1. Objectives and overviews

- Objectives during ownership and monitoring
  As a company shareholder, a fund manager's principle ESG objectives are: (i) to ensure that ESG risks and impacts are managed effectively and (ii) to capitalise on ESG opportunities that arise to the financial and reputational benefit of the company, the fund and its LPs. In so doing, fund managers build their own knowledge base and experience, which can be applied to other investments and build trust in their brand among LPs with a focus on ESG (including DFIs). The holding period of a private equity fund provides a valuable opportunity to demonstrate 'value add' to a business by realising ESG improvements.

  Too often, fund managers focus on completing thorough ESG DD and developing solid action plans, but post-completion their attention to ESG aspects of the investment significantly decreases. As a result, very few of the valuable insights gained during DD about how to improve and add value to a company are put into practice. Such lost opportunities can result in lower returns to investors and to the fund manager's themselves through their own 'carry' arrangements.

  The fund manager's objectives during the ownership and monitoring phase should be to:

    - Help drive timely implementation of the ESG action plan and improve ESG performance. Build capacity within the company to continue assessing and managing its ESG risks, impacts and opportunities, including new ones that arise during the life of the investment.

    - Guide or assist the company to ensure its ongoing compliance with applicable standards, as stipulated in the investment agreement and in line with the fund's ESG policy.

    - Stay informed and respond to new developments and/or risks relevant to the company's ESG performance.

    - Monitor and record any serious incidents and ensure an appropriate response.

    - Ensure that the company records and reports on key performance indicators.

   - Ensure that the company reviews its strategy in light of any changes, such as changes to regulation, markets and technology, as well as changes to the business itself over the investment period.

The scope of the monitoring activities should be informed by the DD phase.

An overview of the activities of the ownership and monitoring stage is shown in the graphic below.

Click to view diagram

2. Actions

2.1 Build on the relationship established during due diligence

Fostering an open and trusting partnership between the fund manager and the company is key to building value in the company because it encourages fruitful discussions and enables a company to benefit from the fund's experience (and vice versa).

- Fostering an open and trusted partnership

  It is important not see this stage of the investment as one during which a company produces information that the fund manager simply reviews. Funds that really add value to the businesses in which they invest, particularly in emerging markets, are those that are prepared to use their experience and contacts to partner with, advise and guide companies on how to build better, more successful and sustainable businesses. The hard work therefore starts once the ink is dry on the shareholders' agreement.

  The exact nature of the relationship will depend on the fund's investment style, as well as the size and type of investment made. However, irrespective of whether a fund is a small investor in a large business or vice versa, it can build a reputation as an investor that understands ESG challenges and provides value-adding guidance.

2.2 Discuss key points early

Typically, the first stage of the holding period will be the most active. In some instances, the company may face some initial difficulties in getting ESG management systems in place, especially if many have been newly introduced. Changing the company's operations and/or culture takes time. The fund manager should support the company to the best extent possible.

- First meeting post-close

  To build on the relationships established during DD, it may be valuable to hold a meeting focused on ESG issues early on in the ownership phase with relevant members of management in order to:

  - Re-affirm the commitment to the ESG covenants and promises made in the relevant legal agreements.
  - Set expectations regarding the type of working relationship the fund wants to have over the life of the investment.
  - Establish clear lines of communication, both formal and informal.
  - Review and further discuss the action plan.
  - Agree dates for follow-up meetings.
  - Agree templates and timetables for formal monitoring.

- Establish formal governance mechanisms for ESG

  Experience suggests that good ESG performance is achieved when ESG matters form a central part of engagement with a company, through board meetings (where ESG is a strategic business risk), supervision site visits and/or ad hoc informal discussions.

  Several formal mechanisms can be used, as appropriate:

  - Ensuring that one or more of the fund's members that sit on a company's board are responsible for raising and addressing ESG factors at board level (if ESG is a strategic risk and/or opportunity for the company).

  - If board members do not feel qualified to oversee the company's progress against the ESG action plan, appointing an independent ESG adviser to provide advice to the board.

