Principles for Responsible Investment

STEWARDSHIP IN PRIVATE EQUITY

A GUIDE FOR GENERAL PARTNERS

MARCH 2024

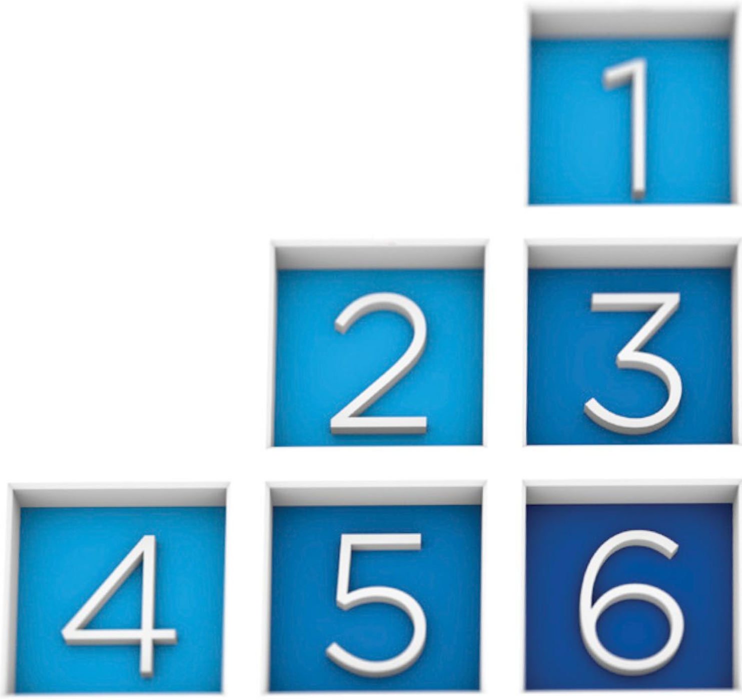
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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ABOUT THIS PAPER

This guide is aimed at helping private equity general partners (GPs) plan and execute stewardship of their portfolio companies. It seeks to aid private equity investors by:

- explaining what stewardship means for this asset class, including practical examples;
- serving as a how-to guide for GPs that are just getting started with stewardship objectives;
- highlighting best practices for both beginners and leaders in stewardship;
- homing in on opportunities to better align with sustainable outcomes.

The target audience includes GPs that are majority investors (such as in buy-out strategies) and minority investors (such as in growth and co-investment strategies). Although this guide does not explore stewardship from the limited partner (LP) point of view, LPs may find this guide useful in assessing general partners. Aside from their role as periodic co-investors, the paper also excludes fund-of-funds and secondaries investors – which resemble LPs in their approach.

The content is based on: a detailed review of responses to the 2021 and 2023 Reporting Frameworks from private equity investors; a stewardship practices survey of members of the 2022-23 Private Equity Advisory Committee; and a series of interviews with private equity practitioners (listed in Acknowledgements). Excerpts from these interviews are highlighted throughout.

This guide complements other PRI content relating to responsible investing in private markets, particularly in private equity, that we began publishing in 2014:

- Integrating ESG in Private Equity, A Guide for General Partners
- Introduction to responsible investment: private equity
- Responsible investment DDQs for private equity and venture capital limited partners
- Guide for limited partners: responsible investment in private equity
- TCFD for private equity general partners
- The Private Credit and Private Equity ESG Factor Map
- Guidance for private equity signatories: directors' duties and ESG (versions available for UK and US directors)

Links to other relevant PRI content are provided throughout and a further reading list is provided at the end of the paper. All feedback is welcome – please contact us at guidance@unpri.org.

EXECUTIVE SUMMARY

The PRI defines stewardship as the use of influence by investors to maximise long-term value, including the value of economic, social, and environmental assets on which returns and client and beneficiary interest depend. This definition is reflected in Principle 2 of the PRI's six Principles, which asset owners and investment managers commit to upon becoming signatories:

> We will be active owners and incorporate ESG issues into our ownership policies and practices.

For many private equity GPs, transforming companies is a fundamental part of their business model and a key way that they deliver value and meet their fiduciary duty to clients. By the simple nature of their investment style and deal/ownership structure, private equity GPs frequently have significant influence over their investments and thus a high capacity to make a lasting impact on the economic, environmental and social value of their portfolio companies.

Despite the natural fit between stewardship and private equity, private market investors repeatedly stated, during our 2021 Reporting Framework survey, that stewardship was a concept that did not apply to the asset class. As we examined this contradiction, it became clear that many private equity GPs may be doing stewardship without naming it as such. Some GPs struggle to connect aspects of their traditional value creation activities with stewardship. Others anchor the terminology to its meaning for listed equity investors and write the practice off as not specific or powerful enough to capture the nature of their activities and impact.

The research for this paper showed GPs need clearer guidance on what constitutes stewardship in private equity, which could also weed out activities that are incorrectly counted as stewardship. In this paper, we have provided that clarity and laid out a set of stewardship actions that general partners can take across the investment life cycle, addressing the when, who, what and how of effective engagement.

When: We map out when key actions of GP-to-portfolio-company engagement occur. Most efforts will occur during the holding period, but important actions can set an engagement up for success in the pre-investment phase – this is especially true for minority co-investors. We look in detail at the due diligence process, deal documentation and how exit strategies can shape engagement activities during the holding period. We also review tactics that can help ensure engagement successes persist after the investor has exited the investment.

Who: In a matrix of relationships between the private equity GP and the portfolio company we have shown that investment committee/deal team buy-in is critical to the success of engagements. A number of strategies are available to achieve such buy-in, including endorsement of ESG focus from the GP's top management team, training programs for deal teams and investment committee members and making ESG a regular part of analyst inductions.

What: GPs determine areas of engagement in one of two ways – a bespoke approach to each company or having a set of ESG priorities that the GP will pursue at every company. The report lists factors for GPs to consider under each approach. It goes on to explore the opportunities private equity investors have to address systemic risks through a focus on sustainability outcomes.

How: The paper concludes by exploring the many tools GPs can use in stewardship efforts with portfolio companies, including:

- establishing expectations, governance and incentive mechanisms
- engendering a company's willingness to change
- building the company's capacity to change
- supporting a company in acting on the desired change

Efforts to monitor and benchmark performance against ESG goals cut across these tools. The report also reviews escalation options if original stewardship efforts are unsuccessful.

The final section of the paper broadens the lens to consider how GPs can help transform capital markets. The tools we explore include public policy engagement, contributing to public goods and influencing standards through collaboration.

GPs that do stewardship well report experiencing significant upsides. These include enhanced client relationships, a positive impact on company earnings and exiting positions at a higher multiple. Several GPs even shared that having strong ESG stewardship capabilities helped them with deal flow or closing competitive deals.

We hope this guide will assist GPs to improve upon existing, or develop new, stewardship practices so that many more GPs can experience the benefits reported to us by our consultation group. Furthermore, we believe that improved practices on stewardship in private equity can unlock the potential of this asset class to contribute to achieving a more sustainable financial system.

CLARIFYING STEWARDSHIP IN PRIVATE EQUITY

Key messages:

- In private equity, engagement with investees represents the dominant form of stewardship.
- Minority investors' ability to engage portfolio companies varies; we explore three scenarios.
- Data collection does not always count as a form of stewardship. GPs' intentions when collecting information and how they use it matters.

The term stewardship encompasses a multitude of activities. Different asset classes have different tools and levers of influence with which to conduct stewardship. The activities of stewardship that are most relevant to private equity GPs are:

- engaging with investees
- holding positions on investee boards and board committees
- engaging with policy makers
- engaging with standard setters, such as NGOs and industry trade groups
- collaborating with other investors
- contributing to public goods and public resources that support stewardship goals

Whereas stewardship focuses on the use of influence broadly, engagement refers specifically to interactions between an investor and another party to improve practices on an ESG issue, make progress on sustainability outcomes or improve public disclosure. These interactions with current or potential investees are so central to private equity investing that they represent the dominant form of stewardship in the asset class.

Therefore, when we are exploring GP engagement with portfolio companies, we use the terms stewardship and engagement interchangeably, while acknowledging that stewardship typically covers a broader range of actions. It is worth noting that, in private equity, the terms active ownership and value transformation – specifically as it relates to ESG factors at a portfolio company – can also be used as synonyms for engagement.

