance of stakeholder theory in corporate strategy, economics, public policy, and business ethics (Nnadi & Mutuaba, 2023). The development of stakeholder theory largely depends on economic theory. It aligns with agency theory but diverges by incorporating social and moral contracts alongside legal and implied contracts (ibid). In summary, stakeholder theory can be defined as a framework that: 1) encourages organizations to acknowledge and consider both internal and external stakeholders; 2) promotes understanding and management of stakeholder needs, wants, and demands; 3) advocates for a

holistic and responsible decision-making process that transcends shareholder-focused approaches; and 4) enables organizations to be strategic, maximize value creation, and safeguard their long-term success and sustainability (Mahajan et al., 2023). In the context of private equity and in accordance with this framework, GPs should consider not only the financial returns for LPs, but also the long-term environmental and social impacts of their investments. By integrating ESG factors, PE firms can thus address the needs of various stakeholders, potentially enhancing value creation across the entire investment ecosystem, from portfolio companies to local communities (Mahajan et al., 2023). Therefore, the principles of stakeholder theory can provide a relevant foundation for understanding ESG integration in private equity.

In this thesis, the framework, together with existing research within the field, provides a basis of reference for hypothesis development and the subsequent analysis, with each research question being connected to principles of stakeholder theory. First, the incentives for integrating ESG into investment decisions will be explored through four potential drivers: ESG as a means to drive value, as a risk mitigator, as a tool to achieve dual objectives, and as a measure to enhance employee motivation. These drivers capture both the financial and ethical dimensions of stakeholder interests. Additionally, given the scarcity of research on which market participants drive the demand for ESG integration, this study will leverage stakeholder theory to explore and analyze these dynamics. While this does not constitute a standalone research question, it is integral to understanding the underlying drivers of ESG integration. Second, the impact of ESG on fundraising outcomes will be examined, assessing how alignment with stakeholder priorities affects capital allocation and investor relationships. Lastly, addressing practical challenges can offer insights into the barriers that firms face when integrating ESG factors, and to what extent these translate into measurable outcomes for investors, portfolio companies, and broader stakeholder groups. Prior research related to each of the three research questions is presented and discussed below.

3.3 The Underlying Drivers Behind ESG Integration

The following sections cover four potential underlying drivers of ESG integration: including ESG as a means to drive value, mitigate risk, achieve dual objectives, and motivate employees. Each section reviews related earlier research from both private and public markets, highlighting unresolved areas that this thesis seeks to address, with the identification of the drivers of ESG integration constituting one of our research questions.

3.3.1 ESG as a Means to Drive Value

ESG as a means to drive value has been studied by several scholars, with Crifo et al. (2015) showing that non-financial ESG practices have been proven to impact private equity investors' firm valuation and investment decisions. The study finds an asymmetric effect of non-financial performance disclosure, with investors responding more strongly to negative ESG news than to positive news. When accounting for investor differences, the results reveal that disclosing socially irresponsible practices reduces firm value by 11, 10, and 15 percent for environmental, social, and governance factors, respectively. This suggests that GPs have more to lose from poor ESG practices than they stand to gain from good ones. Notably, governance has a particularly strong effect on firm valuation when mismanaged, whereas positive governance is typically expected and does not significantly boost value. The authors conclude that poor ESG practices can limit access to equity financing and increase its cost, positioning ESG disclosure as a defensive strategy to protect firm value (ibid).

Bellon (2020) highlights that the PE business model enables PE firms to effectively enhance the environmental performance of their portfolio companies, particularly those that face high environmental and legal liability risks, attributing this capability to several factors that can be tied to operational engineering. This refers to the application of industry and operating expertise to develop and implement value-creation plans, often encompassing strategic changes, productivity improvements, and cost-cutting measures (Kaplan & Strömberg, 2009). Specifically, Bellon (2020) highlights that PE-backed firms encounter fewer financial constraints than public firms, benefit from more extensive legal expertise, and are guided by GPs with considerable industry experience. Consequently, PE-backed firms have more substantial incentives than other companies to reduce pollution when confronted with high environmental liability risks (ibid). Moreover, Duevski et al. (2023) observe that PE firms are more likely to be held accountable for substandard ESG practices within their portfolio companies compared to public equity owners, given the greater influence they can exert over these entities. This, in turn, should provide a rationale for ESG-concerned investors to allocate more capital to firms with above-average ESG practices (ibid).

Research from the public market shows that although capital allocation towards ESG-friendly investments can lead to positive effects on the overall society, exclusion of certain investments or tilting away from the market portfolio can lead to costs. For example, a study by Hong and Kacperczyk (2009) found that sin stocks have a higher expected return than otherwise comparable stocks, meaning that an exclusion or decrease of these holdings will inevitably lead to lower expected returns. Similarly, modern portfolio theory argues that restricting the investment universe will lead to a less favorable mean-variance frontier and a tangency portfolio with a lower Sharpe ratio, exhibiting lower expected returns for the same standard deviation (Pedersen et al., 2021). Baker et al. (2018) come to similar conclusions when examining green bonds, showing that these

are issued at a premium compared to non-green bonds with similar financial characteristics.

Pástor, Stambaugh, and Taylor (2021) present a more nuanced view, although they still agree with research suggesting that green investments lead to lower returns. Their model examines sustainable investing in equilibrium and finds that investors are willing to pay more for green holdings, both due to preference and green holdings' ability to hedge climate risk. This behavior leads to green assets having a negative CAPM alpha, whereas brown assets have a positive CAPM alpha. Increasing the share of green holdings in relation to brown will thus lead to the investor earning a lower expected return. However, investors with a stronger than average preference for ESG investments do not suffer from lower expected returns as they derive utility from their holdings (ibid).

Contrary to the above-mentioned research, multiple studies on the public market observe a positive relationship between ESG and financial performance. Gompers et al. (2003) find that firms with strong shareholder rights, among other things, have higher firm value, profits, and sales growth, indicating that a good governance score is positively correlated with high performance. Similar results are observed in stocks with above-average employee satisfaction scores (Edmans, 2011).

Pedersen et al. (2021) add to the research on the effects of ESG on financial performance and bridge the gap between these conflicting results by examining how investors' ESG preferences and information sets affected equilibrium asset prices and returns. The authors conclude that ESG can act as a predictor of positive returns when the value of ESG is not fully priced in the market. Furthermore, as investors attribute value to ESG, the predictor relationship will be weakened and eventually reversed if investors accept lower returns for more responsible investments. Pedersen et al.'s model therefore suggests that the strong performance of sin stocks can be explained by low investor demand, with ESG affecting returns positively due to market ignorance (ibid).

To conclude, the relationship between ESG investments and financial returns is complex, with prior research showing inconsistent results. The conflicting research, as well as the large focus on public markets, raises the question to what extent both GPs and LPs view ESG as a business case. Moreover, there remains a gap in understanding whether GPs perceive ESG as a component of their operational engineering strategies.

3.3.2 ESG as a Means to Reduce Risk

The link between ESG and risk is made evident in research revealing that 48 percent of institutional investors rate investment riskiness as the primary or second most important reason for considering ESG (McCahery et al., 2022). The authors state that the link between ESG and investment risk is

more pronounced by LPs than GPs, where the former group seems to recognize that robust ESG practices can reduce the likelihood of a left-tail event and, consequently, a firm's downside risk. Moreover, when asked to evaluate the individual components of ESG, LPs particularly emphasize the governance factor as the most effective risk management tool, followed by E and S (ibid). This is further underpinned by studies showing that institutional investors increase the inflow of funds in firms committing to work in accordance with the UN PRI, unconditional on financial performance (Gibson et al., 2022).

This risk-based perspective on ESG finds additional support in the previously mentioned study by Bellon (2020), which suggests that the PE model enhances shareholder value by leveraging the governance structure of the target company as a channel for risk mitigation, although this is contingent on the level of legal liability that a firm is subject to. The author finds that PE ownership reduces pollution if a portfolio company faces high environmental or political risk, while the opposite occurs if the associated risks instead are low (ibid). Another study by Duevski et al. (2023) underscores that LPs are risk averse, demonstrating that E&S incidents in portfolio companies lower the size and probability of raising follow-up funds. Notably, the results show no similar effect when examining governance-related incidents, somewhat contradicting McCahery et al.'s (2022) and Bellon's (2020) research, which suggests that LPs emphasize the governance component of ESG in the context of minimizing risk.

Multiple prior studies on the public market show that financial and non-financial information, such as ESG information, helps reduce a firm's cost of capital. For instance, Botosan (1997), Lambert et al. (2007), and Dhaliwal et al. (2014) demonstrate that comprehensive disclosures can reduce capital costs by enhancing transparency, while El Ghoul et al. (2011) and Ng and Rezaee (2015) link socially responsible practices directly to lower equity costs. Their findings suggest that firms with higher CSR scores generally secure cheaper financing, especially by excluding or mitigating risks associated with socially detrimental sectors (El Ghoul et al., 2011). Similarly, economic sustainability elements, such as growth-oriented innovations and research, reduce equity costs by improving firm value and reducing volatility (Ng & Rezaee, 2015). Non-financial sustainability factors like governance and environmental considerations further reduce risk by decreasing firm-specific uncertainties, i.e., idiosyncratic risk, highlighting that robust ESG structures align with financial stability and lower capital costs (He et al., 2022). These results emphasize the role of ESG as both a financial stabilizer and a risk signal, with the reduced cost of capital serving as an indicator of lower risk exposure.

In conclusion, existing research highlights that particularly institutional investors view ESG as a critical tool for mitigating downside risk and reducing the likelihood of left-tail events. Similarly, GPs benefit from leveraging governance structures to navigate industry-specific risks, enhancing value creation in portfolio companies. While one hypothesis is that risk mitigation

could serve as an incentive to integrate ESG into private equity investment decisions, it also raises the question of whether ESG considerations are driven solely by risk reduction motives and whether this view differs between GPs and LPs.

3.3.3 ESG as a Means to Achieve Dual Objectives

Another potential driver behind integrating ESG into private equity investment decisions is to achieve dual objectives, i.e., financial returns alongside broader environmental and/or social impact. Barber et al. (2021) investigate whether investors are willing to knowingly accept lower financial returns in exchange for non-pecuniary benefits. The study focuses on impact investing, defined as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return" (GIIN, 2023). The results, expressed in terms of willingness-to-pay (WTP), show that investors are willing to accept a 2.5 to 2.7 percentage point lower IRR ex-ante for impact funds. However, WTP is not equal in magnitude across investor types, with five noteworthy groups of investors exhibiting a positive WTP for impact: development organizations; foundations; financial institutions; public pension funds; and investors from certain regions, one of these being Europe (Barber et al., 2021).

Consistent with the idea that ESG-concerned investors value attributes other than financial performance, Benson and Humphrey (2008), Renneboog et al. (2011), and Bialkowski and Starks (2016) show that SRI funds are less sensitive to performance than conventional funds, demonstrating more persistent fund flows. Additionally, Hartzmark and Sussman (2019) support the theory that investors value sustainability by showing evidence of substantial capital reallocation from firms with lower ESG scores to those with higher ESG scores following the introduction of Morningstar's sustainability ratings in 2016. From a GP perspective, integrating ESG can thus reflect a strategic response to the growing interest in dual bottom-line investments among investors. This aligns with the idea that while GPs acknowledge the correlation between ESG practices and financial performance, their primary motivation for integrating ESG factors is to meet client demands (ibid).

To conclude, research indicates that many investors value non-pecuniary benefits alongside financial returns. As a result, a key driver for LPs integrating ESG into investment decisions can be the pursuit of dual objectives. In response, GPs may incorporate ESG factors to align with LP preferences, potentially strengthening long-term revenue stability. Seeing that this motive is more pronounced for some investor types than others, it becomes relevant to further investigate how different types of LPs weigh financial returns against non-pecuniary benefits when evaluating ESG-focused funds. In addition, there is scarce research on whether GPs perceive that there is a trade-off between financial returns and dual objectives - an area that will be further explored.

