ESG-LINKED CARRIED INTEREST MECHANISM

Working paper

June 2024

Introduction

There is a growing interest in scaling efforts to measure and target impact. Recent European Union (EU) developments and financial market trends show a shift towards measurable sustainability performance and contribution to a transition to a more sustainable economy. This shift manifests itself in capacity-building efforts by various financial markets actors and by the creation of financial products that are focused on positive environmental or climate impact, such as green mortgages and bonds, and thematic funds linked to environmental, social, and governance (ESG) impact.

At the same time, market expectations for large corporations to integrate ESG considerations are rising, with many revamping their compensation systems and introducing impact-based incentives structures (IBIS). These require closer monitoring of sustainability performance and verification of information and data gathered. The most common of such efforts is the tying of ESG-related key performance indicators (KPIs) to executive remuneration schemes.

In private equity (PE), where general partners (GPs) traditionally prioritised maximising profits, there is a growing trend to aim for achieving social and/or environmental impact alongside financial returns. This shift, partially influenced by the EU legislation, has led more funds, mainly in Western Europe, to link carried interest to sustainable investment goals, even though it is not mandated by the Sustainable Finance Disclosure Regulation (SFDR), but can be one of the ways of how to achieve intended and measurable impact. Well-designed incentive schemes can align investment philosophies with targets for both financial returns and ESG performance, demonstrating a genuine commitment to sustainability. Additionally, pursuing impact in social and/or environment is a key priority of the European Investment Fund (EIF) and by an extension of the European Investment Bank (EIB), but also the European Bank for Reconstruction and Development (EBRD), whose activities are closely linked to the European Commission (EC) policy agenda.

While in comparison to Western peers, Central and Eastern European (CEE) PE funds are slower to adopt innovative ESG-linked mechanisms, the region offers significant opportunities in impact investment and innovative carried interest[1] mechanisms. The potential lies in the ability of these PE funds to differentiate themselves in the market, attract a larger pool of investors during fundraising, and foster relationships across geographies. At the same time, such mechanisms enable general partners to substantiate claims that a fund is achieving tangible, measured, and verified positive ESG performance, while making a positive contribution to the transition to low carbon growth and meeting the Paris Agreement goals.

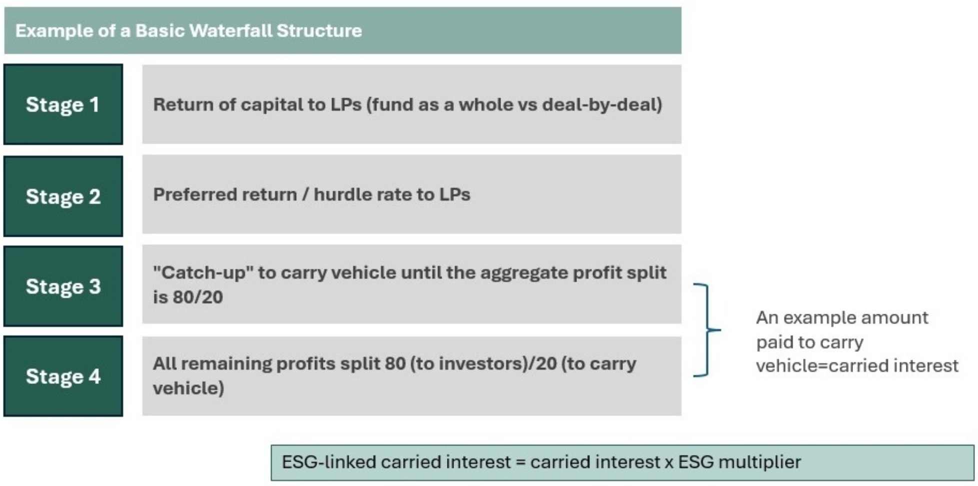
[1] ESG-linked carried interest and ESG-linked carry mechanism and ESG-linked carry are used interchangeably in this paper

Setting the scene

Tying the GP's compensation to social and/or environmental performance creates a new impact-based incentive for GPs to focus on managing and measuring the impact of their investments, both positive and negative.
Finding the right approach to linking GP compensation to impact in a way which is meaningful, measurable, realistic, and providing incentives requires consideration of a variety of elements such as selecting KPIs, compensation structure, measurement, and verification mechanism, etc. However, the benefits of this approach are multiple:

- Strengthening of internal capacities;
- Reputation improvement;
- Diversification of investments;
- Marketing potential;
- Attraction of new limited partners (LPs) and thus expansion of the investor base;
- Potential for improved returns from exiting companies that are tapping into new growth markets or are meeting new demand for low carbon products or services linked to low emission growth.