At its core, stewardship and engagement are about seeking change or improvement. A good litmus test of whether or not something counts as stewardship is to ask if the action:

- intends to move a company towards improving its management of, performance on or transparency regarding a particular ESG issue;
- contributes to decreasing negative outcomes and increasing positive ones;
- inches markets closer to the ultimate aim of achieving a sustainable financial system.

Stewardship for minority investors

We will discuss special circumstances and considerations for minority investors throughout this paper. Their ability to engage portfolio companies depends upon several factors, including:

- the size of the minority investor's holding;
- whether the investor has a board seat;
- any agreements that enable engagement through negative control rights or other means;
- the presence of a lead investor/sponsor;
- the minority investor's relationship with the lead sponsor.

For simplicity, we consider three scenarios of general partner minority positions:

1 Growth equity

- Growth equity investor with minority share of ownership;
- Likely has at least one board seat
- Majority share of ownership still held by founder management;
- Other investors may be involved but none are considered the lead investor.

2 Co-investor with board seat

- Minority co-investor with at least one board seat;
- A lead investor holds majority share of ownership.

3 Co-investor without board seat

- Minority co-investor without a board seat;
- A lead investor holds majority share of ownership.

A SPECIAL NOTE ABOUT DATA COLLECTION

When it comes to clarifying what counts as stewardship in private equity, data collection provides a tricky example. GPs requiring ESG data from portfolio companies is a common practice. Many GPs need this information for their own private reporting to their limited partners. However, the mere act of asking a company to report on something for reporting's sake is not stewardship.

Data collection, however, can count as stewardship in two scenarios. First, if the GP uses the request to signal to the company the importance of a particular issue and an expectation that the company improves its performance on the indicator year-over-year. Secondly, if the GP encourages the company to make the indicator public and therefore introduces an element of public accountability for the data point.

Data collection is also an important enabler of stewardship and often a precursor to a GP taking action. GPs use ESG data to identify areas of concern or opportunities for improvement. They will then monitor data for signs of improvement or the need for more action.

In sum, whether or not data collection is a form of stewardship depends on GPs' intentions when collecting information and how they use it.

THE WHEN, WHO, WHAT OF PORTFOLIO COMPANY ENGAGEMENT

Key messages:

- **When:** Different levers are effective at advancing ESG goals during the pre-investment, holding period and exit stages of an investment.
- **Who:** As the gatekeeper between GPs and portfolio companies, the deal team is critical to engagement success. We explore six strategies to increase deal team buy-in.
- **What:** Selecting and prioritising engagement objectives depends on whether investors take a bespoke approach for each company or pursue key ESG priorities across all portfolio companies.
- Investors focused on systemic risk can pursue positive sustainability outcomes that build on company-specific material risks.
- Throughout this section, we explore how each element applies to minority investors.

There is no one-size-fits-all approach to stewardship with portfolio companies but there are common elements. When an investor is trying to change the policies or practices of a company, an individualised approach that takes into account the company's business and operating environment tends to be most effective. However, in every engagement, investors must decide what they will engage on, when they will start their engagement, whom they will engage and what tools will be most effective in bringing about the desired changes.

Guiding these decisions is the investor's end goal for the company. By setting a clear intention at the outset, a GP will have insights throughout the engagement on progress made and still needed towards the desired end point. Investors will need to monitor progress and remain nimble in their approach – trying out different tools or rethinking what might be compelling to the company if the first approach is not successful.

This section will seek to aid GPs in determining the when, who and what of portfolio company engagement. The section that follows describes how to increase the effectiveness of engagements using a range of stewardship tools.

WHEN TO ENGAGE

In this section, we delve into how the private equity life cycle intersects with and influences portfolio company engagement. We discuss various practices that private equity investors can consider at the key phases of their investment time horizon that improve the likelihood that an engagement will achieve its desired goal.

We will explore the following parts of the private equity investment life cycle – pre-investment (split into due diligence and investment agreement), holding period, and exit. For GPs in buy-out or growth strategies, the majority of their stewardship actions will take place during the holding period, but the due diligence phase and exit can greatly influence what is achieved during this timeframe. For minority co-investors, the pre-investment phase is the most important for securing the target company's and other investors' buy-in for the GP's stewardship activities post investment.

PRE-INVESTMENT

The ability to conduct stewardship at this phase is often quite limited due to short due diligence timelines and limited data availability and access to management. Instead, the pre-investment phase is when GPs can start to set expectations around how they will be working with the future portfolio company on sustainability. This can be done via the data requested at this stage, conversations during due diligence, or more formally in the drafting of deal documents when negotiating the investment agreement.

Due diligence

Including ESG in due diligence improves investors' understanding of potential risks and opportunities early in the process. It also helps the portfolio company know what to expect as it is brought into the GP's fund. The portfolio company's management team is less likely to be surprised by, and more likely to understand, the need for and value of future ESG requests. This helps to maintain a positive working relationship between the GP and the portfolio company and improves the likelihood that management will be receptive to the future requests.

How much an investor can accomplish at this phase depends on the nature of the deal. Some investors may be able to conduct full ESG due diligence, identify which ESG issues to prioritise and create a related value transformation plan at this stage. Some will even begin to engage with a company by having calls with management to identify potential areas and plans for improvement.

On the other hand, when it is a highly competitive deal, an investor may only be able to prioritise assessing a company's most material ESG factors during due diligence – as these could affect the deal team's overall investment thesis. In these situations, the investor will conduct its priority-setting process – when the investor determines what to engage the company on – during onboarding at the start of the holding period.

> "It would be surprising if there was a portfolio company who took us on as an investor who were not aware that [ESG] was likely to be a factor. Due to how this manifests in our diligence process and because we work in partnership with our deal teams, management will have already gotten questions from us during the due diligence process. So, by the time we're showing up with the value creation plan, they are already attuned to the fact that [ESG] will be part of it."
>
> Anonymous

Investment agreement

During investment negotiations with portfolio companies, clear articulation of the GP's ESG expectations can help smooth the way for future engagement.

If a critical ESG issue – one that impacts a GP's overall investment thesis or evaluation of the company's risk profile – emerges during due diligence, GPs may:

- Decide not to invest.
- Create a clear expectation that the company will address the issue immediately after the deal closes, for example through inclusion of mitigating activities in deal documents and/or the 100-day plan.
- Make closing the deal contingent on the portfolio company first fixing the issue.

While most engagement happens during the holding period, the last two items are examples of stewardship that can happen pre-investment. At the point of closing the deal a GP may have significant influence which it can use in support of its ESG objectives. GPs may then codify that influence into 100-day plans, Shareholder Agreements (SHAs) or other agreements negotiated around the deal close.

It is becoming common practice for GPs to incorporate material ESG risks and opportunities identified in the due diligence process into 100-day plans for the majority of their private equity investments. Fifty-five percent of respondents in the private equity module of PRI's 2023 Reporting Framework reported that they do so. [1]

An emerging practice is to also add formal language regarding ESG stewardship to other deal documents, such as SHAs. Some investors in our consultation noted that these clauses are typically quite broad and general, and therefore of questionable value. For instance, indicating that ESG is important to the GP and that the GP expects the company or co-investors to agree to work on ESG issues.

Other investors are getting quite specific in what they require a company to agree to prior to investment. One Reporting Framework respondent said that some investments cannot be finalised unless the portfolio company has accepted a detailed ESG action plan created during due diligence.

Interestingly, several GPs shared that having strong ESG stewardship capabilities helped them with deal flow or closing competitive deals. One investor shared that having positive working relationships with labour unions helped it learn of future business sales. In another case, an investor shared that having a positive reputation for ESG transformation has assisted with winning over reluctant-seller situations because sustainability or ESG was an interest of the founders.

1 The PRI (2023), Reporting Framework, analysis of indicator PE 4 respondent data

The importance of due diligence for minority investors

For minority investors, the pre-investment phase is when they can negotiate what role they will have in the investment, including what tools are available for them to engage in stewardship. Minority investors have greater ability to connect with the company directly if they negotiate for a board seat, obtain negative control rights or include a clause in SHAs addressing the ability to work with the portfolio company on ESG issues.