3.3.4 ESG as a Means to Increase Employee Engagement

Besides certain investors seeking dual objectives, this can also for employees of PE firms and portfolio companies. Although focused on the public market, a study by Edmans (2011) finds that employee satisfaction positively correlates with shareholder returns. More specifically, a value-weighted portfolio of the "100 Best Companies to Work for in America" outperformed industry benchmarks from 1984 to 2009, generating an annual alpha of 3.5 percent compared to 2.1 percent for peers. Additionally, there is evidence that positive social impact boosts job satisfaction, and field experiments reveal that employees react with enthusiasm when companies give back to society (de Neve et al., 2018).

Existing research leads to the hypothesis that PE firms with a strong sustainability agenda can foster a culture where both employees within the firm and those in portfolio companies feel that their work contributes to meaningful outcomes, thereby increasing satisfaction and motivation. This may also enhance PE firms' financial performance, seeing that public companies with satisfied employees have historically outperformed their peers. It is therefore relevant to explore whether GPs and LPs recognize that their ESG practices can generate positive spillover effects, such as attracting and retaining competent, motivated employees, and whether this serves as an incentive for integrating ESG into investment strategies.

3.4 ESG and Fundraising Effects

This section covers previous literature on our second research question, which aims to examine the relationship between ESG integration and fundraising within PE. More specifically, it focuses on how ESG positioning and disclosure practices influence capital raising efforts.

Considering the gradual implementation of EU regulations, most private equity firms are not yet subject to the same disclosure requirements as public entities. On the one hand, PE firms may avoid ESG disclosures as they are not yet legally mandated to provide them, or they may perceive ESG reporting as too costly due to the absence of standardized reporting frameworks and data (Abraham et al., 2024). On the other hand, many PE firms depend on capital flows from investors who increasingly demand ESG reporting or may feel regulatory and stakeholder pressure to disclose how they address ESG issues to ensure sustainable long-term growth. Connecting this to academic research on voluntary disclosure theory, PE firms with strong ESG performance are likely to provide more extensive ESG disclosures to distinguish themselves from average or lower-performing firms (e.g., Dye, 1985; Verrecchia, 1983). In contrast, socio-political theories predict that firms with poor ESG performance may increase their disclosures in response to societal and political pressures, aiming to manage and improve their public perception (e.g., Patten, 2002).

Abraham et al. (2024) examine ESG disclosures within PE and present three key findings: 1) ESG disclosures are on the rise, with social issues now receiving as much focus as environmental issues; 2) Demand for ESG information from fund investors is a significant determinant of PE firms' ESG disclosures; and 3) A higher level of disclosure is linked to better ESG outcomes at the portfolio level. This heightened disclosure also positively impacts GPs' capital raising efforts, with a doubling of ESG disclosures leading to a 15 percent faster fundraising process and a significantly higher likelihood of attracting a UN PRI-committed LP to invest in a fund. This indicates that ESG disclosure not only responds to growing investor demand for sustainable investment opportunities but also aids fundraising (ibid). In addition, Crifo et al. (2015) find that disclosing socially irresponsible practices reduces firm value, as mentioned in section 3.3.1, concluding that poor ESG practices can limit access to capital.

Duncombe et al. (2023) investigate the impact of ESG positioning by private equity infrastructure funds on fundraising success and find that ESG positioning in marketing materials does not significantly affect fundraising outcomes, such as achieving target size or time to final close. There is some evidence, however, that ESG positioning appeared to positively impact fundraising success in earlier years, while this effect has diminished since 2017. Two potential explanations arise. First, investors may have become more sophisticated, conducting their own due diligence on GPs' ESG credentials and relying less on marketing claims. Second, the increased prevalence of ESG positioning may have diluted its significance, making it less of a differentiating factor (ibid). The findings support the cheap-talk hypothesis, which suggests that voluntary disclosures lacking credibility, such as marketing documents that are not legally binding and can contain claims that are difficult to verify, may not influence investor decisions (e.g., Bingler et al., 2022; Kim & Yoon, 2022). The study also underscores that the rising prevalence of ESG positioning has likely reduced its informational value, as investors now prioritize tangible, verifiable ESG metrics over generalized statements in placement memoranda (Duncombe et al., 2023).

A recent study takes a more practical stance and investigates how E&S-related incidents in portfolio companies affect GPs' ability to raise subsequent funds (Duevski et al., 2023). The results show that a one standard deviation in the average number of E&S incidents lowers the relative size of follow-up funds by approximately 2.2 percent, and funds with an above-median number of such incidents realize circa 8.9 to 12.6 percent smaller subsequent funding. The authors also find that GPs who experience E&S incidents in their portfolio companies are less likely to raise additional capital in general. Five years after inception, the probability of initiating a second round of financing is 42.5 percent for funds with no reported incidents, compared to only 31.3 percent for funds in which incidents have occurred (ibid).

To conclude, academic literature shows mixed findings regarding the relationship between ESG disclosure and fundraising. Some studies find a positive correlation between such reporting and fundraising success, while other research suggests that the positive impact of ESG positioning has diminished. Additionally, research shows that E&S incidents in portfolio companies negatively affect fundraising. It thus becomes material to examine if strong ESG positioning is viewed as a competitive advantage among GPs and LPs, and whether this impacts fundraising success.

3.5 Challenges to ESG Integration

While the above sections point to the fact that ESG integration can prove beneficial in many ways, its practical implementation in investment decisions also presents several challenges, constituting one of our research questions. Although emerging EU regulations aim to address some of these challenges, there has historically been a lack of standardization in ESG reporting rules and metrics (Yu et al., 2020). Moreover, sustainability data is not audited to the same extent as financial reports, and no global governing body oversees the accuracy of disclosed ESG information (ibid). The absence of a granular definition of what constitutes a sustainable investment also leaves room for open interpretation and could potentially result in differing approaches among investors (Sustainalytics, 2023). In turn, this vagueness may cause a discrepancy between a firm's ESG claims and its actual practices, i.e., greenwashing, which can hinder effective integration of ESG in investment decisions, making it a critical area to include in this study (Yu et al., 2020). Research shows that firms subject to greater scrutiny from independent directors, public market forces, and institutional investors are less likely to engage in greenwashing (ibid). However, in PE, where private ownership is combined with a large presence of professional investors, especially institutional ones, the prevalence of greenwashing is less easily discerned. This ambiguity raises questions about the extent to which GPs and LPs perceive that greenwashing exists within the PE industry and whether it is considered a significant obstacle to ESG integration. Additionally, insights can be gained by exploring GPs' and LPs' views on whether EU sustainability regulations are expected to reshape the landscape for ESG accountability and whether these regulations may facilitate or pose additional challenges.

4 Methodology

4.1 Research Design

This thesis aims to explore the underlying drivers behind ESG integration in private equity, building on insights from previous research that identify the potential for ESG to serve as a business case, a risk mitigator, a means to achieve dual objectives, and an employee engagement tool. It also seeks to examine whether ESG integration impacts fundraising within the PE industry, drawing upon the effects of ESG disclosure and EU SFDR classifications. Furthermore, the thesis analyzes the potential challenges of ESG integration and its practical consequences, delving into the perspectives of industry practitioners. This study employs a qualitative approach, drawing on data collected through interviews with GPs, LPs, and independent industry professionals. A qualitative data collection method allows for a nuanced exploration of complex, subjective factors, which is well-suited when examining questions of a more intangible nature, such as the research questions of this paper (Bailey et al. 2010). In contrast, a quantitative analysis, relying on structured data and metrics, is less appropriate in this context due to the private equity sector's exemption from public disclosure requirements and the historical lack of standardized ESG reporting frameworks, which limit the availability of consistent quantitative data (Kaplan and Sensoy, 2015). Furthermore, a practical approach is suitable given that the majority of earlier research has adopted a quantitative perspective. As such, the choice of research design also contributes to filling the existing research gap.

4.2 Data Collection

The primary data sources for this thesis are interviews and publicly available information. To capture diverse perspectives, interviews were conducted with both GPs and LPs, complemented by discussions with independent industry professionals with extensive prior experience and knowledge within the fields of PE and ESG. The choice of interviewees was based on intentional selection rather than random sampling to ensure that participants had the necessary expertise to effectively address the research questions (Yin, 2014).

The interviews were of a semi-structured nature. An interview guide and key questions prepared in advance ensured that the same lines of inquiry were pursued with each participant. The structure allowed for follow-up questions on specific topics to be posed during the discussions, thereby enhancing the potential for collecting rich and detailed data (Saunders et al., 2012). This method also allows the interviewer to take a more active role in steering the conversation while maintaining a focus on key research topics - something that is less feasible in unstructured

interviews (Leavy, 2014).

The interview protocol was organized into thematic sections, each starting with broad, general questions to capture a holistic perspective. As the discussion progressed, each theme narrowed down into more specific inquiries, focusing on aspects relevant to existing literature and helping to identify knowledge gaps. To ensure that the interviews were efficiently conducted and aligned with the specific research questions, an overview of the topics was sent to each participant a few days in advance. A pilot study was also conducted, after which the questions were slightly revised. This framework enabled guided interviews, ensuring a structured flow while remaining flexible enough to capture spontaneous insights shared by the interviewees. Additionally, all interviews were recorded and transcribed to ensure accurate citation and documentation.

Since the thesis takes a two-fold approach, examining ESG integration from a GP and LP perspective, the interviews targeted both groups. The GPs were selected primarily based on their geographical presence and size, with a focus on mid-market Nordic leveraged buyout funds rather than exclusively on their sustainability commitment or industry focus. This approach was designed to provide a comprehensive perspective and capture a broader range of insights rather than limiting the study to GPs with the same level of ESG ambition or a narrow industry scope. Consequently, the participants included GPs managing both Article 8 and Article 9 funds, as well as a mix of generalist and sector-specific GPs. The participating LPs mainly consisted of Nordic pension funds as well as fund-of-funds, with private equity constituting one of their investment strategies. These were neither selected based on their outspoken sustainability focus nor limited to a specific SFDR classification. Notably, all LPs were considerably large players within the industry, regarded as influential and important investors from the perspective of GPs. Additionally, all participants managed market-rate funds, meaning that the results are obtained from investors managing funds subject to mainstream financial constraints. In order to mitigate potential bias and ensure a balanced view of the research questions, the interview set was complemented with independent participants, all of whom had extensive experience in and knowledge of private equity and ESG. In total, 19 interviews were conducted digitally or in person between the 19th of September and the 30th of October 2024, ranging between 30 and 60 minutes. An overview of the interviewees is found in Table 1.

Complementary public data, in addition to the interviews, has been used. This data helped to question statements and prompt follow-up inquiries during the interview sessions. The public data encompasses secondary sources gathered from industry reports, as well as PE-firm fund prospectuses and sustainability reports.