The percentage of ESG-linked carry interest can vary and is set by the GP, and a basic example of how the mechanism as such works is below (the percentages/numbers shown as just for illustration purposes and do not mean an endorsement of values).



Source: adapted from PaperJam

Below we present an analysis of the key questions and aspects that need to be considered in the development, design, and operation of this type of financial vehicle.

Our methodological approach and findings

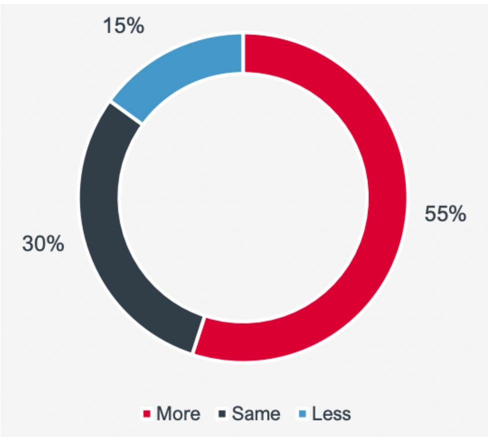
We conducted a comprehensive desk research on this topic with a focus on existing real-world examples from various countries and markets.

We note that linking carry to ESG or impact indicators is a relatively new concept, and not universally applicable approach which can be easily replicated in all PE funds. Therefore, the following analysis of existing approaches across different markets and PE firms predominantly serves to provide an overview of available approaches and practices under each aspect of the ESG-carry set up, including exploration of relevant impact indicators.

In addition, we have reached out to a variety of relevant experts in the field. Through our network and independent non-profit status, we have been able to liaise with senior experts who have substantial experience in developing impact-based incentive structures - experts who are typically not easily accessible and respond to consulting requests. In total, over 35 stakeholders were contacted, out of which over 17 replied and participated in 60-minute consultations.

In the sections below, we provide more information on existing practices applied in the field, along with a set of practical recommendations relevant to the CEE context.

Capital that LPs (who have previously invested in impact funds) plan to commit to impact funds in the next 12 months



Source: Rede Partners Private Markets Sustainability and Impact Report

Review of existing practices

As part of our research, we have identified multiple approaches to setting up the ESG-linked carry mechanism across different funds. Below, we list questions and areas that need to be addressed as part of the development and design process.

Decision making framework developed by Impact Linked Compensation Project

Decisions	Focus areas	Considerations
Mechanism	Choosing a model	☐ Existing financial incentives ☐ Who should participate ☐ Incentive timeline
	Deciding what is at stake	☐ Carrot vs stick ☐ All or nothing vs sliding scale ☐ Amount of compensation tied to impact
	Operationalising	☐ Cost allocation ☐ Foregone compensation ☐ Documentation and administration
Yardstick	Selecting metrics	☐ Relevant impacts and outcomes ☐ Proxies ☐ Numbers of metrics
	Setting targets	☐ Level of ambition ☐ Timeframe ☐ Level of flexibility
	Getting to the portfolio level (or not)	☐ Top-down vs bottom-up ☐ Weighting results ☐ Opting out of portfolio level integration
Governance	Designing structures	☐ Oversight bodies ☐ Level of LP involvement ☐ Use of outside expertise
	Assigning responsibilities	☐ Metrics and targets approval process ☐ Adjustments of metrics and targets ☐ Target, data, and process verification

Source: Impact Linked Compensation Project, adapted from the report "Impact linked compensation: Considerations, design options and frameworks".