Many minority co-investors are keen to trust the lead GP's transformation plan and act more as a silent partner in the deal. These investors will still want to establish clauses in the deal documents requiring notification in the event of a serious ESG controversy.

Most minority co-investors seek to have a positive working relationship with the lead sponsor. The pre-investment phase provides an important opportunity for establishing the tenor of the relationship as well as trust in the lead sponsor. During this period, minority investors can conduct due diligence on both the prospective company and the lead sponsor or, in syndicated deals, only on the lead sponsor. This analysis enables the minority investor to determine its confidence in the lead sponsor's ability to manage the material ESG risks identified pre-investment.

At the end of the review, if the co-investor is not confident in the lead sponsor's ESG risk management abilities, it has two options. It can walk away from the deal if the ESG risks are high. Or it can try to establish itself as a trusted advisor to the lead sponsor to provide training on ESG best practices throughout the life of the co-investment relationship.

Alternatively, if the co-investor determines that the lead investor's practices are more advanced than its own, it could treat the investment as an opportunity to collaborate, learn and improve its own practices.

> "We conduct our own materiality-based assessment on the company and we also conduct ESG diligence on the lead sponsor. This analysis is intended to help us determine what confidence we have that the GP will be able to manage these material issue risks or factors."
>
> Anonymous

HOLDING PERIOD

A typical private equity holding period ranges from three to seven years. This is when GPs will have the most influence and when the majority of stewardship activities takes place. The general rule for ESG engagements is to start as early as possible during the holding period as that gives more time to make the necessary changes before exit.

During the on-boarding phase, investors should gather the ESG data they need to benchmark current performance and identify where there are opportunities to move the company. Onboarding is also an appropriate entry-point to educate senior management about the GP's ESG expectations if this was not covered during due diligence.

Outside of any formal agreements made during the investment agreement phase, the investors we spoke to had a wide range of opinions on what should happen during the first 100 days to six months of the holding period. The actions that investors take during this timeframe vary based on their style and their perceptions of the company's readiness to be engaged. Generally, we observe three approaches:

Start: Begin a collaborative partnership with the portfolio company on the priority ESG goals.

Wait: This approach was common when it was clear that the management team would be replaced, either fully or partially, upon acquisition. In these cases, the consensus was to wait until the management team stabilised. If possible, the GP's ESG team should work with the deal team to hire senior managers who have relevant ESG experience or who seem open to the GP's ESG transformation thesis.

Tackle governance: Other investors believe that the early days of a relationship with a portfolio company is the perfect time to start building out the governance infrastructure that will be needed to support the ESG initiatives at the portfolio company. These investors use the first six months to set up the required board committees and establish policies, reporting structures and so on. Having supportive governance mechanisms in place supports the management team's willingness to undertake the GP's future ESG requests.

For the remainder of the holding period, GPs will use an assortment of tools (see **Tools of stewardship** section) to move their portfolio companies towards their prioritised ESG goals. Along the way they will measure progress and adjust their strategy as needed.

> "The majority of our engagement occurs during the holding period. Following investment, we start by setting the governance and identifying the person responsible for ESG integration, generally the CEO; holding an ESG training for the portfolio company's entire management team; and then working with management on the materiality analysis and on identifying the actions, targets, and monitoring KPIs for the material topics identified with the aim of creating value and mitigating risks."
>
> Daniela Popa, ESG Manager, Ambienta

EXIT AND POST-EXIT

In order for an engagement to be considered a success, a GP must move a company from willingness to act, to being capable of acting, to taking action and achieving the intended goal (or putting the company on a path to achieving it) all before exit. Leaders in stewardship also expand their lens to include whether the company is likely to continue acting on the intended sustainability goal after the GP has exited its position.

A GP typically has very little leverage at the exit phase in the investment life cycle as it unwinds its position. Exits therefore mostly serve as a motivating force for engagements conducted during the holding period. When a GP develops its exit strategy, it should also be evaluating the company's progress to date and any opportunities to enhance the company's performance on ESG factors to maximise the investment's end value.

For example, if the GP is planning to exit by selling the holding to another company, it should consider how the portfolio company can match or exceed the sustainability performance of its new parent. If the GP plans to sell the portfolio company to another GP, it should consider which ESG issues the other GP prioritises. Positive performance on those may make for a smooth exit at the highest possible value. If an IPO exit is planned, the GP should consider ways to position the company with regard to ESG credentials, such as:

- achieving a positive rating from the major ESG research providers;
- getting included in ESG indices;
- meeting the sustainability disclosure criteria of its future stock exchange;
- confirming eligibility for article 8 or article 9 funds (a consideration GPs may also undertake when selling to other private equity owners).

From a sustainability outcomes perspective, an engagement is not considered a success if the portfolio company abandons its efforts shortly after the GP has exited. Therefore, leading GPs also concern themselves with comporting their engagements in a way that embeds improved ESG performance at the company even after the GP is no longer a partner. Here are some strategies that these GPs employ:

- **Focus on corporate culture:** Given the sticky nature of corporate culture, it is unlikely to change with the exit of the investor. GPs' influence on senior managers within the company is a significant lever in this area. The executive management team plays a considerable role in setting a tone at the top. Therefore, achieving management buy-in during the holding period can often be critical to the post-exit success of an engagement. When done well, a corporate culture is embedded that can persist even if there is a change in senior leadership. In the **Tools of stewardship** section we discuss how GPs can impact management buy-in.
- **Promote public commitments:** If a portfolio company has publicly committed to a particular action or policy as part of a GP's ESG engagement, it is less likely to reverse its commitment post-exit. Examples of public commitments include those a portfolio company self discloses, such as goals in a corporate sustainability report, and commitments disclosed through third parties, such as the Science Based Targets initiative (SBTi). One GP in our consultation noted that the portfolio companies it helped pursue B Corp Certification seemed to remain committed to the B Corp process following exit.
- **Link ESG performance to executive compensation:** Executive compensation structures also tend to be sticky at portfolio companies post-exit.
- **Negotiate with the new buyer:** One GP in our consultation was able to negotiate the insertion of a clause in the SHA pertaining to the continuation of ESG programs put in place during its ownership. Presently, these sorts of contracts are rare. In this instance, the selling GP retained a minority position in the company, which likely helped its ability to obtain such a concession.

Of course, portfolio companies are also likely to pursue the GP's engagement priorities post-exit in the case of complete business transformations – such as when a GP brings about a new business line or revenue structure.

