

PRIVATE EQUITY

OVERVIEW

- This starter guide provides a quick summary of how a general partner (GP) can manage environmental, social and governance (ESG) issues in private equity.
- It outlines options for how to include ESG issues throughout the investment process, and in the relationship between the GP and the limited partner (LP).
- Selected further reading is provided throughout. For more information on anything in this guide, or responsible investment more broadly, [please get in touch](#).

The PRI defines responsible investment as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership.

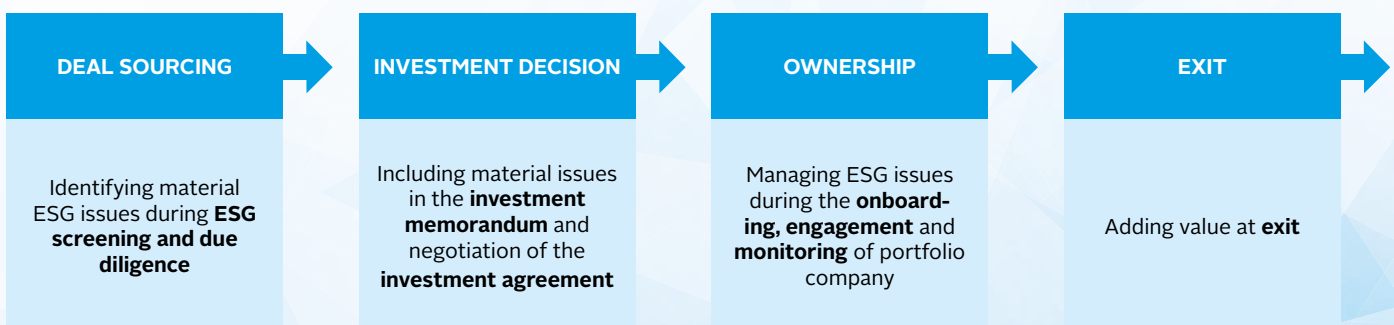
With a strong emphasis on stewardship, and close contact between the GP and company management, private equity is naturally suited to responsible investment. A systematic and informed approach to identifying and managing ESG issues across the portfolio will protect, and can significantly enhance, investment value. Responsible investment is also a marker of the operational excellence of the fund itself, demonstrating transparent and strategic fund management.

AN INTRODUCTION TO RESPONSIBLE INVESTMENT

EXPLORE THE SERIES



This guide will take you through the following typical steps to implement responsible investment across the investment process:



DEAL SOURCING

SCREENING

Private equity firms can screen deals against ESG criteria to identify critical issues. This could prompt further investigation during due diligence or lead to abandoning the investment entirely. The screen could be in the form of a list of serious ESG risks – such as human rights violations and environmental damage – or an exclusion list of controversial industries, such as tobacco or weapons.

GP VERSUS LP SCREENING

Criteria for a screen can come from the GP or LP. A GP can have screening criteria which it applies to investments for a particular fund, affecting all LPs in that fund. Alternatively, an LP can either have its own screen applied to the whole fund by using an investment restriction, or can choose to be excused from a deal using an excuse (or opt-out) right. The criteria will be agreed during fund formation.

DUE DILIGENCE

Due diligence is the point at which to investigate any material ESG issues, and how they are being managed. This process typically involves investigating legacy issues, although it is also important to consider future issues such as climate-related risks and the transition to a low-carbon economy. The issues identified at this stage often become the focus of ESG management efforts during the holding period.

Common approaches include:

- questionnaires to gauge if portfolio companies have an ESG policy and/or related reporting processes in place;
- identifying opportunities to increase company value and reduce risks through ESG initiatives, such as providing health and safety training;
- assessing the potential performance impact of megatrends such as climate change;
- reviewing legal requirements related to ESG issues, such as environmental permits and licenses.

PRI resources:

[A GP's guide to integrating ESG factors in private equity \(chapter 4\)](#)



[Responding to megatrends: Investment institutions trend index](#)



INVESTMENT DECISION

INVESTMENT MEMORANDUM

The ESG findings unearthed during due diligence can be included in the investment memorandum to ensure that the investment committee is aware of such issues when deciding whether to invest in a company. Even if no risks are identified, including this outcome in the memo can be useful to highlight that ESG factors were considered during due diligence. This can include indicating how the company performs relative to its peers.