Demand for the use of ESG-linked carry mechanisms from investors

The demand for ESG-linked carry is rapidly growing, driven by influential investment bodies such as the EIF and EBRD, which have been actively investing in funds in the CEE region. These entities are considered key investors and contributors to new funds for most PE and venture capital (VC) players, underscoring the importance of developing and incorporating ESG impact measurement and linked interest approaches.

Beyond the requirements set by the EIF and EBRD, other institutional investors are increasingly seeking investments that deliver measurable positive impacts aligned with their sustainable goals and net-zero targets. Therefore, implementing ESG-linked carry mechanisms and impact measurement can differentiate funds from the competition, expand the investor base, and foster new relationships across different geographies.

Impacts targeted

Based on our research, funds with ESG-linked carry mechanisms typically target positive environmental/climate or social impact. A small number of funds aim to address both, but this approach introduces additional complexity in impact measurement, reporting, and understanding the interlinkages between the selected KPIs. For this reason, it is crucial to provide a clear and transparent articulation of impact definition to ensure the credibility of the strategy and efficiency of the measurement and monitoring practices. The targeted impact must be clearly aligned with the fund's strategy and philosophy and achieving it should support, rather than compromise, financial returns.

Approaches to identifying and selecting the right KPIs

At the core of ESG-linked carry mechanisms are metrics and targets against which a portfolio's social and environmental performance can be measured, and the GP compensation determined. We observed that on average, funds set approximately 2-4 KPIs in total.

- Under environmental impact, the KPIs related to climate change mitigation (i.e., CO2 emissions reduced and/or avoided[2]) seem to be the main go-to metric, especially for funds investing in companies with manufacturing, production, or in general, emissions intensive activities. In most cases, funds only measure Scope 1 and Scope 2 emissions of their portfolio (Scope 3). There is a consensus in the CO2e calculation practice that measuring the Scope 3 emissions adds complexity to the processes, as companies often struggle to obtain and track the required data leading to reliance estimates. However, it is crucial to attempt to include Scope 3 to provide the full assessment of environmental performance and impact, especially because the largest part of emissions can be in Scope 3.
- For social impact, we noted a clear link between the selected KPIs and the strategy/sectoral focus of the fund. For instance, a fund targeting investments in health care tracks the number of patients provided with care (or additionally, the number of patients under certain income bracket provided with health care). Similarly, funds focused on investing in companies

2 Avoided emissions are approached with caution as their value and impact can vary greatly depending on a method of avoidance and the context in which they are measured. The lack of clear consensus further complicates their assessment. Therefore, it is important to critically evaluate the circumstances and methodologies used to achieve these emissions reductions to ensure that they contribute to impact.

providing financing to low- and moderate-income consumers tracks the number of consumers served.

- Portfolio vs. Asset level: In general, funds with sector-specific focus tend to set KPIs at the portfolio level, collecting information on the same metric from each portfolio company. The GP determines portfolio-level impact metrics during due diligence and in investment documents between the fund and each portfolio company. All portfolio companies report both short- and long-term metrics. In such cases, the PE funds still look at investments individually, and weigh factors such as ability of portfolio companies to meet impact objectives, quality of the systems used to evaluate impact, and performance reporting compliance, and then aggregate the results. The data is collected at the time of investment into a company, and then the frequency of reporting by each company is determined by the GP. In most cases, the data is collected annually, or every two years – this depends on the overall set up of the fund (whether the fund is closed in seven or ten years, for example). The interim or annual data is usually self-reported and is not verified, since verification is sought at the point of investment and then at the point of exit or fund closure.

- It is important to understand the sector and geography specific targets and measurements. This can help prevent the selection of targets that lack ambition, are not necessarily material or driving positive impact, or are too easily attainable.

- Going forward, the use of the EU taxonomy aligned capex and turnover targets could help GPs create targets and KPIs that are science-based and embedded in the current regulatory framework, presenting an opportunity to develop transition finance portfolios that help drive real world impact by increasing the business activities that are aligned with a sustainable economic growth.