Emerging practice: impactful exits

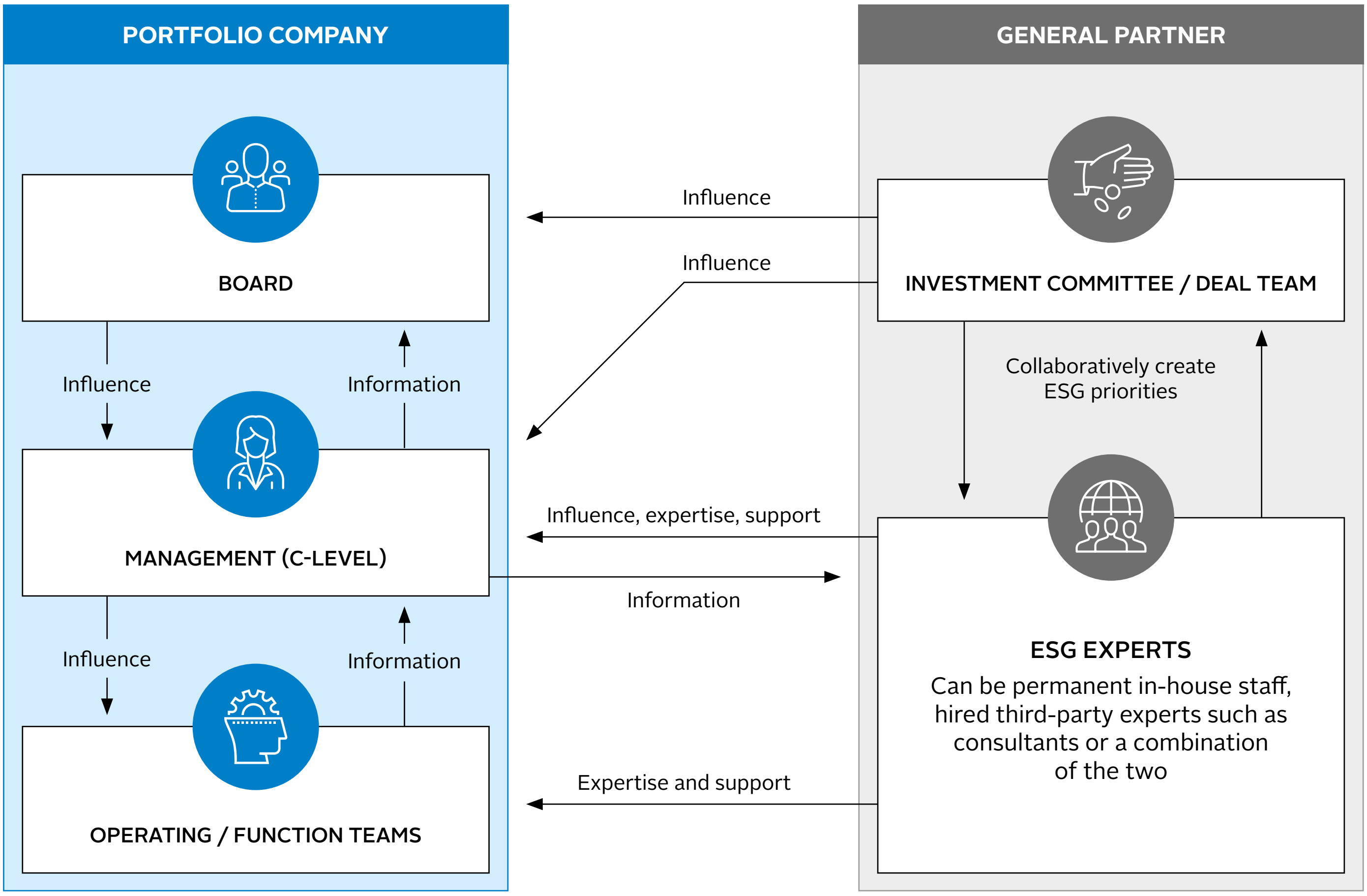
A handful of private equity investors are evaluating how their exit from a portfolio company can generate a positive impact. These GPs may explore channels for employee ownership of the firm or sharing capital gains from the sale of the portfolio company with the company's employees. Ownership Works is one example of this approach.

WHOM TO ENGAGE

GPs who are brand new to the concept of ESG stewardship may be surprised to learn that the initial focus of their engagements should be on their own team. Repeatedly throughout our consultation, GPs told us that investment committee/deal team buy-in was critical to the success of their engagements. This is because the deal team is the gatekeeper between the GP and the portfolio company.

Throughout the course of stewardship, a matrix of relationships is built among the private equity GP, the portfolio company and within the two organisations. When the deal team understands and sees the value in its firm's ESG expectations, those expectations are passed on to the portfolio company's board. From the board, those expectations cascade down to the executive management team and from there are assigned to operating and function teams to implement and execute. Figure 1 illustrates the ways that expertise, support and information can flow between the different parties.

Figure 1: Matrix of stewardship relationships



This lattice of relationships is part of the reason why private equity investors can experience such success with their engagements. As can be seen in Figure 1, the management team is receiving influence on ESG from three directions; if it is not receptive to its GP's in-house ESG specialists, the message can be reinforced from the deal team and the board. This is a concept we will explore again in the **Escalation** section.

Below we highlight a range of strategies available to investors to gain deal team buy-in if it has not already been secured.

- **Buy-in from the top:** If the CEO or top management team within the GP endorses the importance of ESG-related risks, it is more likely to be viewed as important by the investment committee and deal teams.
- **Training programs/inductions:** Inductions of new investment analysts should include training on ESG risk factors. Existing deal team/investment committee members should also receive training on the value of ESG risk assessment for the investment side of the house. Case studies from portfolio companies that recognised economic benefits from implementing ESG best practices can be used in trainings to highlight the value of integrating ESG considerations.
- **Write-ups and routine procedures:** The deal team's documentation, presentations, and key performance indicators should include an assessment of ESG-related risk. In addition, after the deal has closed, ESG considerations should be a standing agenda item for portfolio company board meetings. This supports awareness of ESG factors becoming a systematic part of the process.
- **Positive peer pressure:** This approach works by leveraging the competitive nature of deal teams and analysts. Firms may use ESG data collected at the portfolio company level to create fund-level ESG profiles, and then distribute these details across the firm to allow comparison across deal teams, funds or strategies. Some firms go a step further by offering an annual ESG awards program.
- **Anticipated regulatory pressure:** Some investors in our consultation noted that ESG factors have become part of their internal auditing process in preparation for future ESG regulatory requirements. Elevating ESG to a compliance consideration increases its level of importance for the deal team.
- **Deal team compensation:** Tie variable compensation for deal team members to performance against ESG goals.

Approaches for minority investors on whom to engage

For growth equity investors, there is no change in the above guidance.

For co-investors with and without board seats, the lead investor will become an important focus of their engagement efforts. This is because the lead investor will typically be the de facto gatekeeper to the relationship with the company.

Were a minority investor to skip engaging the lead investor and go directly to the company, the minority investor risks:

- creating confusion amongst the company's management team regarding the co-investors' priorities;
- creating friction in the company's decision-making, possibly wasting time and resources and harming the value of the investment;
- damaging the relationship with the lead investor, which could exclude the minority investor from future deals.

Therefore, even when a co-investor has access to the board via a board seat, it will often still seek to align and coordinate with the lead investor in the first instance.

Presently, most interactions between co-investors and lead investors relate to data gathering for non-stewardship purposes, such as fulfilling data collection requirements from the minority investor's LPs. As noted earlier, data collection for these purposes does not count as stewardship.

The PRI's Principle 2 on stewardship applies to co-investors even though the lead investor's role limits a co-investor's ability to engage with the underlying portfolio company. We will explore tools that minority investors can use to engage their portfolio companies and lead investors in the **Tools of stewardship** section.

WHAT TO ENGAGE ON

Before stewardship with a portfolio company begins, a private equity GP must first decide what it will be engaging its company on and what it is seeking to get the company to do.

There are generally two ways that GPs do this: adopting a bespoke approach for each company or having a set of ESG priorities that they pursue at every company. These are not mutually exclusive.

The GP's internal context and maturity with working on ESG issues will frequently dictate which of these approaches it takes. For instance, the number of portfolio holdings and the bench strength of its in-house ESG capabilities may impact whether it has the capacity to consider bespoke ESG engagement plans at each company.

GPs with a more concentrated set of holdings may find that they are able to do both scenarios easily. Whereas GPs with over 100 companies in various industries will find that a bespoke ESG engagement plan for each holding is untenable without a requisite number of in-house ESG specialists or significant outsourcing.

These GPs could either pursue a highly customised approach at a handful of companies or specialise on certain issues and seek positive performance on these issues at all or most of its holding companies. The GP must decide, at a fund level, what will be the most valuable way to implement its ESG strategy. Both scenarios could result in similar value accruing to the fund, but each will require a different engagement procedure and allocation of resources.

Most GPs start with a bespoke approach, which can be costly and difficult to maintain as the number of portfolio holdings increases. As GPs' practices mature, many find that engagement costs can be reduced by pursuing a set of common ESG engagement priorities across the portfolio. Efficiencies include specialisation of the team's skill set and developing resources that can service the entire portfolio. This whole-portfolio approach may help companies address systemic sustainability issues[2] that are important to all market actors, including future buyers of portfolio companies and the general partner's LPs.

In the next sections we unpack these two approaches to engagement strategy and conclude by discussing how a focus on sustainability outcomes would be beneficial for private equity investors.

BESPOKE APPROACH

In this approach the GP will start by identifying potential areas for engagement to pursue with a given company. To develop a comprehensive list of ESG issues for engagement, private equity GPs are encouraged to consider:

- Conducting a materiality assessment to identify material risks and opportunities arising from the company's operations. Such analysis would consider the demands and needs of – and impacts on – key stakeholders such as employees, suppliers, customers, regulators and the communities and natural systems surrounding the company's operations and supply chain;
- Appraising the current and future level of regulation;
- Evaluating the priorities of key LPs;
- Exploring what will be needed at exit, reflecting the likely priorities of target buyers;
- Identifying positive and negative real-world outcomes related to investees' operations, products and services.