  - If ESG factors are of strategic importance for a company (e.g. high inherent risk companies), establishing an ESG sub-committee to the board can be beneficial, to ensure that sufficient time is dedicated to material ESG matters. The fund can have different levels of oversight and involvement in the sub-committee, including having a voting / observer seat, nominating an independent director and / or reviewing minutes from committee meetings.

  - Linking remuneration of senior executives to certain performance targets on ESG matters.

  - Asking company directors to chair and form the ESG sub-committee in order to maintain close links to the board, while ensuring that strategic ESG factors receive top-level oversight and are fully integrated into business decisions. The company's ESG manager and the fund manager's ESG representative may attend the sub-committee as observers to maintain links with executive management and provide technical input to ESG decision-making.

  - If ESG factors are not core to a company's strategic objectives, but are still significant to day-to-day activities, establishing an executive committee to oversee ESG management, including the implementation of the ESG action plan.

- Revisit and discuss DD findings
  It is advisable to conduct a more granular assessment of any ESG matters identified but not fully addressed during DD and to discuss the findings with the company. This step might be particularly valuable if new risks have been identified since DD, if the operating context has changed or if other new information has come to light.

- Discuss key monitoring information and key performance indicators (KPIs)

In addition to reporting templates, it is important to consult with the company and agree the KPIs that will be used to monitor key ESG factors early in the investment phase. These metrics can help to focus management and employees on material business issues, and help to build commitment as well as track and chart improved performance. Discussions of potential KPIs are likely to have taken place during the DD phase, and may have been included within the action plans. The fund manager should ensure that systems are in place to enable the company to regularly report on these KPIs and to revisit them occasionally to ensure their relevance.

2.3 Regular monitoring: Oversight of and support on ESG matters

Regular monitoring refers to the activities which: (i) take place on an ongoing basis throughout the life of the investment; (ii) are planned and structured; and (iii) are recorded in standard records and reports. The main objective is to ensure that ESG factors are being managed as agreed at investment and that, to the extent possible, the fund manager provides support to the company.

There are a suite of regular monitoring activities/channels that can be used depending on the fund's and the portfolio company's characteristics:

- Regular meetings with the company's board and/or management
  Fund managers should regularly discuss ESG performance with companies, including the implementation of any ESG action plan. Discussions may take place at different levels, including board meetings, meetings with senior management, and meetings with those responsible for ESG at the operational level. If the fund does not have a board seat, it can still request copies of board documents.

- ESG monitoring reports

  Regular reporting is a very helpful tool to monitor a company's ESG improvements and setbacks. The frequency, content and format of such ESG monitoring reports is typically set out in the investment agreement. Reports should provide at least an annual summary of the company's ESG performance, including progress against the ESG action plan and KPIs. The frequency of the reports can be adjusted according to the level of ESG risks (with higher risk companies reporting more often) and on the company's ESG management capabilities. In many cases, this should grow over the investment period, such that formal reporting can be done less frequently.

To ensure an appropriately focused report and reduce workload, it can be useful to agree a template that can be used by the company to report to both its own board and the fund.

Standard practice is to compile the following reports during ownership and monitoring:

Quarterly/semi-annual/annual ESG monitoring reports: Prepared by companies and submitted to the fund manager, ideally following a fairly standard format, to allow longer-term oversight of trends in company's ESG performance and action plan implementation, and to facilitate comparison of companies and aggregation of information and data for fund-level ESG reporting.

Annual reports: Prepared by the fund manager for LPs and investment partners, usually on an annual basis. Annual reports may incorporate ESG information.

Investors/advisory committee: LPs will typically require that a fund manager arranges regular investors committee/advisory committee meetings, and consideration should be given to highlighting significant ESG events at such meetings. Such meetings are a useful forum for discussing issues and seeking the input of investors.

Fund annual meeting: Fund agreements usually require an annual investors meeting. Fund managers should consider using such meetings to showcase ESG achievements and to keep investors up to date with issues.