INVESTMENT AGREEMENT

The GP should clarify its expectations of how ESG issues should be managed when negotiating and finalising the investment agreement with the portfolio company. The GP is more likely to secure management support if it signals its goals early in the process.



PRI resources:

A GP's guide to integrating
ESG factors in private equity
(chapter 5)



OWNERSHIP

Approaches to creating portfolio company value through responsible investment

 <p>Reducing costs and liabilities</p> <p>For example:</p> <ul style="list-style-type: none">■ reducing potential liabilities, such as those stemming from environmental contamination■ increasing engagement, and therefore productivity, of the workforce■ using resources (e.g. energy and water) more efficiently	 <p>Increasing revenue</p> <p>For example:</p> <ul style="list-style-type: none">■ identifying new, sustainable product lines■ attracting and retaining top talent through strong company values■ acquiring new customers as a result of better brand image
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ONBOARDING

Once the investment has been made, the GP can start to have deeper conversations with company management about which ESG issues should be prioritised, and then begin to plan how to manage them. For example, this could involve establishing a process to collect data on energy usage and agreeing on targets to reduce consumption.

WORKING WITH THE PORTFOLIO COMPANY (ENGAGEMENT)

While some companies will have managed ESG issues effectively for some time, others may be less advanced. The GP will need to work with management to balance the responsible investment objectives they want to give the company with the rest of the team's responsibilities.

Measures that can be put in place at the portfolio company include:

- drafting an ESG policy;
- assigning resources and responsibilities, and setting up processes to implement the policy;
- making the portfolio company's board accountable for ESG performance;
- organising meetings with representatives from all portfolio companies to share knowledge on ESG topics.

MONITORING

The GP will need to monitor the portfolio company to assess whether its ESG goals are being met, and may be required to report to LPs on whether ESG issues are being managed properly. Monitoring can involve scheduled meetings with portfolio companies, collecting internal data from the company and reviewing any public sustainability reporting. Site visits can reveal the extent of the company's ESG activities, verify reported information and demonstrate commitment from the GP.

There are numerous resources available offering standardised ESG metrics, as well as software to streamline data collection. Some GPs use two types of KPIs: core (applicable to all portfolio companies, which can be rolled up to generate a fund-level KPI) and tailored (e.g. based on sector).

PRI resources:

[A GP's guide to integrating ESG factors in private equity \(chapter 6\)](#)



[ESG monitoring, reporting and dialogue in private equity](#)



EXIT

The premise underlying all responsible investment efforts during the holding period is that managing ESG issues throughout the investment cycle can reduce risk and enhance company value, which can be realised upon exit.

Other benefits a responsible investment approach can yield at exit include:

- Identifying and managing material ESG issues and ensuring they are well managed avoids a buyer raising unforeseen risks to negotiate a lower price.
- Setting KPIs at the beginning of the holding period provides evidence to support claims that ESG issues are well managed.
- Demonstrating that the company has taken a professional approach to managing ESG issues can be used to signify that the company has been well managed in general.

THE LP-GP RELATIONSHIP

While an LP cannot make, or materially influence, specific investment decisions, an LP can influence a decision-making process. In fulfilling its fiduciary duties, an LP should monitor and, where necessary, engage a GP about the policies, systems and resources used to identify, assess and make investment decisions, including how ESG issues are taken into account.

This can fall into the three main areas:

FUNDRAISING

From the GP's side, references to responsible investment can be included in the Private Placement Memorandum. For the LP, this is the point at which to start enquiring about the GP's responsible investment approach. LPs can also use a due diligence questionnaire (DDQ) as a starting point for dialogue, and should use the PRI's LP responsible investment DDQ: and how to use it (also incorporated into the Institutional Limited Partners Association (ILPA) DDQ).

FUND TERMS

Including responsible investment in fund terms reinforces the GP's commitment to addressing ESG factors, and encourages the adoption of related business practices across the organisation. This can be outlined in the Limited Partnership Agreement or side letter.

REPORTING

Regular communication on responsible investment throughout the life cycle of a fund will help to strengthen the LP-GP relationship, as well as signal good management and manage reputational risks.

PRI resources:

LP responsible investment DDQ: and how to use it



Incorporating responsible investment requirements into private equity fund terms



ESG monitoring, reporting and dialogue in private equity



FURTHER READING

For a list of resources on responsible investment in private equity from other organisations, [visit the PRI website](#).

CREDITS

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