GPs will then pare back that list to a manageable set of items that will be the focus of their stewardship with the portfolio company. GPs can use the questions in Figure 2 to isolate engagement priorities:

> "We tailor our engagement with companies based on several factors – the material issues for that company, what industry and geography they operate in, and the regulatory environment around their business. We also take into account the maturity of the business and engagement from the management team alongside our ability to influence through our ownership stake or number of board seats in the company. We look at all these different factors with the goal of engaging with companies across our portfolio."
>
> Leela Ramnath, Global Head of Sustainability Strategy, Warburg Pincus

2 From the Reporting Framework glossary, these are issues that pose systematic risks to the common economic, environmental and social assets on which returns and beneficiary interests depend. Systematic risk (interchangeable with "market risk" or "market-wide risk") refers to risks transmitted through financial markets and economies that affect aggregate outcomes, such as broad market returns. Because systematic risk occurs at a scale greater than a single company, sector or geography, it cannot be hedged or mitigated through diversification. However, systematic sustainability issues can, and should, be influenced through responsible investment activities.

Figure 2: Questions for GPs to identify ESG engagement priorities

REVENUE FOCUSED

- Will positive/negative performance on the issue affect revenues?
- Is the company positioned to generate new revenue streams based on the issue?
- Is there something that clients want that can be recognised immediately as a revenue opportunity?

PEER COMPARISONS

- How does the company compare to similar businesses?
- Are there areas where the company is clearly lagging or where it has an opportunity to stand out as a leader?

COSTS AND PROFITABILITY

- Will positive/negative performance on the issue affect costs or efficiency?
- Will positive/negative performance on the issue affect employee recruitment and retention?
- Is the company facing increased compliance or legal costs, labour strikes, or customer or community boycotts if a particular action is not taken?

VALUATION AND PORTFOLIO IMPACTS

- Will the company's actions on the issue result in a negative externality that could harm one of its stakeholders (including the natural environment) or affect wider systems on which the GP's portfolio depends?
- Will positive performance on the issue lead to future buyers paying more for the company?
- Will negative performance on the issue pose reputation or license-to-operate risks for either the portfolio company or the GP?

WHOLE-PORTFOLIO APPROACH

In the second approach, the GP will begin by creating a thesis on which ESG issues have a significant impact on all or a majority of the companies in its portfolio. Factors to consider:

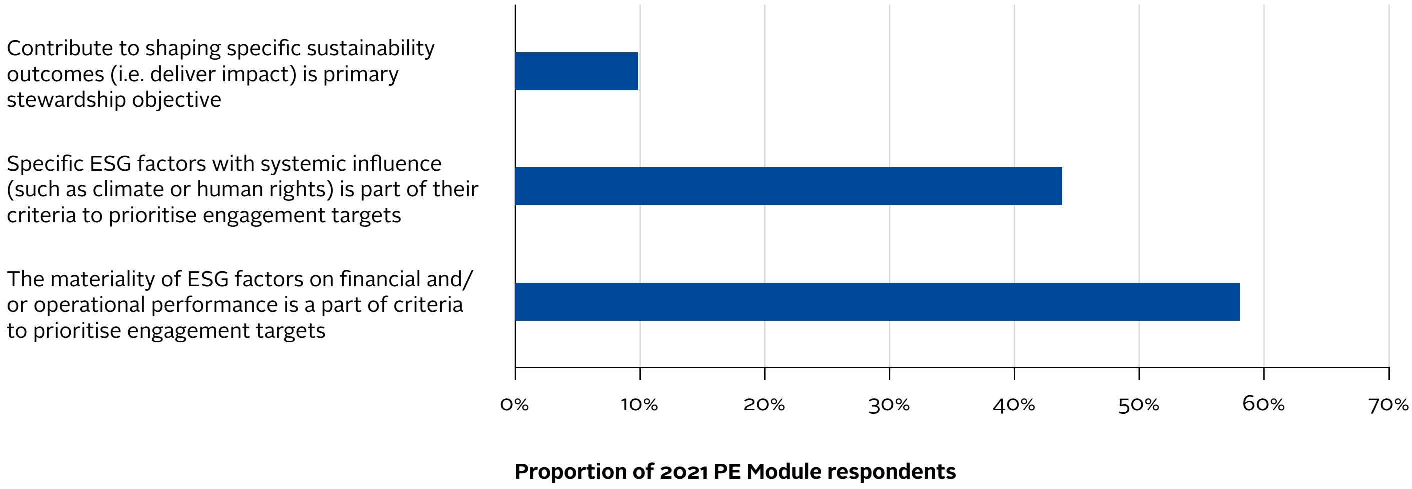
- **Current or proposed regulation:** Globally, companies are increasingly expected to robustly report on material ESG matters. This is particularly true for climate risk, where regulations increasingly require improved governance, data disclosure and risk assessment.
- **Global norms:** For example, standards calling for the respect of universal human rights.
- **Systemic sustainability issues:** Issues that pose systematic risks to the common economic, environmental and social assets on which returns and beneficiary interests depend. These can be risks transmitted through financial markets and economies that affect aggregate outcomes, such as broad market returns.
- **Minimum standards:** For example, as markets' expectations of managing ESG risks increase, companies will likely be expected to have proper governance systems to manage and oversee the companies' ESG efforts.

Four ESG issues came up during our consultation as being the ones most commonly pursued by GPs across all their portfolio holdings: climate change; diversity, equity and inclusion (DEI); cybersecurity; and proper ESG management systems.

Approaches for minority investors

Being a minority investor may affect how an investor identifies a list of priority issues. For growth investors, the process may resemble that used by majority investors. For minority co-investors, some may defer to the lead investor. Others may go through a default priority-setting process and share their thoughts with the lead sponsor in a collaborative manner. Others may speak up only in extreme situations to propose that an issue is engaged on to prevent reputational damage.

Figure 3: Criteria GPs use when setting engagement priorities



Source: The PRI (2021), Reporting Framework, analysis of indicators ISP 15 (first bar) and ISP 16 (second and third bar), private equity respondents' data only

SUSTAINABILITY OUTCOMES

The majority of GPs conducting ESG stewardship do so with a company-specific, materiality-only focus. Only a small subset of leaders is taking a broader view to consider systemic sustainability issues and outcomes when determining engagement priorities (see Figure 3).

Increasingly, PRI signatories are recognising that the real-world sustainability outcomes connected to their investment activities can feed back into the financial risks they face. For example, negative sustainability outcomes at a portfolio company can:

- pose financial risks over short- and long-term time horizons due to legal and regulatory developments;
- harm the investor's reputation or social license to operate;
- harm other assets in the GP's portfolio or other funds.

Investors are also increasingly focusing on what they can do to protect the value of their portfolios from systemic risks linked to sustainability issues, such as climate change, biodiversity collapse or social instability. These risks cannot be mitigated simply by diversifying the investments in a portfolio.

They threaten the functioning of the economic, financial and wider systems on which investment performance relies. Such universal risks threaten the performance of all portfolios exposed to those systems.[3]

As the Freshfields, PRI, and Generation Foundation report, [A Legal Framework for Impact](), establishes, if an investor concludes, or on the available evidence should conclude, that certain sustainability issues pose a material risk to achieving its financial investment objectives, it will generally have a legal obligation to consider what it can do to mitigate that risk and to act accordingly. This could include using stewardship with investees or engagement with policy makers to pursue positive sustainability outcomes that could influence the relevant sustainability issues or the assets' exposure to them; and to do so in ways that reduce the investment risk.[4]

3 The PRI, Freshfields Bruckhause Deringer and Generation Foundation (2021) A Legal Framework for Impact

4 The PRI (2023), Evaluating stewardship for sustainability

A focus on sustainability outcomes can bring benefits in addition to risk management. These include aligning with client and beneficiary expectations and improving opportunities for the asset to benefit from global transitions – such as the transition to a low-carbon economy.

Increased investor focus on sustainability outcomes will be necessary to achieve a sustainable financial system that benefits investors, beneficiaries and clients alike.[5] Private equity investors are well positioned to make a meaningful impact on sustainability outcomes because of the operational control they can have over portfolio companies. For instance, they have an outsized opportunity to transform high-emitters to become less energy intensive – creating an immediate positive outcome on emissions and increasing the asset's value for future buyers.