Public reporting by companies for external stakeholders: Depending on the size and nature of the company's and the company's interaction with stakeholders, it may be appropriate to disclose relevant ESG information to its stakeholders (e.g. by reporting following Global Reporting Initiative standards).

One-off incident or accident reports: These should include root-cause investigations and subsequent changes made to prevent such an event occurring again. Refer to 2.4 below: Manage unplanned events.

- Periodic review: Company's ESG management system, performance and action plan
  A periodic review process should be established whereby each company's ESG performance to date is reviewed and any necessary changes are considered and implemented.

It is essential that each portfolio company has a strong, well-functioning ESG management system(s). The fund manager should always assess the adequacy of the company's ESG managements system(s) and discuss with them any improvements/amendments to be made. The fund manager's team may play an active role in helping the company to improve these systems.

Discussing and agreeing KPIs to be monitored by the company and the fund manager would significantly contribute to maximise the efficiency and adequacy of the review process. When establishing roles and responsibilities for ESG within the company, it should be clear who will conduct the performance reviews and have responsibility for ongoing improvements.

The results of these reviews should become part of the regular cycle of commercially-driven investment performance reviews that will be undertaken by a fund manager and may contribute to the process of valuing a portfolio company.

Typically, action plans need to be amended at some point during the investment period due to issues such as the occurrence of unplanned events, changes to the business plan or underestimation of the time and resources needed to implement certain actions. Fund managers should closely monitor the implementation of the ESG action plan(s) and discuss any amendments with the company.

- Review other useful information

Independent certification reports: If a company has been certified to a reputable certification scheme, the independent audits provide a useful source of information for fund managers in understanding its ESG performance.

Media searches: Media searches conducted by the fund manager on a company and the region (if the fund is not local) to identify any relevant changes to the operating context or brewing disquiet among stakeholders.

- Conducting site visits

Site visits are usually undertaken during the monitoring phase on a routine basis. The frequency and scope of the site visits is driven by a number of factors, including materiality of ESG risks and a company's performance. Site visits are very helpful in determining how well ESG matters are being managed and validate information provided by a company. Site visits may also be undertaken in the following circumstances to address more specific issues:

- In response to an accident or incident, concerns raised by stakeholders, media reports or enquiries or action by law enforcement authorities.
- When an acquisition or major development/extension in operations is being considered.
- A substantial change in the management team.

- Engaging consultants
  Depending on the level of the ESG risks and the capacity and expertise within the fund team, external consultants may be engaged during monitoring. As at the DD phase, there are significant benefits to someone from the fund accompanying such consultants. Experts may be engaged to conduct regular audits, to do one-off spot checks or evaluations or to advise the company on specific areas.
- Fund internal review meetings
  Regular internal portfolio review meetings involving partners, investment officers and ESG officers can enable insights to be shared, priorities for closer monitoring agreed, and collaboration where a company is not making adequate progress (e.g. a partner could escalate the issue at the next board meeting).

2.4 Manage unplanned events

The fund manager must have a mechanism to respond appropriately and swiftly to serious accidents, incidents or events, or other changes in the company's circumstances, and to ensure that lessons are learnt and applied in future (to this or other investments). Serious incidents may need to be reported to various bodies (e.g. the company's board, the fund's LPs, regulators).

Different circumstances may trigger the need for a fund manager to react to an unexpected event:

- Serious accidents

  The fund manager should ensure that a system is in place through which portfolio companies promptly notify investors of any serious accidents, including those that result in loss of life, serious injury, material adverse impacts on communities and/or the environment, material breach of law or side letter requirements. Subsequently, and within a defined time period (typically set out in the investment agreement), the company should submit an investigation report to the fund. The fund manager should check the company has implemented measures to avoid the repetition of the event. In most cases, such accidents should be reported to LPs by the fund manager and to other parties by the company (e.g. regulators).