Table 1
Overview of Interviews

Classification	Company Type	Role	Date	Duration
Pilot study	n.a.	Independent Researcher	19/09/2024	60 min
GP	Nordic PE Firm, Article 9	Investment Associate	24/09/2024	60 min
GP	Nordic PE Firm, Article 8	Senior Investment Manager	2/10/2024	50 min
GP	Nordic PE Firm, Article 8	Partner	3/10/2024	55 min
GP	Nordic PE Firm, Article 9	Partner & Head of ESG (Group interview)	10/10/2024	45 min
GP	Nordic PE Firm, Article 8 & 9	Investment Professional	15/10/2024	60 min
GP	Nordic PE Firm, Article 8	Head of Sustainability	21/10/2024	50 min
GP	Nordic PE Firm, Article 8 & 9	Head of Sustainability	28/10/2024	45 min
LP	Swedish Institutional Investor	Head of ESG	26/09/2024	55 min
LP	Swedish Pension Fund	Head of ESG	27/09/2024	60 min
LP	Swedish Fund-of-Funds	Head of PE	30/09/2024	60 min
LP	Nordic Fund-of-Funds	Head of Sustainability	2/10/2024	60 min
LP	Swedish Pension Fund	ESG analyst	16/10/2024	60 min
LP	Swedish Pension Fund	Head of ESG	21/10/2024	50 min
LP	Swedish Pension Fund	Head of ESG	30/10/2024	60 min
Independent	n.a.	Independent ESG Advisor	4/10/2024	60 min
Independent	n.a.	Independent ESG Advisor	8/10/2024	30 min
Independent	n.a.	Independent ESG Advisor	24/10/2024	60 min
Independent	n.a.	Independent ESG Advisor	28/10/2024	40 min

4.3 Research Quality

Semi-structured interviews present several data quality challenges, such as reliability, bias, validity, and generalizability (Saunders et al., 2012). Reliability refers to whether independent scholars could replicate the research and conclude similar results. Reliability can be compromised by various biases, including interviewer, interviewee, and response bias (ibid). Since an interview is not a neutral social interaction, the respondent's perception of the interviewer can influence its answers (Abercrombie et al., 1994). Additionally, findings are interpretive, meaning they may be affected by the interviewer's own assumptions and biases (Saunders et al., 2012). However, Marshall and Rossman (1999) argue that the goal of qualitative research is not strict replicability, as the conditions being studied are complex and constantly evolving. Expecting the research to be replicable is hence unrealistic and would diminish the benefits of this type of research. Nevertheless, to enhance reliability, all interviews were carried out with both authors present, recorded, and thereafter transcribed individually. Furthermore, all prior research used in the study is referenced, increasing transparency and the potential for replication, even if exact duplication of results is unlikely.

Validity relates to how effectively a researcher can access and understand interviewees' knowledge and experiences, as well as accurately interpret their intended meaning. Qualitative studies are often able to achieve a high level of validity due to the flexible and responsive nature of interviews (Saunders et al., 2012). In order to further strengthen the validity of the study and thus ensure that the data is properly interpreted, Maxwell (2004) suggests triangulation - collecting data from diverse individuals, settings, or methods to reduce the risk of systematic biases. The interviews targeted GPs, LPs, and independent industry professionals to gather holistic and diverse perspectives in order to reduce the likelihood of biases or one-sided conclusions. Moreover, the GP group was in itself diverse, consisting of pure investment professionals as well as ESG specialists, managing both Article 8 and 9 funds. Additionally, publicly available data such as sustainability reports and fund prospectuses was used to complement and cross-check the statements made in the interviews.

Compared to quantitative approaches, the qualitative research design does not allow for the same generalizations of the findings due to the small sample size, limiting any general conclusions beyond the objects studied (Saunders et al., 2012). However, some transferability of the findings is possible, as they reflect current views, drivers, and challenges of ESG integration among market participants (Yin, 2015). While the insights may not apply universally, they offer valuable indications of broader trends and considerations related to ESG integration within private equity investing.

Research ethics refers to the principles and standards that guide a researcher's conduct in relation to those impacted by the research (ALLEA, 2023). In line with these principles, the study was voluntary, meaning that the respondents independently chose to participate. Moreover, as previously mentioned, all respondents were briefed on the nature and objectives of the study before agreeing to participate. They also received an overview of the interview themes well in advance of the meeting to ensure transparency (Leavy, 2014). Additionally, the confidentiality of all interviewees was upheld, ensuring that their identities and responses remained anonymous throughout the thesis. By ensuring anonymity, participants are encouraged to provide more honest answers as they are more likely to be transparent without fear of identification (Sekaran & Bougie, 2010).

5 Results

Throughout this section, the empirical results of the interviews are presented. The results are organized into subsections directly aligning with the research questions this paper seeks to address:

1. What are the primary drivers of integrating ESG into private equity investment decisions?

2. What effect does ESG integration have on private equity fundraising outcomes?

3. What are the main challenges with ESG integration and their practical consequences?

Each section covers both GP and LP views, complemented by perspectives obtained from the independent participants. At the end of each subsection, key takeaways are summarized to highlight the most significant insights and briefly connected to the developed hypotheses, theoretical framework, and earlier studies. This forms the foundation for the subsequent discussion, enabling a cohesive analysis that ties back to the overarching research questions and informs the broader implications of the findings.

5.1 The Underlying Drivers Behind ESG Integration

5.1.1 ESG as an Attractive Business Case

The results show that all interviewed GPs regard sustainability as a core driver of financial value and a key aspect of their investment strategies. In general, a large majority of GPs also expressed that ESG merely being a charitable or ethical concern is an outdated view.

> "A few years ago, the way people talked about sustainability was perhaps skewed towards one side of the spectrum, where it was seen as something done alongside the investments, almost leaning towards charity [...] We don't view sustainable investments in that way but instead believe that investments aligned with the SDGs equals good investments." - Investment Associate, Nordic PE Firm, Article 9

Several GPs state that robust ESG work can yield financial benefits, including higher exit multiples, although they mentioned the difficulty in quantitatively attributing monetary value directly to ESG factors. Nevertheless, they argue that ESG positioning future-proofs portfolio companies, thus broadening the potential buyer pool and making them more attractive to acquirers.

Furthermore, GPs mentioned that a strong ESG profile can be seen as enhancing organic growth potential and improving competitive positioning by tapping into new customer segments and finding additional revenue streams. For instance, one GP conducted an internal study demonstrating that companies creating some type of environmental benefit had a competitive advantage and grew faster than their peers.

> "I really can't provide a quantitative answer to that [how ESG affects exit multiples], but I believe it is largely due to future-proofing. If a company is already future-proof, it saves a lot of time for everyone involved, so I believe the pool of potential buyers becomes much larger. You may also be able to grow faster organically if you have a sustainable offering, but it's more difficult to assign a concrete value to that, as it starts to mix sustainability with financial profile." - Senior Investment Manager, Nordic PE Firm, Article 8

> "We want to invest in companies we believe will be worth more in the future. ESG is important today and will most likely be even more attractive from an investment point of view in five years due to sustainability being even more important." - Investment Associate, Nordic PE Firm, Article 9

In addition, GPs mentioned that ESG constitutes a value-creation tool within operational engineering, for example, through cost savings.

> "The value creation aspect [of ESG integration] is focused on operational engineering, such as improving the product offering and analyzing the target group." - Investment Associate, Nordic PE Firm, Article 9

> "Often cost and sustainability go hand in hand if it is operations related. Sometimes you can use sustainability as a lens to find extra cost savings." - Head of Sustainability, Nordic PE Firm, Article 8

The independent interviewees agreed that sustainability can enhance a company's financial value. For example, one participant pointed out that investing in companies deemed socially essential can result in greater financial resilience, as these companies tend to be less vulnerable to economic cycles. However, they also highlighted the challenge of quantifying this impact, noting that it remains unclear how ESG factors are currently reflected in exit prices, underscoring the complexity of assigning a monetary value to sustainability.

> “When undertaking ESG initiatives, they [our PE clients] aim to ensure that what they invest in is scalable and that there is a net gain in the long-term [...] However, they haven’t clearly identified which factors can be leveraged, there might be different ones at play. Some buyers do factor this in, which can result in better transaction prices, but a lot of it operates on speculation.” - Independent ESG Advisor

Three out of seven GPs acknowledged that while ESG can drive value, it must also be weighed against financial considerations and operational feasibility. This, as some investments otherwise may risk costing more than they will yield. Building on this, one GP noted that certain ESG improvements are viewed as integral to profitability, not primarily as a means to enhance the company’s attractiveness through a stronger ESG profile, but rather because they are considered financially material.

> "If I am really blunt, I think that anything constituting a big enough financial risk or opportunity, companies will do, no matter if it is classified as sustainable or not." - Head of Sustainability, Nordic PE Firm, Article 8

The majority of interviewed LPs also point out that ESG presents a business case, but place greater weight on ESG as a risk management tool. Moreover, they stated that ESG considerations have become indispensable in the PE landscape, reflecting an evolving mindset where the primary motive is not only to mitigate risk but also to drive value and enhance exit potential.

> “For a company to survive, sustainability must be a component on the agenda. This is the new normal. ESG was somewhat of an edge 5-7 years ago, but now it has progressed to the point where it’s more mainstream.” - Head of PE, Swedish Fund-of-Funds

In summary, the results confirm that both LPs and GPs view ESG integration as a strategic business case, with GPs leveraging ESG as part of their operational engineering. Furthermore, the results align with the positive relationship between ESG and financial performance found by, among others, Crifo et al. (2015) and Gompers et al. (2003). Notably, ESG as a core driver of financial value was more evident among GPs, while LPs mainly emphasized the necessity of recognizing and mitigating ESG-related risks. The risk perspective will be further developed in the following section.

5.1.2 ESG as a Risk Mitigation Tool

Although there was consensus among GPs that the primary incentive to integrate ESG is the business case perspective, several also recognized that it can serve as an effective risk mitigation channel. They point out that sustainability is a way to maintain stability and reduce potential downside risks across portfolio companies, which should ultimately lead to higher financial returns. Some GPs also underscored the importance of ESG for managing specific business risks, particularly in highly regulated sectors.

> "If we can lower the risk level of a company [by making it more sustainable], this should also reduce the risk premium in the investment, hopefully leading to a good financial outcome. [...] However, our ESG analysis has shifted from focusing on the risk aspect to leaning more towards the opportunity side." - Partner, Nordic PE Firm, Article 8

Independent participants agreed that GPs take a two-fold approach to ESG integration, viewing it from both a commercial and risk perspective. One interviewee noted that GPs can readily address risks at the organizational level, while the real value lies in enhancing the business offering.

> “There exists two components: the business model, which consists of the offering and services, and the organization. Within the organization, one can quickly reach a baseline standard for ESG with policies, by providing data to stakeholders, etc. But within the business model, there are several ways where it [ESG] can act as a value driver.” - Independent ESG Advisor

ESG as a risk mitigation tool was more pronounced by LPs, with a majority stating this as the primary motive for ESG integration. Furthermore, LPs expressed that while environmental risks are often relatively more straightforward to quantify in financial terms, other areas like human rights or cybersecurity can be more difficult to both identify and translate into monetary terms. Yet, they require careful scrutiny due to potential reputational fallout, underscoring the need for managing these risks effectively.

> “If one fails to recognize and integrate ESG-related risks into their strategy, I would argue they run a significant risk of deteriorating returns.” - ESG Analyst, Swedish Pension Fund

When asked how they practically reduce risks through ESG integration, the general approach is to assess the policies, processes, and investment strategies of GPs, i.e., their governance model, rather than tangible social or environmental KPIs.

> "We conduct our own analysis to assess how the company operates, looking at the systematic approach it takes, the policies and commitments in place, the goals it has set, and the plans to achieve those goals. We evaluate how realistic those goals seem to be, as well as the governance structure [...]. It needs to be systematic and represent genuine effort." - ESG Analyst, Swedish Pension Fund

There was general consensus among the interviewed LPs that ESG integration by GPs has become a baseline expectation, essential for the survival of any PE firm in today's market. Therefore, lacking established ESG practices not only poses a risk in itself, deterring LPs from investing in the firm, but also undermines ESG's role as a critical risk mitigator.

To summarize, both GPs and LPs consider ESG a vital tool for managing and reducing exposure to various financial and operational risks, supporting the hypothesis of ESG as a risk mitigator. Neither GPs nor LPs view risk as the sole incentive to integrate ESG, although the results reveal nuances in their motivations. LPs find risk mitigation to be the most important factor for integrating ESG, while GPs view this as a secondary driver. This distinction aligns with prior research by McCahery et al. (2022) and Duevski et al. (2023), both suggesting that LPs exhibit greater risk aversion compared to GPs.