It is important to emphasise that a focus on sustainability outcomes does not mean that the GP has abandoned its focus on materiality or fiduciary duty to maximise risk-adjusted returns. What distinguishes a sustainability-outcomes focus from a materiality focus is that the GP will consider systemic sustainability issues as it determines its ESG engagement priorities with a target company. It also will seek to align intended engagement outcomes with global sustainability goals and thresholds that are reflected in internationally recognised frameworks. Examples include the Paris Climate Agreement, the International Bill of Human Rights, and the UN Sustainable Development Goals (SDGs).

For outcome-focused investors, the paradigm is less what can be achieved at an individual company during the holding period and more what actions are needed from that company to contribute to a sustainable financial system. In Figure 4 we delve into two topics – climate change and DEI – to illustrate the different approaches for a materiality-only engagement and one with an intentional focus on sustainability outcomes.

> "If the company is executing on sustainability outcomes and internalising sustainability outcomes as a business driver, we are ultimately seeing a much stronger company on the other side after 3-5 years of the investment. There's a higher valuation on the back end."
>
> Serge Younes, Head of Sustainability, InvestIndustrial

Figure 4: How engagements are shaped by the investor's focus

Topic	Materiality-centric	Sustainability outcomes
	GPs encourage portfolio companies to...	
Climate change	▪ Measure and track their carbon footprint. ▪ Create an annual TCFD report.	▪ Set science-based emissions reduction goals in line with 1.5°C thresholds. ▪ Pursue decarbonisation in line with year-over-year reduction scenarios from the IPCC.
Diversity, equity and inclusion	▪ Hire diverse managers and directors. ▪ Track and disclose employment diversity at various levels. ▪ Develop a DEI strategy to recruit, develop and retain diverse workers.	▪ Minimise negative outcomes/increase positive ones relating to the companies' impact on DEI beyond their workforce, such as on customers, community members, and suppliers. ▪ Where possible align with the goals set out in SDGs 5, 8 and 10 (gender equality, decent work, reduce inequalities).

5 The PRI defines a sustainable financial system as one that rewards responsible investment, operates within planetary boundaries, respects human rights and promotes equitable societies.

THE TOOLS OF STEWARDSHIP

Key messages:

- Stewardship can be conducted at the company level and at a more systemic, capital markets level.
- Publishing research, developing pools of diverse director talent, engaging with regulators and collaborating with other GPs can all contribute to capital market transformation.
- Company-level transformation often begins with setting up the governance and incentive systems needed to facilitate change.
- Investors have multiple tools to encourage portfolio companies' willingness, capacity and ability to take action to meet the investors' engagement objectives.
- While it is rare for GPs' engagement efforts to stall, investors can re-strategise or leverage their matrix of relationships within a company as escalation strategies.

Throughout our research we came across several practices that GPs frequently use to advance their stewardship efforts. Below we list many of these tools to help illustrate what stewardship can look like for this asset class. We split these practices into two levels of stewardship for the private equity asset class: actions to transform capital markets and, within this broader category, actions to transform portfolio companies. Each is explored in detail below.

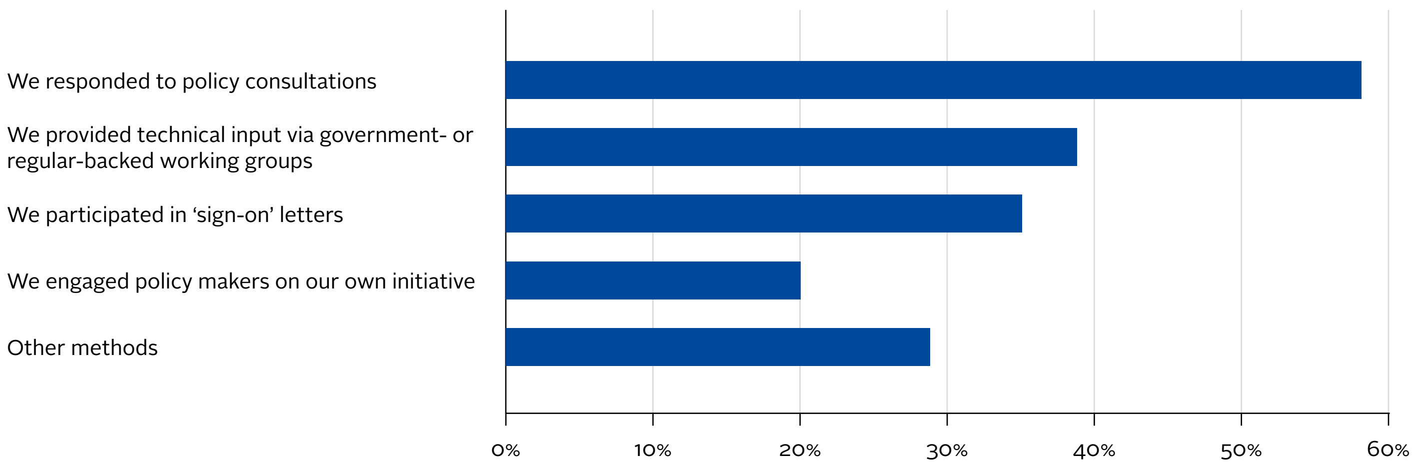
ACTIONS TO TRANSFORM CAPITAL MARKETS

This category relates to how an investor leverages its influence on actors within the capital markets – companies, other investors and regulators or policy makers – to maximise the long-term value of economic, environmental and social systems. The actions that are not company-specific fall into three main areas:

Public policy engagement: Public policy critically affects the ability of investors to generate sustainable returns and create value. The ways that investors can participate in public policy engagement is asset-class agnostic. Engagement with policy makers can refer to investors' direct or indirect dialogue with regulators or other policy makers to contribute to specific policy developments. It may include participating in sign-on letters; responding to policy consultations; providing technical input via government- or regulator-backed working groups; or engaging policy makers on the investor's own initiatives. Engagement with policy makers may be conducted individually or through investor collaborations. It may also be conducted on behalf of investors by third-party organisations such as trade associations, think tanks, service providers or non-profit organisations. For further details and resources, please see the PRI's A sustainable finance policy engagement handbook.

The private equity industry often engages on public policy through various channels, such as industry bodies like BVCA[6], Invest Europe or the American Investment Council. Figure 5 details the proportion of private equity investors using various public policy tools.

Figure 5: Use of public policy stewardship methods



Source: The PRI (2023), Reporting Framework, analysis of indicator PGS 39.1, private equity respondents' data only

6 The British Private Equity and Venture Capital Association

Contributing to public goods: This refers to the development of resources that can help bring about sustainability outcomes or encourage alignment with best practices among actors in the economy and society. Typically, this tool refers to contributions to public intellectual property, for example research publications. However, private market GPs that have programs to develop new director talent may also be contributing to public goods in a unique way.

As investors and advocates of board diversity have learned, underrepresented populations on corporate boards face a glass ceiling effect. Most board nominees are chosen from C-suites of other companies or individuals with former board experience – populations that historically and persistently have been majority white male.

Private equity investors play an outsized role in hiring and appointing senior talent. According to 2020 data from Executive Advisory, a Chicago-based research and executive recruiting firm, more than a quarter of paid board seats in the United States are created by private equity firms.[7] Also, 2023 data from the University of Chicago noted that 71% of private equity buy-outs hire a new CEO.[8] In addition to setting portfolio-wide board diversity goals, many GPs are also taking an active role in developing the talent pipeline through training and mentoring programs. Talent-pool development extends beyond DEI to encompass training and developing ESG-competent directors, also presently underrepresented on corporate boards. By developing a diverse pool of first-time directors and executives, private equity investors are helping to erode the headwinds that face underrepresented groups.

Influencing standards through collaboration: Collaboration in the private equity asset class typically manifests as GPs working together in groups focused on specific ESG issues that they are grappling with individually at their portfolio companies. This differs from collaboration in listed equity, where investors will work together to engage either a single company or a group of companies on a particular issue or issues.