  Investigating and creating formal reports on serious incidents gives fund managers an insight into the types of issue at the company and an opportunity to address root causes. It can also provide relevant information on the adequacy of the company's ESG management system.

- Non-compliance

  It is important to check each company's ongoing compliance with the applicable ESG legislation and with the standards stipulated in the investment agreement. Where an instance of material non-compliance is identified (e.g. related to the ESG action plan or against regulatory requirements) the company may find it useful to develop and implement a remediation action plan.

  Similar to the development of an ESG action plan based on the findings of the DD phase, the remediation action plan may follow a similar format and highlight the key areas of non-compliance to be addressed, the recommended remedial actions, time frame, responsibility, and resources be applied. External experts may be commissioned to assess and confirm successful implementation of the remediation action plan.

- Adverse inspection findings from regulators
  A fund manager should ensure that there are procedures in place that will lead to any

portfolio company informing it if of any adverse material findings arise from an inspection by local regulators, departments or agencies. The fund manager will want to know what the consequences and findings of that visit were, and what remedial measures can be put in place.

- Grievance mechanism and stakeholder complaints
  Maintaining good stakeholder relations is also critical to maintaining a company's licence to operate. Poor stakeholder relations can result in a range of problems and costs. Fund managers should emphasise to companies that it is essential to alert them to any significant stakeholder-related issues (e.g. social protests and relevant grievances) and the status of relationships with key stakeholders, such as local communities. Companies should, as appropriate, have a grievance mechanism and a stakeholder engagement plan in place.

- Departure of a key ESG officer
  Fund managers should ensure that the company promptly hires another professional to ensure adequate ESG management. The role is a key one and so it is important to identify the reasons behind the departure.

- Changes to the business
  If significant changes occur in the business (e.g. acquisitions or expansion involving material ESG risks), the fund manager may need to commission an independent or focused ESG assessment or monitoring visit. This exercise could serve to assess a company's capacity to manage the changes and their implications, including the need to upgrade existing management systems.

- Negative media
  Critical or concerning media articles about a portfolio company should be discussed immediately with the company. Their veracity should be checked, and if the concerns they identify prove to be real or to have significant potential to damage the company, the company and fund manager should agree on a course of action to address them.

2.5 Prepare for exit

From the earliest phases of investment, thought should be given to how ESG performance improvements can contribute to increasing the company's value at exit. Towards the end of the investment period, it is advisable to consolidate information on ESG performance in order to be able to evidence how ESG improvements have added value to a company.

- Relevant information to evaluate and demonstrate the value of ESG improvements at exit
    - Documented and effective systems and processes to manage any ESG risks and impacts.
    - Clear documents illustrating how effective ESG management has improved business operations (e.g. data showing how energy efficiency measures have reduced operation costs).
    - Performance against ESG KPIs over the investment period and in comparison to competitors, if possible.
    - Any residual areas of inefficiency or underperformance and resources that the buyer will need to deploy to address them.

3. Outputs

Key outputs that good ESG management should deliver during the ownership and monitoring stage include:

- Greater value of each company partly due to the fund's influence on and support provided to the company.
- Fund managers and LP's ongoing and appropriate oversight of each company's ESG performance.
- Compliance with fund's ESG policies and related standards.
- Responsive and effective management of unplanned events (e.g. serious accidents).
- Good stakeholder relations, including companies and LPs.
- Records to demonstrate good ESG performance and compliance with the fund's policies.

- ESG monitoring reports

  As explained previously, it is standard practice to compile the following reports, which provide valuable ESG information:

  - **Quarterly/semi-annual/annual ESG monitoring reports:** Prepared by companies and submitted to the fund manager.

  - **Company's annual reports:** Prepared by the fund manager for LPs and investment partners, usually on an annual basis. Annual reports may incorporate ESG information.

  - **Serious accident reports:** Prepared by the company, including root-cause investigations and corrective action plan to prevent recurrence of similar events.

  - **Content for annual reports:** Prepared by the fund manager for LPs and investment partners, usually on an annual basis. May contain relevant ESG information.