5.1.3 The Potential Trade-Off Between ESG and Financial Returns

Half of the interviewed GPs stated that they do not see a trade-off between financial returns and broader sustainability goals, believing that dual objectives can be achieved. This group of GPs could all provide examples of having passed up on financially attractive opportunities due to ESG misalignment, viewing poor ESG practices as harmful to financial returns, and reinforcing the idea that there is no trade-off between the two. On the contrary, they believe that strong ESG practices and financial returns go hand in hand, with one GP noting that its ESG strategy has increased the likelihood of being the preferred partner in auctions, occasionally allowing it to acquire companies at a slight discount. Additionally, positioning its portfolio companies as sustainability role models has created exit benefits, justifying higher multiples.

> "We considered a company that developed a process to convert CO2 from burning oil into hydrogen and graphene. It had a lot of positives, but due to high demand in the oil

and gas industry, the product was only used there. It was a great business model, but not a sustainable target customer, why we passed up on the investment." - Investment Professional, Nordic PE Firm, Article 8 & 9

In contrast, the other half believed that a trade-off partially exists, depending on the time horizon, customers' willingness-to-pay, and the general economic environment. As one GP noted, the recent outperformance of fossil fuel companies, driven by the energy crisis, demonstrated that brown investments can generate higher returns than green. This, due to the cost of externalities not being effectively priced in, leading to market distortion.

"For example, installing solar panels can make sense if it is in the early days of an investment as they have a pay-off of maybe three years. However, if you figure this out in year six and plan to sell in six months, this would be a bad idea. The next buyer is not necessarily going to count that in - you pay for the cost but do not get the payback." - Head of Sustainability, Nordic PE Firm, Article 8

"There is always a risk that customers may not be willing to pay enough to cover the investments made in product development and the climate benefits provided, making it evident that a trade-off sometimes exists. It can cost more than it is worth." - Partner, Nordic PE Firm, Article 8

A majority of LPs stated that the dual objectives of financial performance and ESG impact are often central to their investment mandates, particularly for institutions with long-term fiduciary duties, such as pension funds. Three out of five institutional investors mentioned that they view sustainability as a means to enhance overall investment quality rather than as a separate or competing objective.

"We are very clear that our mission and overarching goal is to generate returns and create value for pensions. We haven't set sustainability goals as something to be achieved in parallel, instead, sustainability is a means to reach our return targets. It helps us identify certain risks that could potentially undermine an investment and provides a perspective for recognizing opportunities." - Head of ESG, Swedish Institutional Investor

The other group of institutional LPs stressed the notion of fiduciary responsibility, stating that they do not have the right to sacrifice returns, regardless of the sustainability benefits obtained. Furthermore, one institutional investor noted that generating financial returns is in itself a key

component of sustainability - pension funds must still be available when savers retire. In contrast, another institutional investor asserted that it has occasionally foregone its fiduciary duty. This by rejecting a financially attractive investment due to too many uncertainties regarding the company's transition plan, stating that it risked being locked into a situation where sustainability goals could not be met.

Like GPs, most LPs also believe that companies prioritizing ESG are likely to achieve greater long-term resilience and returns, reflecting a conviction that sustainable companies can outpace peers over time.

> "If you had asked me 5-7 years ago, I would have said yes [there is a trade-off]. I was critical of how many people used the impact card to attract investors, and it was hard to prove that impact wouldn't negatively affect returns - I now realize I was probably wrong. If you do everything right and run a company with a strong ESG agenda, you can actually increase returns because the next buyer is willing to pay a bit more." - Head of PE, Swedish Fund-of-Funds

Similar to the GPs who note that a trade-off can partially exist, LPs also emphasize that the achievement of dual objectives hinges on several factors.

> "If regulations and consumer behavior don't keep pace, it simply won't be profitable for companies [to transition], that is a critical condition. Of course, there can be disruptors that prioritize sustainability from the start and see massive uptake, Tesla is one such example, it transformed an entire industry. But other companies, like Volvo Cars, had to adjust its short-term EV targets because market demand hadn't caught up and regulations were delayed." - Head of ESG, Swedish Institutional Investor

In summary, both GPs and LPs increasingly believe that dual objectives can be achieved through ESG integration and confirm the hypothesis that non-pecuniary benefits are valued alongside financial returns (e.g., Benson & Humphrey, 2008; Hartzmark & Sussman, 2019). Nevertheless, the pursuit of dual objectives was not viewed as a primary driver of ESG integration but rather as a fundamental prerequisite for considering ESG factors in investment decisions. This was made evident as LPs stressed their fiduciary duty, thus contrasting prior research by Barber et al. (2021), stating that institutional investors are willing to pay for impact. Moreover, interviewees of both groups acknowledged that trade-offs may arise, for example, due to shifts in consumer demand and overall market conditions.

5.1.4 ESG and Secondary Benefits

From a GP point of view, several participants noted that they had seen a positive correlation between their ESG work, recruitment, and employee motivation, both within the PE firm itself and at the portfolio company level.

> "We very quickly become an attractive place to work, and a lot of talented people have joined us. Beyond believing in the company overall, our sustainability strategy is unique [...] It has helped us in recruitment, everyone is very passionate about their job." - Investment Associate, Nordic PE Firm, Article 9

One of the independent participants further emphasized the secondary benefits that ESG can yield, zooming in on a portfolio company level. They noted that some companies may not fully recognize the positive social or environmental impacts of their products, presenting an attractive opportunity for GPs to illuminate these benefits.

> "Being able to show a portfolio company the positive societal impact of their products can ignite an inspiring passion within the organization. If PE firms could develop this potential, they could help portfolio companies attract more talent, reach new customers, grow faster, and establish a strategy that is more sustainable, both commercially and impact-wise." - Independent ESG Advisor

When raising the question with LPs, no participant identified any positive spillover effects, indicating that this may be a less emphasized or less evident benefit from their vantage point.

The results support the hypothesis that ESG integration can lead to positive spillover effects, with GPs recognizing its value as a recruitment and engagement asset. This finding aligns with prior research by Edmans (2011) and de Neve et al. (2018). However, these benefits were not viewed as core drivers but as secondary positive outcomes. Furthermore, the observation that LPs had not identified similar effects reinforces the idea that positive recruitment and engagement effects do not serve as primary incentives for ESG integration.

5.1.5 The Key Actors Driving ESG Integration

While prior research points to the fact that demand for sustainable funds is increasing, there is limited literature on which market players are primarily influencing this shift. To address this gap, we included the topic during the interviews, aiming to understand whether ESG integration by

PE firms is a response to outside pressure or internally motivated. This is key to understanding the drivers behind ESG integration and will contribute to the analysis of the forces shaping ESG practices within the private equity industry.

Five out of seven GPs stated that LPs have been the driving force behind their ESG integration. Although they quickly grasped the business case perspective, identifying financial motivations to fulfill LPs' demands, they argued that LPs are still driving the development through requirements and capital allocation choices. Furthermore, they emphasized that EU regulation has contributed to this development, as well as growing climate change awareness across society. In general, GPs acknowledged that they have welcomed the increased demand as it suits their ownership model and investment philosophy, striving to be responsible and reputable investors.

> "I don't believe it is us [GPs] that have driven this, unfortunately. Many LPs have chosen to allocate, rather than GPs driving, their capital into sustainable funds. Many of these LPs manage the capital for someone else, who in turn may have an interest in green investments. Regulation has also played a large role, with, for example, Article 9 funds and the EU Taxonomy." - Partner, Nordic PE Firm, Article 9

> "The more extreme weather events we experience in Europe, the more real it becomes. What that does is create pressure in the system, so everyday citizens expect their banks and pension funds to do something about it. That then gets passed on through the chain to us." - Head of Sustainability, Nordic PE Firm, Article 8

Certain types of LPs seem to be particularly influential in driving the ESG agenda. According to the interviewed GPs, these LPs are Nordic investors in general, and pension funds in particular. Other geographical markets are still lagging behind, partly leading GPs to drive the sustainability conviction in areas outside the Nordics.

> "The AP-funds are at the forefront when it comes to setting requirements [...] I absolutely think that the Nordic region is somewhat better [at driving ESG]." - Senior Investment Manager, Nordic PE Firm, Article 8

> "In London, one investor asked us why we try to mix investments and ESG and thought it would be better for us to join Greenpeace on the weekends and earn money during the work week, saying that these things don't go together." - Partner, Nordic PE Firm, Article 9

In contrast, two Article 9 GPs said that it is not the LPs, but rather themselves, that have driven the development, and that sustainability has been a learning journey for investors. Furthermore, they mentioned that while LPs have pushed the industry in general to up their game - leading to an increased supply of Article 8 funds - their own ambition to invest in the green transition is rooted internally, stating that they view this as the investment opportunity of a lifetime.

LPs unanimously believe they are at the forefront of driving ESG development. Some of the pension funds partly attribute this to their customers being closely linked to collective agreements and the Swedish labor model, which is why social issues had been a priority for these investors long before ESG became mainstream. However, all pension funds stressed that the decisive factor behind integrating ESG is regulation, with Swedish law shaping their mandate. A vast majority of LPs also acknowledged that this progress has occurred in tandem with GPs, who swiftly adapted their practices to satisfy investor needs.

> "The drive comes from the institutional investors, who in turn have received it from regulations. PE firms were very quick to grasp this, and since those are their primary investors, they understood the importance of meeting the requirements [...] If you want institutional money, you must have the ESG package." - Head of PE, Swedish Fund-of-Funds

One of the independent interviewees presented a more forward-looking perspective, emphasizing the central role of regulation as the primary driver for continued ESG integration.

> "We have tried for a long time to build a consumer-based ESG demand, but I think we need to let go of that. It hasn't happened in the Nordics, so it's very unlikely that it will happen anywhere else. The companies need to be pushed towards transition, it is insane that the oil and gas industry is subsidized and that regulatory requirements aren't more stringent [...] A lot of the responsibility [in driving ESG forward] lies with the politicians." - Independent ESG Advisor

To summarize, most GPs identified LPs as the primary force behind their ESG integration. Similarly, LPs uniformly position themselves as leaders in ESG development but also recognize that their mandate is shaped by national regulation. This dynamic can be understood through stakeholder theory, which highlights how external stakeholders, such as regulatory bodies, shape the decision-making process of firms by influencing the broader legal and market infrastructure within which they operate (Clarkson, 1995).

5.2 ESG and Fundraising Effects

When asking about ESG reporting and its potential effects on fundraising, GPs find a neutral or non-negative relationship. While all GPs report sustainability data on a consistent basis, a majority perceive that LPs view ESG disclosures mainly as a tick-the-box exercise and not a decisive factor in their investment decisions. This is further made evident as most GPs stated that they rarely get requirements they cannot meet, suggesting that they do not find investors' ESG disclosure demands challenging. They also asserted that LPs are more interested in assessing the fund-level strategy rather than specific portfolio company KPIs. Nevertheless, GPs highlighted that a lack of ESG disclosures would negatively affect fundraising - a view also supported by independent interviewees.

> "I'd call it a hygiene factor at this point. I work with both impact funds and firms struggling with ESG. Everyone feels pressure - either fearing they'll look bad or that they won't be able to raise funds if they don't act." - Independent ESG Advisor

Regarding regulatory disclosures, all GPs managing Article 9 funds believe this classification has given them a competitive advantage in fundraising. They argue that it not only distinguishes them from other PE funds but also assists LPs in meeting their own Article 9 mandates. Moreover, GPs managing multiple funds with differing SFDR classifications, including both Article 8 and 9, stated that while their investor base partly overlaps, they have also successfully attracted new LPs who are actively seeking Article 9 funds. This view was not shared among Article 8 GPs, who believed that there were no clear additional benefits to gain from being an Article 9 fund. However, they did acknowledge that investors' appetite for Article 6 is low, indicating that Article 8 has become a minimum requirement.