In these issues-based groups, GPs will work with other GPs, LPs and investors from other asset classes to pool resources and expertise to tackle issues where the industry does not yet have a clear pathway, such as on climate change and biodiversity. The GPs can then take expertise gained from these collaborations back to their engagements with their investment holdings.

> "I think from a sustainability and responsible investing perspective, the growing amount of collaboration is phenomenal because, what would have taken us maybe a decade to try to figure out independently, is taking us months because we're collaborating and putting a lot of brain power into figuring out what we need to do."
>
> Serge Younes, Head of Sustainability, InvestIndustrial

Examples of private equity collaborations

The Initiative Climat International: A global community of private equity investors that seeks to better understand and manage the risks associated with climate change.

Level 20: A non-profit organisation founded to improve gender diversity in the private equity industry.

The Predistribution Initiative: A non-profit organisation designed to co-create improved investment structures and practices that share more wealth and influence with workers and communities.

7 Executive Advisory (2020), Private Equity Board Seats

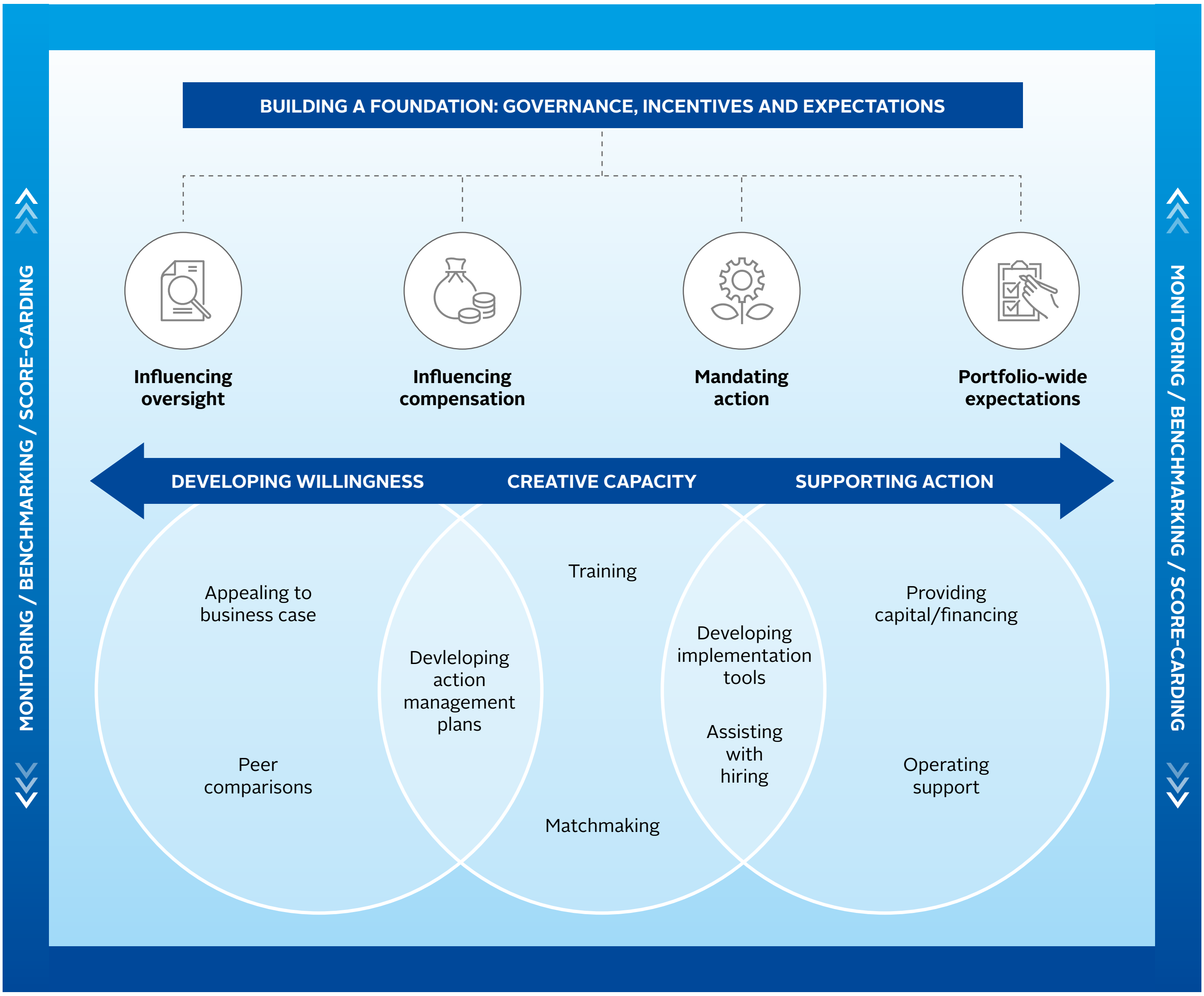
8 University of Chicago, Becker Friedman Institute (2023), The Market for CEOs: Evidence from Private Equity

ACTIONS TO TRANSFORM PORTFOLIO COMPANIES

This section groups the actions GPs often take throughout engagement into five broad categories. The first, focused on governance and incentives, aims to create a foundation for the remaining actions.

The next three areas are developing the company's willingness, creating capacity and supporting action. The final area, monitoring portfolio company progress, cuts across all engagement efforts (see Figure 6).

Figure 6: The GP toolbox to facilitate successful company engagements



BUILDING A FOUNDATION: GOVERNANCE, INCENTIVES AND EXPECTATIONS

Good governance and incentive structures help compel a company to act and move the company through the stages of willingness, capacity and action. Private equity GPs have a variety of options when seeking to influence these structures.

Influencing oversight: Through their roles on the board, private equity GPs can make sure that:

- ESG is discussed at regular intervals at the board or board committee level;
- ESG targets and incentives are discussed at the board level and are subject to board approval;
- ESG targets and incentives are monitored by an ESG-oversight committee or another committee;
- ESG monitoring responsibilities are overseen by a certain level of management, and the management-level committee reports regularly to the board;
- ESG issues are included at annual investor meetings, as appropriate;
- executive management team members are hired and replaced, as needed.

All of these elements help to reinforce ESG's importance to the business and ensure that key ESG risks and opportunities are appropriately managed and accounted for.

Influencing compensation: Via their role on the board, private equity GPs can build incentive structures that encourage company management to act on ESG priorities, such as by linking ESG performance to the management team's variable compensation. So far, this is a nascent practice. Only 9% of PRI's private equity signatories reported doing so for all or most of their investments in 2023.[9]

Obligations from the acquisition agreement: This includes any pre-agreed ESG conditions in the SHA, which help to establish the expectations and operating relationship between the GP and portfolio company (see details on SHAs in the **When to engage** section for more information).

Portfolio-level expectations: As an expectation of all holding companies, portfolio-level goals set a tone that permeates the GP's relationships with each portfolio company. These cross-portfolio intentions may be publicly stated in the GP's disclosures or marketing documents or may simply be an internal program (some GPs are in jurisdictions where the legal or political context makes it difficult to broadcast such intentions). An example of a portfolio-level goal would be requiring all portfolio companies to measure their GHG emissions or to meet TCFD reporting requirements.

DEVELOPING WILLINGNESS

Securing a company's willingness to make progress on a certain ESG objective is frequently the first milestone in a successful stewardship endeavour. Rather than compel their companies to act, most GPs prefer to win the buy-in of the portfolio companies' executive management teams. Some portfolio companies are onboarded into a GP's portfolio already in full agreement that improving certain ESG factors is in their best interest. If this is the case, a GP may forgo these tools and skip to tools to build the company's capacity to change.

Develop and appeal to the business case: Aid the company in understanding why the requested action is in its best interest. This can be done by clearly showing the company how a certain action will increase revenues or decrease costs or by highlighting demands from key stakeholders for a company to take a certain action. Such demands could arise from employees, customers or regulators. Sometimes a GP merely sharing why a certain action is important to itself as an investor can be enough for an investee company's management to begin to champion the issue.

Leverage peer competition: Desire to outperform peers can be a powerful motivator, and so it is important to demonstrate where a portfolio company is lagging industry peers. When no peer comparisons are possible (either due to data issues or because the company has a unique operating context), showing a company how it compares to other portfolio companies can sometimes create the same outcome.