> "We have seen that our sustainability work has created value throughout our value chain, from fundraising to exit." - Head of ESG, Nordic PE Firm, Article 9

> "It doesn't really matter if you are Article 8 or 9, rather that it would be a problem if we had no sustainability at all - that would make you stand out and hurt you." - Head of Sustainability, Nordic PE Firm, Article 8

GPs' perception that ESG reporting is mainly viewed as a hygiene factor was confirmed by the vast majority of LPs. They mentioned that being unable to fulfill their requirements would constitute a deal-breaker, although this had seldom been the case. Moreover, they stated that additional follow-up inquiries have consistently been responded to, further supporting the results

that GPs do not find sustainability reporting very demanding. However, there was consensus that higher quality ESG reporting, ceteris paribus, weighs in favor of that fund in connection with fundraising.

> "ESG reporting is not crucial in investment decisions, except that we would never invest in something that is directly destructive [...] However, I believe it positively impacts GPs' fundraising. If you were to compare two similar funds and one has good ESG reporting, it would likely be chosen over the other." - Head of PE, Swedish Fund-of-Funds

In contrast to GPs managing Article 9 funds, who believed their SFDR classification provides an advantage in fundraising, no LP mentioned that they see a clear trend regarding capital allocation towards Article 9 funds. There was also agreement that being an Article 8 fund is sufficient to be included in the LPs' investment universes. For instance, one LP stated that while they expect GPs to recognize the importance of responsible investing, this does not necessarily mean the fund must be impact focused. This was further supported by independent interviewees who stated that Article 9 brings more clarity, but probably not additional funding. Moreover, they underscored that LPs mostly view ESG as a hygiene factor, while there is not yet sufficient demand for impact and Article 9 funds.

> "I see that there have been requirements from LPs to meet certain minimum levels, but I haven't seen a difference in Article 8 or 9 when it comes to attracting capital. If the ESG profile was really decisive, we would see more activity within the space."
> - Independent ESG Advisor

> "ESG today is about processes and risk mitigation, which Article 8 ensures. If instead of being Article 8 you would've been an Article 6, you would risk losing a majority of LPs [...] ESG is important as a hygiene factor, but Article 9 is not demanded."
> - Independent ESG Advisor

When asked about how ESG incidents in portfolio companies influence future capital commitments, LPs noted that controversies as such are not necessarily deal-breakers. Instead, they emphasized that their assessment depends primarily on the root cause of the incident, how it was managed, and what remediating actions were taken.

> "If it can be demonstrated that new processes have been established or strengthened, incidents in themselves are not a reason to divest or avoid investing [...] If the company

has not taken relevant actions as a result of the incident, it is a red flag, and we do not want to invest, but if improvements have been made, incidents are not a deal-breaker."
- ESG Analyst, Swedish Pension Fund

To summarize, the results show conflicting findings in terms of the potential competitive advantage that ESG brings and the hypothesis that it may impact fundraising. Both GPs and LPs view ESG reporting primarily as a baseline requirement in fundraising rather than a differentiating element. This view was shared among independent participants, noting that Article 8 is increasingly required, but that there is not yet demand for impact and Article 9. This is in line with research by Duncombe et al. (2023), who find that ESG has become less of an edge in recent years. Yet, LPs did confirm that among comparable funds, those with more extensive ESG reporting tend to be favored. In contrast, GPs managing Article 9 funds believe that the classification provides a competitive advantage in attracting capital, supporting the findings of Abraham et al. (2024) that robust ESG disclosure aids in fundraising. Additionally, LPs indicated that ESG incidents alone are not decisive for future capital commitments but are more dependent on how such are managed. This contrasts research by Duevski et al. (2023), who suggest that E&S incidents are a significant determinant for LPs' investment decisions.

5.3 Challenges to ESG Integration

While the above results reveal that GPs and LPs see many benefits of ESG integration, its practical implementation can be complex and lead to investors facing several challenges, on which there is scarce research. In the sections below, the most prevalent obstacles to ESG integration identified by study participants are presented.

5.3.1 EU Sustainability Regulations

In general, GPs view EU sustainability regulations in a positive light due to increased comparability and accountability. Despite its advantages, the vast majority of GPs also pointed out that the CSRD places a heavy administrative burden on portfolio companies, redirecting focus from implementing tangible sustainability improvements to instead complying with the regulation. This was also emphasized among independent participants, raising concerns that excessive regulatory demands can stifle the entrepreneurial spirit in portfolio companies.

"Right now, the regulation is more confusing than it is helpful. Business leaders are getting confused and focusing on complying with regulations rather than improving the

business model, which hinders development. They change the business to comply, but could've done it differently if they had focused on their actual impact." - Investment Professional, Nordic PE Firm, Article 8 & 9

Several GPs mentioned that the criteria for classifying as Article 9 according to the SFDR are very strict, arguing that the Swedish market is too small to limit yourself to only impact companies. Two GPs also note that from an investment perspective, the SFDR can create challenges due to the vague definition of a sustainable investment and the broad definition of Article 8 funds. Nevertheless, one of the two GPs noted that lower requirements of Article 8 funds are advantageous in the sense that they allow investors to help companies transition from brown-to-green, something that is not possible within the framework of Article 9.

"SFDR [...] it isn't working exactly as it should, the market almost wants to move away from it since the definition of a sustainable investment, or lack thereof, is so unclear." - Head of Sustainability, Nordic PE Firm, Article 8

"You can argue that the bar for Article 8 is relatively low. However, they [Article 8 funds] give you much more room to work on those brown-to-green transition cases. Thus, if thinking about the impact you can have as a fund, this is an important impact lever that is currently reserved for Article 8 funds, even though most impact investors flock around Article 9 funds. It will be interesting to see what the regulator will do to promote brown-to-green investments while maintaining the high standards related to Article 9." - Head of Sustainability, Nordic PE Firm, Article 8 & 9

LPs do not see the CSRD regulation as a challenge to the same extent as GPs, although they recognize the difficulties GPs and their portfolio companies face. Instead, LPs identified several key benefits, including the concept of double materiality, as well as the harmonization and standardization of ESG reporting, creating common benchmarks across different funds. Some LPs also observed that mandatory ESG reporting is pressuring American funds with large European investors to adapt to these regulations. Nonetheless, LPs raised concerns about the potential burden on smaller companies, noting that compliance can be costly, yield limited direct benefits, and may primarily serve as a safeguard against greenwashing rather than adding tangible value.

"CSRD is challenging for companies that now have to start reporting, but for us, it means we get much better data to feed into our analyses. So for us, it's definitely a positive. The aspect of double materiality is a key part of this - companies are actually expected to take responsibility for their negative impact." - Head of ESG, Swedish Pension Fund

However, most LPs expressed concerns about the fact that the SFDR's definition of a sustainable investment is open for interpretation. Moreover, they stated that Article 8 funds are too broad in scope, making it unclear how sustainable a product truly is. This was also confirmed by one of the independent participants.

> "From an investor perspective, the ability to verify and compare data is a positive aspect. This is beneficial for LPs, although the impact has not yet been fully realized due to the broad definition of Article 8." - Independent ESG Advisor

In contrast, a few LPs were of the opposite opinion and stated that the SFDR brings clarity to the market in terms of ESG claims, allowing investors to make informed decisions.

> "The SFDR makes it clear to consumers what constitutes a sustainable fund and not just saying, "We don't invest in tobacco and want a 1 percent higher fee." It serves as a form of consumer protection." - Head of ESG, Swedish Pension Fund

In summary, the results confirm the assumption that EU regulations are expected to significantly impact ESG integration in private equity, presenting both opportunities and challenges. Both GPs and LPs have a positive attitude towards new EU regulations, recognizing their potential to enhance transparency and accountability. However, GPs emphasize that CSRD compliance requirements often divert resources from practical ESG integration and meaningful implementation, redirecting efforts to meet regulatory criteria. For LPs, the main challenges instead lie in SFDR's broad definition of Article 8 funds and what constitutes a sustainable investment - an issue previously highlighted by Sustainalytics (2023). GPs, however, considered this issue less critical, instead identifying benefits tied to Article 8 funds since these enable brown-to-green transition investments.

5.3.2 Greenwashing

In general, GPs did not see greenwashing as very prevalent within the industry, but simultaneously recognized that inconsistencies in frameworks and data can risk diluting the credibility of ESG claims, both at the fund and portfolio company level. Nevertheless, they believed that new regulations and heightened LP expectations are seen as helpful in strengthening accountability. One Article 9 GP also stressed that marketing yourself as a transition fund almost becomes self-regulating, as it leads to heightened scrutiny from both LPs and the media.

> "Due to higher LP requirements and regulations, greenwashing is slowly disappearing. We have previously seen some greenwashing in potential investments. They marketed themselves as sustainability leaders, but when we started to work with them, we realized that they didn't have a clue [about sustainability]." - Senior Investment Manager, Nordic PE Firm, Article 8

> "I believe greenwashing is one of the reasons Article 9 funds came to a rise. With them, it is impossible to greenwash." - Investment Professional, Nordic PE Firm, Article 8 & 9

Similarly, LPs expressed little concern for greenwashing, arguing that they are generally lower within the private market as all investors conduct due diligence, making it difficult to provide an inaccurate representation.

> "The PE industry is quite self-regulating, if you mess up, you're out. If you engage in something that is perceived as greenwashing, you'll struggle to raise future capital. You know who the PE funds are and who the investors are, so it doesn't take long to get a bad reputation." - Head of PE, Swedish Fund-of-Funds

One of the independent participants provided a new perspective, distinguishing between intentional and unintentional greenwashing.

> "There are different dimensions of greenwashing, and I don't believe intentional greenwashing is as common as unintentional [...] For example, new PE firms looking to attract capital often lack an established track record but instead showcase what they plan to achieve. This can ultimately lead to greenwashing, although it may be unintentional, as they can fail to meet all the plans they set out to do." - Independent ESG Advisor

The results show that neither GPs nor LPs view greenwashing as a significant challenge to ESG integration, contradicting the hypothesis that this could present an obstacle. However, they acknowledge that ambitious ESG claims can increase the risk of greenwashing accusations, though this is somewhat mitigated by high scrutiny, in line with Yu et al. (2020).

5.3.3 Quantifying Impact

A majority of GPs expressed concerns about how to accurately measure impact, including how to translate it into monetary terms. Moreover, it was made evident that GPs have differing views on

the concepts of additionality and net impact, even after being provided with a definition during the interviews. Their approaches to measuring additionality varied from considering a scenario in which the target company did not exist, to believing that growing sustainable companies inherently creates additionality. Similar results were observed when GPs were asked how they assess net impact, with one employing an established framework while the majority noted that although they attempt to, measuring it remains a challenge.

Even though quantifying impact was seen to constitute a major challenge, all GPs strongly believe that they can generate additionality. They stress that the PE governance model is especially suitable for this, being able to take companies off the listed market to transform them, returning with a new profile and restructured business, which might have been more difficult under public scrutiny. Moreover, they stated that they can contribute to additionality by investing in companies that are capable of scaling up thanks to the resources, expertise, and capital that PE firms bring to the table.

> "If we weren't to believe in additionality, we would be doing a bad job as investors. We want to play an active role in decarbonizing the European economy. The way we look at our investments is that by being involved, we can scale and accelerate that journey through the capital we bring in, as well as our partnership approach, expertise, and network." - Head of Sustainability, Nordic PE Firm, Article 8 & 9

This view was supported by an independent participant, although arguing that most GPs are not utilizing their full capacity.

> "I don't think most PE firms are tapping into their full potential, probably only about 20-50 percent across all areas. PE professionals primarily identify as investors [...] This sometimes leads to challenges in understanding how to contribute effectively, as the cultural and control mechanisms within their portfolio companies may not be fully understood." - Independent ESG Advisor

Similar challenges in terms of measuring additionality are observed from interviews with LPs. Even so, they share the view that GPs can generate such and that the PE governance model is especially suitable for this. Moreover, LPs believed that net impact is even more complex to measure, with no participant stating that it calculates exact numbers. A common explanation was that while individual components of a company's impact can be analyzed, it is difficult to assess how they relate to one another. Another challenge brought up is that the lack of a market standard in terms of measuring impact means that you put yourself at risk for potential or actual greenwashing. Yet, some stated that they do make a comprehensive evaluation of the fund's potential for positive impact and that a lack thereof tends to reflect negatively on the assessment.

> "Even though it [net impact] is difficult to quantify, we follow up on the impact they report and try to understand and aggregate that internally. This helps us evaluate future investments when new funds come in and to determine if it is better to invest in this fund, a green bond, or buy forest?" - Head of ESG, Swedish Pension Fund

The results show that both GPs and LPs see difficulties in measuring and assessing impact in relation to the concepts of additionality and net impact, with Yu et al. (2020) highlighting the lack of standardized ESG reporting metrics as a challenge. However, there was strong consensus that GPs are, in fact, able to generate additionality.

6 Discussion

The following section presents a discussion of the interview findings, aiming to explain the results in light of the theoretical framework and earlier research outlined in section 3. The discussion will be structured around the three research questions:

1. What are the primary drivers of integrating ESG into private equity investment decisions?

2. What effect does ESG integration have on private equity fundraising outcomes?

3. What are the main challenges with ESG integration and their practical consequences?

6.1 The Underlying Drivers Behind ESG Integration

6.1.1 ESG as an Attractive Business Case

Stakeholder theory states that value creation is enhanced when firms adopt a holistic and responsible approach to decision-making (Freeman, 1984). This supports the hypothesis and results that both participant groups, particularly GPs, increasingly regard ESG as a core driver of financial value, arguing that ESG improvements future-proofs companies, which can ultimately lead to higher exit multiples. Independent participants echoed this perspective, noting that some buyers incorporate ESG considerations into transaction prices. This aligns with Crifo et al.'s (2015) study, showing that good ESG practices increase firm price, as well as Baker et al.'s (2018) finding that green bonds are issued at a premium compared to non-green bonds with similar characteristics. However, GPs' and LPs' perceptions that ESG integration presents a business case contradicts Pástor, Stambaugh, and Taylor's (2021) research indicating that green holdings have a negative CAPM alpha and that tilting the portfolio towards such assets would ultimately lead to lower returns. Notably, this research focuses on public markets, suggesting that the same results may not hold in the private sphere.

Furthermore, several GPs mentioned that ESG has become part of their operational engineering strategies, confirming the hypothesis that ESG can be used as a value creation lever. This also finds support in prior research, with Kaplan and Strömberg (2009) describing operational engineering as a crucial component for driving financial returns within the private equity model. Moreover, some GPs stressed that ESG often intersects with cost-saving initiatives, meaning that ESG efforts enhance profitability while supporting sustainable practices. This aligns with Bellon's

(2020) view that PE-backed firms face fewer financial constraints and can more effectively adopt sustainability-driven improvements, indicating that operational engineering can be leveraged as a strategy to achieve dual objectives.

Another perspective of stakeholder theory asserts that firms are bound by societal and legal frameworks (Clarkson, 1995). This implies that they must effectively navigate the demands imposed by different stakeholder groups, which aligns with GPs' view that while ESG can drive value, it must simultaneously be weighed against financial considerations and operational feasibility. This can be connected to Bellon's (2020) study, which emphasizes that while private equity firms can effectively enhance the environmental performance of their portfolio companies, it is particularly evident in contexts where firms face significant environmental liability risks, showcasing that PE firms respond to external pressures. It can also be linked to the findings of Duevski et al. (2023), who argue that PE firms are more likely to be held accountable for substandard ESG practices within their portfolio companies compared to public equity owners, given the greater influence they can exert over these entities. This implies that GPs may pursue certain ESG-related initiatives not primarily to fulfill ESG goals but because such issues are financially material to the business.

6.1.2 ESG as a Risk Mitigation Tool

ESG as a risk mitigation tool reflects stakeholder theory, which posits that companies must consider the interests of all stakeholders, including employees, communities, regulators, and investors, and address risks that affect them (Freeman, 1984). Although there was consensus among GPs that the primary incentive to integrate ESG is the business case perspective, several also recognized that it can serve as an effective risk mitigation channel. They point out that sustainability is a way to maintain stability and reduce potential downside risks across their portfolio companies. The results similarly align with prior research by, for example, Lambert et al. (2007) and Dhaliwal et al. (2014), showing that robust ESG practices lead to a lower cost of capital, which serves as an indicator of reduced investment risk. Moreover, some GPs underscore the importance of ESG for managing specific business risks, particularly in highly regulated sectors. Consistent with Bellon's (2020) findings, this suggests that GPs subject to high regulatory and environmental risks may put greater weight on ESG as a risk mitigator compared to those with lower exposure to such risks.

ESG as a risk mitigation tool was even more pronounced by LPs than GPs, with a majority stating this as the primary motive to integrate ESG. These results align with McCahery et al.'s (2022) finding that LPs, compared to GPs, put a larger weight on the link between ESG and risk management. Prior research also indicates that investors perceive the governance component as being most effective in mitigating risks, which was confirmed by LPs (ibid). Moreover, LPs

mentioned that while certain social risk areas, such as human rights, can be difficult to translate into monetary terms, they remain critical to manage due to the reputational risk they pose to the PE firm and its broader stakeholder network. Connecting this to existing research, E&S incidents are shown to significantly reduce the size and likelihood of future capital-raising efforts (Duevski et al., 2023). Given that GPs increasingly view ESG as a value-creation driver, it is thus crucial that they also maintain a strong focus on ESG from a risk management perspective due to its potential financial implications. Notably, LPs' large emphasis on ESG as a risk mitigator could partly reflect the composition of the sample, seeing that a majority of participants were Swedish pension funds, which are restricted by their investment mandates from taking excessive risk. This overrepresentation could potentially skew the results, pointing to a perspective that may not be true within the broader LP community.

6.1.3 The Potential Trade-Off Between ESG and Financial Returns

Freeman (1984) states that firms maximize value when they consider the interests of all stakeholders, not just shareholders. From this viewpoint, integrating ESG is not a trade-off but a long-term investment in stakeholder relationships that can help future-proof companies and generate sustained financial returns. Nine out of fourteen interviewed GPs and LPs stated that they do not see a trade-off between financial returns and broader sustainability goals, believing that dual objectives can be achieved. However, contrary to the hypothesis that the pursuit of dual objectives serves as a core incentive for ESG integration, our findings indicate that it is instead a prerequisite for considering such factors. Furthermore, most GPs acknowledged the difficulty in quantifying ESGs' effect on returns but stated that not incorporating sustainability considerations could prove financially detrimental. Concerning the identified monetary benefits, one GP highlighted that its ESG strategy had increased its chances of being the preferred partner in auctions, occasionally enabling acquisitions at a slight discount. Additionally, positioning its portfolio companies as sustainability role models has created perceived advantages at exit.

Although we lack access to the financial performance of GPs' individual holdings, making it difficult to validate these claims, the observations align with previous research. Studies by Benson and Humphrey (2008), Renneboog et al. (2011), and Bialkowski and Starks (2016) indicate that SRI funds tend to be less performance-sensitive than conventional funds, which may imply that investors attribute value to ESG factors beyond immediate financial performance. It is also consistent with findings by (Hartzmark and Sussman, 2019), showing evidence of substantial capital reallocation from firms with lower ESG scores to those with higher ESG scores. This supports the idea that ESG integration can contribute to firm attractiveness in the eyes of buyers, potentially enhancing long-term value in private equity contexts.

Several interviewed GPs could provide examples of passing up on profitable short-term investments that did not meet ESG standards. However, this was not due to a willingness to sacrifice returns but rather based on the conviction that poor ESG practices are financially harmful in the long run. Our results therefore contrast with Barber et al.'s (2021) research, which suggests that some investors knowingly prioritize social and environmental impact at the expense of returns. The findings instead reflect a more stakeholder-oriented view of fiduciary duty, indicating that these investors view ESG and profitability as interlinked.

The remaining participants stated that a trade-off may arise at times, influenced by factors such as time horizon, consumer demand, and the broader economic environment. Hong and Kacperzyk (2009) support the view that a trade-off exists by showing that sin stocks can sometimes generate higher expected returns than otherwise comparable stocks, suggesting that ESG-aligned investments may entail opportunity costs. Nonetheless, these GPs apply exclusion criteria to avoid investments in sin industries, which may be due to several underlying factors. On the one hand, it could indicate an awareness of the non-pecuniary benefits valued by their investors, which resonates with Barber et al.'s (2021) findings. On the other hand, it could be to avoid the risk of stranded assets and investments in companies that will not survive in the long run, indicating that they only believe in a short-term trade-off, thus supporting a longer-term view of value creation in line with stakeholder theory.

Moreover, all institutional LPs stressed the notion of fiduciary responsibility, emphasizing that returns are prioritized above all else in the industry. This contrasts Barber et al. (2021), who find that public pension funds are particularly willing to pay for impact. Interestingly, the views of what this fiduciary duty entails differ slightly among the interviewed LPs. Some LPs prioritize returns over sustainability unless profitability is assured, while others view sustainability as a goal that must be achieved in parallel. This divergence in perspectives among LPs may indicate an evolving understanding of what fiduciary responsibility encompasses and how long-term value creation is defined. Stakeholder theory can help explain this shift, as it expands the concept of fiduciary duty by recognizing the importance of social and moral contracts alongside legal and implied ones (Nnadi & Mutuaba, 2023). Therefore, while some maintain a traditional view of fiduciary duty as focused solely on maximizing profits for investors, others recognize that financial returns are increasingly linked to the effective management of ESG factors and that long-term value is best achieved through a holistic approach that benefits all stakeholders.

6.1.4 ESG and Secondary Benefits

Stakeholder theory shifts the focus from solely focusing on shareholders to also including other stakeholders such as employees. Jones (1995) highlights that mutual trust and cooperation among

stakeholders can create competitive advantages for firms. This can be closely linked to our findings, which reveal that GPs see positive spillover effects from ESG integration. These include increased employee motivation and retention, as well as advantages in recruitment. The results also align with prior research by De Neve et al. (2018), showing that positive social impact boosts job satisfaction. Connecting this research to Edman's (2011) study finding that employee satisfaction is positively correlated with shareholder returns, one could argue that ESG integration may similarly have positive financial spillover effects. One interviewee reinforced this point, highlighting that GPs can unlock financial value by helping portfolio companies recognize the positive social or environmental impact of their products. This awareness, in turn, can enhance the company's human capital and commercial appeal.

Importantly, these factors were not considered material drivers for integrating ESG, but rather secondary benefits identified by GPs. Notably, interviewed LPs did not perceive similar spillover benefits, suggesting that GPs may experience more immediate and visible impacts on recruitment and motivation due to their closer engagement with operational practices. This disparity further proves that human capital considerations, while valuable, are not the primary drivers for ESG integration.

6.1.5 The Key Actors Driving ESG Integration

In light of limited research on whether GPs, LPs, or other external forces are driving ESG integration, the following section will be based exclusively on the qualitative results obtained from the interviews, framed within the theoretical lens of stakeholder theory. Drawing upon these findings, this analysis aims to understand whether ESG integration is an internally motivated strategy by GPs or a response to external pressures while also adding new dimensions to previously discussed factors such as ESG serving as a business case, risk mitigator, tool to achieve dual objectives, or means to increase employee motivation. Beyond these potential incentives, we thus seek to identify the principal forces shaping ESG demand in the industry.