9 The PRI (2023), Reporting Framework, analysis of indicator PE 12

CREATING CAPACITY

After willingness has been achieved, a GP will then need to focus on whether the portfolio company has the capacity and skill level needed to act on the requested transformation. A GP can focus on building willingness and capacity at the same time. For instance, increasing executive management's understanding of the importance of a topic through training can build buy-in for acting on an issue at the same time as developing management's know-how.

Developing action/management plans: In this practice, a GP works collaboratively with its portfolio company to design a roadmap of how the company will achieve the intended outcome. In doing so the portfolio company identifies what resources and know-how it will need to achieve the desired end goal. It also helps management immediately take ownership over operationalising the GP's ESG goals.

Training: This can take the form of specialised training, workshops, annual conferences for investees or seminars. In some cases, it will be the GP's staff that provides the training, in others the GP will hire external experts to present or enroll key personnel from the portfolio company in external courses. Training can be compulsory. For example, some investors mandate that the C-suite of newly acquired companies attend an ESG-onboarding session. In the 2023 Reporting Framework, one-third of signatories reported providing ESG training to portfolio company C-suite executives. A quarter said they do so for other employees at the portfolio company.[10]

Matchmaking: Some GPs create networks among their portfolio companies so that they can learn from each other's successes and failures. These networks can help speed up adoption of best practices throughout the portfolio. GPs can also encourage companies to join relevant industry forums and working groups, such as the UN Global Compact, to encourage learning from industry peers.

Assistance with hiring: GPs we spoke to play various roles in helping portfolio companies hire the personnel needed to advance sustainability. Some merely state an expectation that the company hire suitable personnel and help to carve out the budget required. Others help connect portfolio companies with talent search firms. Others play a direct role in helping to train and develop talent. Sometimes consultants are retained rather than hiring additional staff. In these cases, GPs may already have a consultant that they work with, or they may assist the portfolio company in a request for proposal (RFP) process to find the right partner. More than half of the private equity signatories in the 2023 Reporting Framework said they support portfolio companies by finding external ESG expertise, such as consultants or auditors.[11]

Developing implementation tools: GPs develop a range of resources to help a portfolio company undertake a particular action and measure progress. Implementation tools can include creating software solutions, checklists, workbooks, calculators (e.g., a carbon calculator), assessment tools and how-to manuals. Implementation tools can also be a great mechanism to scale efforts across a broader portfolio as the same tools can be used to assist multiple companies.

SUPPORTING ACTION

While a GP may take a driving role in building willingness and capacity, it more often plays a supporting role when it comes to portfolio companies taking action. While some GPs may provide operational support, there is a clear distinction that they are not the operators.

Operational support: GPs sometimes have partners that are dedicated to value creation and working with portfolio companies on ESG issues. These operational partners may help by creating tools (described above) or by providing more bespoke support. For example, one investor in our consultation group noted that her firm helped centralise procurement of renewable energy for several of its portfolio companies. As these companies were small, it would have been challenging and not cost effective for each of them to do this procurement separately.

Providing capital and financing: Sometimes progress on an ESG objective will require the injection of capital. For instance, if a GP is seeking to decarbonise its holdings, it may need to assist with acquiring or upgrading production machinery. Some GPs make a direct investment at the outset of the deal, which they will seek to recuperate a return on at exit; others, through their position on the board, are involved in capital expenditure decisions throughout the life of the deal; others may set up additional investment funds to help fund the initiative. GPs can also explore the use of sustainability-linked loans to tie performance on ESG targets to reduced cost of financing.

10 The PRI (2023), Reporting Framework, analysis of indicator PE 12

11 Ibid

MONITORING/BENCHMARKING/SCORE-CARDING

Extracting data from portfolio companies plays a role in each of the four action areas described above – some GPs even feel that reporting is their strongest stewardship tool. GPs can use the data to monitor and motivate progress on ESG initiatives in multiple ways:

- **Willingness** and **establishing governance and incentives:** Managers are more likely to pay attention to an ESG factor if they know they will have to report to their investors on relevant performance.
- **Capacity:** The company must understand its starting point and its end target to make meaningful progress on an ESG goal.
- **Acting:** Reporting helps the company set effective goals and evaluate year-on-year progress.

Approaches minority investors can use in company transformation

Minority investors have access to some, but not all of the tools used to transform portfolio companies detailed above.

Growth investors can use nearly all the tools, though they may face more limited ability than buy-out investors to use the tools in the establishing governance, incentives and expectations category.

Co-investors (with or without board seats) can:

- monitor, benchmark and score-card in alignment with the lead investor;
- appeal to the co-investor with business cases or peer comparisons;
- invite company management to trainings or matchmaking sessions already being hosted for other companies in the portfolio;
- share any pre-developed implementation tools with co-investors or the portfolio company.

Co-investors with board seats can, in addition, have access to influence on oversight and compensation, but will be more limited than in a buy-out situation.

Minority investors are also coming up with creative ways to conduct stewardship, even when they have limited control and influence.

> "For a number of minority investments, we've put in place an impact committee. This ad hoc committee enables us to discuss ESG on a quarterly basis and have a significant voice, alongside the majority shareholder, with the company."
>
> Candice Brenet, Head of Sustainability, Ardian

THE ROLE OF ESCALATION

Escalation refers to the approaches an investor takes if initial stewardship efforts are unsuccessful at achieving its objectives over a given time period. The need for escalation is uncommon in the private equity asset class, especially for majority investors that have quite a bit of control and influence over the company. Yet, when initial stewardship efforts fail, GPs will need to determine why their efforts are not yielding the desired results and decide the best course of action.

A useful first step is to take stock of where the company is on the continuum of willingness, capacity and action on the desired change. While these three phases do not necessarily need to be followed in a particular order, if a company is failing to act, it is often because it lacks the capacity to do so or an understanding of why it should. From the list of tools above, investors can select the ones they believe to be most relevant and compelling to the company's situation.

For example, if the company lacks capacity, it may mean the investor needs to spend more time investing in training, developing tools or ensuring sufficient personnel support. Breaking down the requested change into smaller, simple, actionable steps may also be helpful.

When a company lacks willingness, however, the investor may need to explore an array of escalatory actions. One step could be to revisit the tools in the willingness section. For example, if management disagrees with the GP's hypothesis of the business case for a particular action, the GP can provide the company with peer comparisons that show how others are approaching the matter.

The multi-layered relationships that GPs have with their portfolio companies, as illustrated in Figure 1, can aid a GP's escalation efforts. If for example the management team shows an uncooperative attitude to a request from the GP's team, the request can be reinforced at the board level. By putting the ESG issue on the board agenda, management is unable to fully ignore it and is expected to be accountable on the matter. Similarly, requiring a company to report on progress relating to the issue can have a reinforcing effect.

Lastly, in an extreme case where the issue is one that the GP views as critical to the business and the deployment of various tools has been ineffective, private equity GPs who are majority owners can replace obstructive management team members.

> "There are concentric circles of influence that the GP systematically can leverage to create urgency, action, and prioritisation. Perhaps you start with the management team, test the deal team's appetite by highlighting optimisation or value creation opportunities, or create a step change by influencing the board's thinking. Depending on the culture change needed, thinking about the various entry points and blended toolkits can help you realise greater change."
>
> Angela Jhanji, Managing Director, EQT Partners

FURTHER READING

STEWARDSHIP

- The PRI (2023), Evaluating managers' stewardship for sustainability
- The PRI (2021), Introductory Guides to Responsible Investment: Stewardship
- The PRI (2019), Active Ownership 2.0: the evolution stewardship urgently needs

SUSTAINABILITY OUTCOMES

- The PRI, Freshfields Bruckhause Deringer and Generation Foundation (2021), A Legal Framework for Impact
- The PRI (2020), Investing with SDG outcomes
- The PRI (2017), The SDG investment case
- Impact Management Platform (2023), Actions of impact management

CASE STUDIES

- (2023) Linzor: Responsible and active ownership in emerging market private equity
- (2023) Frazier Healthcare Partners: Diversity, Equity, Inclusion and Advancement Scorecard

DEFINITIONS

- The PRI, CFA Institute, and the Global Sustainable Investment Alliance (2023) Definitions for responsible investment approaches
- The PRI (2023) Reporting Framework glossary

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UN environment programme finance initiative

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

United Nations Global Compact