Stakeholder theory asserts that firms operate within a network of interrelated stakeholders, each with their own interests and influence on corporate decision-making (Freeman, 1984). The results show that a vast majority of GPs view LPs as the primary drivers behind their ESG integration, noting that LP demands, capital allocation decisions, and regulatory pressures have been instrumental in advancing this agenda. This reinforces stakeholder theory's idea that GPs' actions are often shaped by the expectations and requirements of key stakeholders (Freeman, 1984). Nordic LPs, especially pension funds, are seen as particularly influential, contrasting with markets like the US, where ESG priorities appear less pronounced. This resonates with the view of LPs, who unanimously consider themselves to drive the development. Moreover, they observe that GPs have

rapidly adapted to meet evolving LP demands, with many embracing ESG integration to access institutional capital. This dynamic raises the question of whether GPs are incentivized to consider ESG simply in order to attract funding rather than the stated primary objectives of driving value and mitigating risks.

In contrast, two GPs managing Article 9 funds argue that they have been at the forefront of ESG integration and impact investing, with their ambitions originating internally. These findings suggest that while LPs, supported by regulation, have raised the industry's baseline for ESG standards, a small group of niche impact investors is advancing these efforts further. This challenges the theory that GPs integrate ESG solely due to external pressure, instead reinforcing the view that ESG serves primarily as a value driver.

6.2 ESG and Fundraising Effects

According to stakeholder theory, the way in which control within a firm is exercised is shaped by its network of both formal and informal relations. Since LPs contribute with capital commitments, the GP-LP relationship is crucial, suggesting that GPs should be particularly receptive to LP requirements and demands. This is confirmed by our results, with a majority of GPs asserting that their improved ESG reporting stems from LP demands. Moreover, it aligns with previous research, linking investor pressure to enhanced disclosure practices (Abraham et al., 2024). Although Abraham et al. (2024) suggest that ESG disclosure can aid in fundraising, our results partly contrast these findings. They instead reveal that ESG reporting has become standard practice among GPs and is primarily viewed as a hygiene factor, meeting LPs minimum expectations, rather than a competitive advantage in fundraising. This resonates with Duncombe et al. (2023) who find that while ESG positioning in marketing materials appeared to have a positive effect on fundraising success in earlier years, this impact has diminished since 2017. This shift, as confirmed by our results, reflects stakeholder theory. ESG has become a standard requirement set by LPs, prompting nearly all GPs to integrate it in order to meet stakeholder expectations.

Furthermore, our results indicate that subpar ESG disclosure has more significant negative consequences than above-average reporting has positive effects - an asymmetric relationship observed in previous research by Crifo et al. (2014). Nonetheless, LPs acknowledge that all else equal, strong ESG reporting tends to favor a fund, suggesting that a modest positive relationship between disclosure quality and fundraising may still persist. These findings align with the experience of GPs managing Article 9 funds who perceive a competitive advantage in fundraising, despite LPs stating that Article 8 classification is sufficient for inclusion in their investment universe. Since the SFDR's Article 9 classification entails higher disclosure requirements than Article 8, GPs' belief in its fundraising benefits may be valid, as LPs do appear to value

higher-quality reporting when differentiating between otherwise comparable funds. This aligns with voluntary disclosure theory (Dye, 1985; Verrecchia, 1983), which suggests that PE firms with strong ESG performance often provide more extensive reporting to distinguish themselves from average or lower-performing peers. Moreover, Article 9 GPs mentioned that they experienced a faster fundraising process than their peers, despite the overall economic landscape, and fundraising climate in particular, being challenging. This finding is consistent with Abraham et al. (2024), who observe that robust ESG disclosure enables faster fundraising while also increasing the likelihood of attracting UN PRI-committed LPs. Further connecting this to our results, GPs managing both Article 8 and 9 funds noted that they had successfully attracted new investors specifically seeking Article 9 mandates, suggesting that this SFDR classification may indeed facilitate fundraising efforts. The absence of Article 9 focused LPs in our study may, however, contribute to the observed relationship between ESG disclosure and fundraising outcomes appearing more skewed than it may be in a broader market context.

Moreover, our results find that ESG incidents alone are not decisive for LPs' future capital commitments. Instead, LPs focus on how such incidents are managed, stating that they would refrain from re-investing if sufficient corrective actions were not taken following an incident. This highlights that LPs prioritize governance of controversies within portfolio companies over the actual occurrence of such incidents. The finding contrasts with Duevski et al. (2023), who observe that E&S incidents negatively impact the size and probability of raising follow-up funds. Conversely, the results align with McCahery et al. (2022), who state that LPs view the governance component as the most effective risk management tool. However, it is important to note that Duevski et al. (2023) did not account for how E&S incidents in their sample were managed, limiting the ability to draw definitive conclusions.

6.3 Challenges to ESG Integration

Previous research, although limited in comparison to other areas of ESG literature, has identified several challenges related to the integration of ESG. These challenges include the lack of standardized ESG reporting rules and metrics, the absence of a clear definition of a sustainable investment, as well as risks related to perceived greenwashing (Yu et al., 2020; Sustainalytics, 2023). Adding to existing literature, interviewees mentioned other challenges, of which emerging EU regulations and difficulties in measuring impact were most frequently mentioned.

Stakeholder theory emphasizes the legal and societal frameworks within which firms operate, meaning that GPs and LPs must comply with regulatory bodies while simultaneously balancing the needs of other stakeholder groups. Pertaining to the forthcoming EU regulation, CSRD, and SFDR, the results reveal a generally positive consensus among both groups, agreeing that EU

regulations will enhance transparency and harmonize ESG reporting - addressing a historical lack of comparability within the industry. Our findings thus show that EU regulations help tackle some of the challenges brought up in existing literature related to the absence of specific regulatory ESG disclosure guidelines (Yu et al., 2020). Yet, GPs also raise concerns about the administrative burdens imposed by compliance, particularly in relation to the CSRD. They fear that excessive regulatory demands can divert focus and resources from tangible sustainability improvements, thereby hindering effective ESG implementation. Moreover, a majority of LPs, as well as two GPs, expressed concerns that the broad definition of an Article 8 fund, along with the lack of a clear definition for what constitutes a sustainable investment, makes it challenging to accurately assess the ESG standards of an Article 8 fund. Connecting this to prior reasoning by Sustainalytics (2023), this ambiguity could potentially lead investors to interpret and classify investments inconsistently.

Nevertheless, it was highlighted that Article 8 funds enable brown-to-green investments, whereas Article 9 restricts investors from transitioning companies. Research by Crifo et al. (2015) suggest that investors can enhance profitability by addressing poor ESG practices, while well-established ESG practices are not viewed as an additional source of value. Our results, combined with existing literature, imply that investors may have a financial incentive to pursue brown-to-green investments, potentially deterring GPs from the Article 9 classification. This may partly explain the relatively low prevalence of Article 9 funds in the private equity market, though further research is needed to validate this claim.

In terms of greenwashing risks, the majority of GPs agree that outside pressure from regulation, reporting standards, and LP demands decrease the overall level of greenwashing in the market, aligning with Yu et al.'s (2020) assertion that a high presence of institutional investors makes firms less likely to engage in such practices. Given that GPs and LPs perceive greenwashing as relatively uncommon in the market, this was not mentioned as a major challenge to ESG integration. However, some GPs caution that the regulatory burden and fear of greenwashing may have unintended effects. With ESG disclosures previously being voluntary and classifications as Article 6, 8, or 9 left to each GP's discretion, some have opted to classify themselves more conservatively than what is reflected in their actual efforts. This in order to avoid potential allegations of greenwashing, a strategy known as greenbleaching. Independent interviewees further highlighted this issue, noting that high ESG ambitions can sometimes inadvertently result in unintentional greenwashing. Together, these insights suggest that fears of greenwashing accusations may incentivize GPs to adopt a more prudent approach to ESG than they prefer, not least in external marketing disclosures. Therefore, greenwashing risks can constitute an indirect hindrance to ESG integration, although not explicitly stated by GPs or LPs.

Closely tied to the topics above is the challenge of quantifying impact, for which there are no common standards or metrics. According to Abraham et al. (2024), PE firms may perceive ESG

reporting as too costly due to the absence of standardized reporting frameworks and data, which could explain the results. Moreover, many GPs mentioned that the risk of greenwashing intensifies when claiming impact, which could be another potential explanation for why few make external statements regarding the impact they generate or their potential attempts to measure it. Albeit the acknowledged difficulty in quantifying this, compounded by the lack of a clear framework for assessing additionality or net impact, our findings reveal that both GPs and LPs share a belief in the potential for GPs to generate impact. While this conviction suggests optimism, it does not provide conclusive evidence that such impact is being achieved in practice, raising the question of whether we can confidently assert that GPs are achieving positive outcomes beyond financial returns. This uncertainty reveals a potential shortfall in ESG integration: if firms struggle to generate tangible positive societal outcomes, they may face challenges in fully addressing the broader needs of all stakeholders. Overlooking the interests of key stakeholders can, in accordance with stakeholder theory, threaten GPs' ability to maximize value creation.

7 Conclusion

7.1 Concluding Remarks

ESG investing is gaining significant traction within the private equity industry as investors and firms increasingly recognize its importance for long-term value creation. Utilizing a qualitative approach with 19 interviews, this study aims to examine: 1) the primary drivers behind this shift; 2) the impact of ESG integration on fundraising; and 3) the main challenges faced by market participants amid this market transformation. Regarding the first research question, both internal and external pressures are found to drive ESG integration in private equity. Externally, Nordic pension funds are seen as the key players in pushing the development, in turn enforced by regulation steering their investment mandate. Yet, these external pressures only set the industry's baseline level and do not fully explain the full range of ESG integration. Instead, there are indications that higher ESG ambitions - investments in accordance with Article 9 - stem from internal GP motives. Internally, several factors are identified as drivers, though different market participants assign varying levels of importance to these. For GPs, the primary incentive is the business case that ESG presents, constituting a key value creation lever in their investment strategies. While this is also a critical motivator for LPs, they put more emphasis on ESG serving as a tool for risk mitigation. Moreover, there is mutual consensus that ESG can be used to achieve dual objectives, although this is seen as a prerequisite to ESG integration rather than as a driving force. Positive spillover effects, such as increased employee motivation, were not seen as underlying incentives, although recognized as a secondary benefit by GPs.

As for the second research question, our results do not find a strong relationship between ESG integration and fundraising success, but rather a non-negative or neutral correlation. ESG disclosure has evolved into a standard requirement among most LPs, and failing to meet this baseline level of disclosure can significantly harm fundraising efforts. However, we observe a slight but positive correlation between ESG integration and fundraising success among Article 9 GPs, seeing their SFDR classification as a key differentiator. Yet, Article 8 GPs and LPs are less convinced that Article 9 provides significant fundraising advantages, indicating that the perceived benefits of stricter ESG disclosures may not be as evident outside the more rigorous Article 9 classification. To conclude, while ESG disclosure has mainly become a check-the-box exercise, the extent of integration - particularly in the context of SFDR classifications - may still offer some competitive edge.

In terms of the third research question, both GPs and LPs highlight challenges associated with the EU sustainability regulations. GPs find that the heavy administrative burden imposed by the CSRD may divert critical resources from implementing tangible sustainability improvements,

potentially reducing their ability to achieve impact. Simultaneously, LPs are concerned about the SFDR's lack of a clear definition for what constitutes a sustainable investment while also pointing to issues that the Article 8 classification is too broad in scope. Moreover, our findings show that quantifying impact constitutes a major challenge due to the absence of standardized metrics and the heightened risk of greenwashing brought on when making such claims. Despite this, both GPs and LPs share a strong conviction in GPs' ability to generate impact.

7.2 Limitations and Future Research

This thesis identifies three potential limitations that can be addressed in future research. Firstly, the qualitative study format, coupled with a relatively small sample size of 19 interviews, limits the possibility of applying the results in a broader market context. Although generalizability is not the purpose of qualitative research, future studies could expand the pool of interviewees, both in size and diversity, including participants from regions beyond the Nordics, to capture a more comprehensive range of practices and challenges. Additionally, targeting other types of LPs, such as endowment funds and family offices, could provide deeper insights into how different types of investors view and affect ESG integration. By addressing this limitation, future research can contribute to a broader understanding of ESG integration in private equity.

Secondly, both GP and LP study participants recognized that ESG can drive value in portfolio companies, albeit there are difficulties in providing quantitative proof of the monetary benefits yielded. Future studies could aim to address this, either through a quantitative study or through case studies. Such research could track ESG investments over time to analyze their financial performance alongside sustainability outcomes, potentially being able to distinguish how ESG strategies translate into financial terms. Quantitative evidence linking ESG integration to financial returns could encourage greater adoption, align stakeholder expectations, and reduce skepticism about the benefits of sustainability.

Lastly, EU sustainability regulations have recently been enacted, with the CSRD yet to be fully implemented in the private market. Consequently, some of the conclusions drawn in this study may evolve once the industry has fully adopted the regulations. Future research can therefore complement the results of this thesis by analyzing the private market's response to the full implementation of the SFDR and CSRD. This would provide more robust insights into how SFDR classifications impact capital allocation decisions and whether the CSRD is still seen to hinder effective impact generation. Moreover, understanding these evolving dynamics is critical for assessing whether the EU regulations achieve their intended goals of improving transparency and attracting private funding to help Europe make the shift to a net-zero economy.

List of References

Abercrombie, N., Hill, S., and Turner, B. S. (1994). *The Penguin Dictionary of Sociology*. Penguin Books, 3rd edition.

Abraham, J., Olbert, M., and Vasvari, F. (2024). ESG Disclosures in the Private Equity Industry. *Journal of Accounting Research*, 62(5):1611–1660.

Academies, A. . A. E. (2023). *The European Code of Conduct for Research Integrity – Revised Edition 2023*. ALLEA, Berlin.

Alfonso-Ercan, C. (2020). Private Equity and ESG Investing. In Esty, D. C. and Cort, T., editors, *Values at Work*. Palgrave Macmillan, Cham.

Baker, M. P., Bergstresser, D., Serafeim, G., and Wurgler, J. A. (2018). Financing the Response to Climate Change: The Pricing and Ownership of U.S. Green Bonds. Working Paper, available at SSRN.

Barber, B. M., Morse, A., and Yasuda, A. (2021). Impact investing. *Journal of Financial Economics*, 139(1):162–185.

Bellon, A. (2020). Does Private Equity Ownership Make Firms Cleaner? The Role Of Environmental Liability Risks. *ERN: Econometric Studies of Private Equity*.

Benson, K. L. and Humphrey, J. E. (2008). Socially responsible investment funds: Investor reaction to current and past returns. *Journal of Banking & Finance*, 32(9):1850–1859.

Białkowski, J. and Starks, L. T. (2016). SRI Funds: Investor Demand, Exogenous Shocks and ESG Profiles. Working Papers in Economics 16/11, University of Canterbury, Department of Economics and Finance.

Bingler, J. A., Kraus, M., Leippold, M., and Webersinke, N. (2022). Cheap talk and cherry-picking: What ClimateBert has to say on corporate climate risk disclosures. *Finance Research Letters*, 47:102776.

Botosan, C. A. (1997). Disclosure Level and the Cost of Equity Capital. *The Accounting Review*, 72(3):323–349.

Business Roundtable (2019). Business Roundtable Redefines the Purpose of a Corporation to Promote an Economy That Serves All Americans. Accessed: 2024-10-22.

Chung, J.-W., Sensoy, B. A., Stern, L., and Weisbach, M. S. (2012). Pay for Performance from Future Fund Flows: The Case of Private Equity. *The Review of Financial Studies*, 25(11):3259–3304.

Clarkson, M. B. E. (1995). A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance. *The Academy of Management Review*, 20(1):92–117.

Crifo, P., Forget, V. D., and Teyssier, S. (2015). The price of environmental, social and governance practice disclosure: An experiment with professional private equity investors. *Journal of Corporate Finance*, 30:168–194.

de Neve, J.-E. et al. (2018). Work and well-being: A global perspective. In for Happiness, G. C. and Wellbeing, editors, *Global Happiness Policy Report*. Sustainable Development Solutions Network, New York, NY.

Deloitte (2022). How the SFDR is Changing the Dynamics of Private Equity. Accessed: 2024-11-07.

Dhaliwal, D., Li, O. Z., Tsang, A., and Yang, Y. G. (2014). Corporate social responsibility disclosure and the cost of equity capital: The roles of stakeholder orientation and financial transparency. *Journal of Accounting and Public Policy*, 33(4):328–355.

Donaldson, T. and Preston, L. E. (1995). The Stakeholder Theory of the Corporation: Concepts, Evidence, and Implications. *The Academy of Management Review*, 20(1):65–91.

Duevski, T., Rastogi, C., and Yao, T. (2023). ESG Incidents and Fundraising in Private Equity. Available at SSRN.

Duncombe, S., Park, M., Tarsalewska, M., and Trojanowski, G. (2023). ESG positioning in private infrastructure fundraising. *International Review of Financial Analysis*, 90:102924.

Dye, R. A. (1985). Disclosure of Nonproprietary Information. *Journal of Accounting Research*, 23(1):123–145.

Edmans, A. (2011). Does the stock market fully value intangibles? Employee satisfaction and equity prices. *Journal of Financial Economics*, 101(3):621–640.

El Ghoul, S., Guedhami, O., Kwok, C. C., and Mishra, D. R. (2011). Does corporate social responsibility affect the cost of capital? *Journal of Banking & Finance*, 35(9):2388–2406.

Freeman, R. E. (1984). *Strategic Management: A Stakeholder Approach*. Pitman, Boston, MA.

Gibson Brandon, R., Glossner, S., Krueger, P., Matos, P., and Steffen, T. (2022). Do responsible investors invest responsibly?*. *Review of Finance*, 26(6):1389–1432.

Global Impact Investing Network (GIIN) (2023). What you need to know about impact investing. Accessed: 2024-12-01.

Gompers, P., Ishii, J., and Metrick, A. (2003). Corporate Governance and Equity Prices*. *The Quarterly Journal of Economics*, 118(1):107–156.

Hartzmark, S. and Sussman, A. (2019). Do Investors Value Sustainability? A Natural Experiment Examining Ranking and Fund Flows. *The Journal of Finance*, 74.

He, F., Qin, S., Liu, Y., and Wu, J. (2022). CSR and Idiosyncratic Risk: evidence from ESG information disclosure. *Finance Research Letters*, 49:102936.

Hennink, M., Hutter, I., and Bailey, A. (2010). *Qualitative Research Methods*. SAGE Publications.

Hong, H. and Kacperczyk, M. (2009). The price of sin: The effects of social norms on markets. *Journal of Financial Economics*, 93(1):15–36.

ILPA and Company, B. . (2022). LPs and Private Equity Firms Embrace ESG. Accessed: 2024-11-20.

Jones, T. M. (1995). Instrumental Stakeholder Theory: A Synthesis of Ethics and Economics. *The Academy of Management Review*, 20(2):404–437.

Kaplan, S. N. and Sensoy, B. A. (2014). Private Equity Performance: A Survey. Charles A. Dice Center Working Paper No. 2015-10, Fisher College of Business Working Paper No. 2015-03-10, working paper.

Kaplan, S. N. and Stromberg, P. (2009). Leveraged Buyouts and Private Equity. *Journal of Economic Perspectives*, 23(1):121–46.

Kim, S. and Yoon, A. (2022). Analyzing Active Fund Managers' Commitment to ESG: Evidence from the United Nations Principles for Responsible Investment. *Management Science*, 69(2):741–758.

Lambert, R., Leuz, C., and VERRECCHIA, R. (2007). Accounting Information, Disclosure, and the Cost of Capital. *Journal of Accounting Research*, 45:385–420.

Leavy, P., editor (2014). *The Oxford Handbook of Qualitative Research*. Oxford Library of Psychology. Oxford University Press, New York, NY.

Mahajan, R., Lim, W. M., Sareen, M., Kumar, S., and Panwar, R. (2023). Stakeholder theory. *Journal of Business Research*, 166:114104.

Marshall, C. and Rossman, G. (1999). *Designing Qualitative Research*. SAGE Publications.

Maxwell, J. (2004). Using Qualitative Methods for Causal Explanation. *Field Methods*, 16:243–264.

McCahery, J. A., Pudschedl, P. C., and Steindl, M. (2022). Institutional Investors, Alternative Asset Managers, and ESG Preferences. *European Business Organization Law Review*, 23:821–868.

Metrick, A. and Yasuda, A. (2010). The Economics of Private Equity Funds. *The Review of Financial Studies*, 23(6):2303–2341.

Morningstar (2020). Investors Back ESG in the Crisis. Accessed: 2024-11-07.

Morningstar (2024). Global ESG Flows Q2 2024 Report.

Ng, A. and Rezaee, Z. (2015). Business sustainability performance and cost of equity capital. *Journal of Corporate Finance*, 34:128–149.

Nnadi, M. and Mutyaba, P. E. (2023). The moderating effect of corporate sustainability attributes of products on the financial performance of firms. *Reference Module in Social Sciences*.

Patten, D. M. (2002). The relation between environmental performance and environmental disclosure: a research note. *Accounting, Organizations and Society*, 27(8):763–773.

Pedersen, L. H., Fitzgibbons, S., and Pomorski, L. (2021). Responsible investing: The ESG-efficient frontier. *Journal of Financial Economics*, 142(2):572–597.

PwC (2024). Private Equity and the CSRD Countdown. Accessed: 2024-11-07.

Pástor, , Stambaugh, R. F., and Taylor, L. A. (2021). Sustainable investing in equilibrium. *Journal of Financial Economics*, 142(2):550–571.

Renneboog, L., Horst, J., and Zhang, C. (2011). Is Ethical Money Financially Smart? Nonfinancial Attributes and Money Flows of Socially Responsible Investment Funds. *Journal of Financial Intermediation*, 20:562–588.

Review, H. B. (2022). Private Equity Should Take the Lead in Sustainability. Accessed: 2024-09-11.

Saunders, M., Lewis, P., and Thornhill, A. (2012). *Research Methods for Business Students*. Pearson Education, 6th edition.

Sekaran, U. and Bougie, R. (2010). *Research Methods for Business: A Skill-Building Approach*. John Wiley & Sons, 5th edition.

Sorensen, M. and Yasuda, A. (2023). Chapter 7 - Stakeholder impact of private equity investments. In Eckbo, B. E., Phillips, G. M., and Sorensen, M., editors, *Private Equity and Entrepreneurial Finance*, volume 1 of *Handbook of the Economics of Corporate Finance*, pages 299–341. North-Holland.

Sustainalytics (2023). Sustainable investment calculations under mifid ii and sfdr remain perplexing for esg investors. Accessed: 2024-11-19.

Union, E. (2019a). Regulation (EU) 2019/2088 on Sustainability-related Disclosures in the Financial Services Sector. Accessed: 2024-09-26.

Union, E. (2019b). Regulation (EU) 2019/2088 on Sustainability-related Disclosures in the Financial Services Sector. Accessed: 2024-09-26.

Union, E. (2022). Directive (EU) 2022/2464 on Corporate Sustainability Reporting Directive (CSRD). Accessed: 2024-09-26.

Verrecchia, R. E. (1983). Discretionary disclosure. *Journal of Accounting and Economics*, 5:179–194.

Yin, R. K. (2014). *Case Study Research: Design and Methods*. Sage Publications, 3rd edition.

Yin, R. K. (2015). *Qualitative Research from Start to Finish*. The Guilford Press, 2nd edition.

Yu, E. P.-y., Luu, B. V., and Chen, C. H. (2020). Greenwashing in environmental, social and governance disclosures. *Research in International Business and Finance*, 52:101192.