BOX 1: Metrics

At its core, ESG-linked carry mechanisms are built upon carefully chosen metrics and targets. These metrics serve as benchmarks to evaluate a portfolio's social and environmental performance, subsequently influencing GP compensation.

Under the environmental impact category, KPIs mainly address climate change mitigation factors, for example:

- GHG emissions – Scope 1&2
- Emission avoidance/emissions avoided
- Water use/reuse
- Energy consumption - including types of energy
- Waste management

On the social impact side, KPIs are closely aligned with a fund's strategy and sectoral focus. However, the most commonly used or considered metrics are gender-related or with a focus on injuries, especially in industrial sectors:

- Gender pay gap
- Gender parity
- Women in leadership positions (managers, executives, board members)
- No of people from under-privileged backgrounds served/no of people with access to green energy/affordable housing, etc.
- Work-related injuries/total recordable incident frequency

Portfolio companies report both short- and long-term metrics on regular basis. Depending on a type of the metric, this may be monthly, quarterly, or annually. Additionally, there are other factors which are considered and reported on regularly, such as portfolio company's performance and impact reporting quality. These results are then aggregated for annual disclosures.

In conclusion, funds should set KPIs and targets which are measurable and comparable across the portfolio and aligned with the overall impact objectives of the fund. The targets set should be realistic and attainable, yet ambitious. To avoid accusations of easily attainable targets, funds can cooperate with ESG advisors, introduce a management or board member whose expertise and focus is ESG or sustainability, or create an independent advisory committee focused on ESG topics. Another option is to use benchmarking, and to understand what the sustainability-related performance and potential of investee companies is against their peers. This can be done during the due diligence process, and the benefits of this include a more thorough understanding of the companies' market position, and its existing data collection systems.

Incentives: Penalising and/or rewarding GPs based on the achievement of impact targets?

Generally, an impact-based incentive structure can be designed to penalise GPs for subpar impact by reducing compensation (carried interest) and/or reward meeting the impact targets by increasing compensation above conventional levels (in form of a bonus). This model is based on a pass/fail basis – a predetermined portion of carried interest is forfeited, or awarded if the ESG targets are met.

Another common approach is a "sliding scale", where the proportion of linked interest is adjusted based on the degree to which the impact target is met. While this may be perceived as a more manageable and lower risk option, it adds complexity that some investors may not be welcome. It also increases the risk of greenwashing and potential reputational damage. Despite these concerns, most researched funds have adopted the sliding scale approach, with many opting for less than 25% of carry.

Based on our analysis of PE funds and firms of size and characteristics similar to the most common CEE funds, the prevalent incentive structure requires meeting the minimum impact target for the GP to receive the full carry amount (i.e., base carry + impact-linked carry). If the GP meets a predetermined financial hurdle but does not meet the impact target, a base carry only will be awarded. In practice, for instance, if the fund's base carry is 15% and the impact performance target is met, the GP carry increases 5% to a total compensation of 20%.

In certain cases, we note a more complex structure with multiple levels of ambitions of targets. For example, a GP can earn a further 10%—for a total carry of 30%—if an additional (more ambitious) impact target is met (e.g., the first target would equal to reduction of GHG emissions at the portfolio level by 30%, the second target would represent reduction by 50%).

The split/proportion of the carried interest between base carry and ESG-linked carry largely varies across funds. While the most common approach seems to be assigning 25% of the carried interest to impact, we note that certain funds used different proportion, for instance 90% base to 10% impact, or 80% base to 20% impact (specific examples: Energy fund in UK where GP agreed to forfeit 25%, Swen Capital Partners – their Blue Ocean Fund subject 50% of their carried interest to impact target achievement. EQT opted for 10% forfeiture if impact is not achieved). The approach to the compensation structure seems to be mainly based on the strategy and investment philosophy of funds, as well as the preferences and expectations of their client base (the investors they target for the new vehicle).

In most cases, forfeiture generally entails assessment of the accrued amount of carried interest as against impact targets at fixed intervals – most commonly, following a fund's annual impact assessment.

What should be done with any monetary proceeds not distributed to GPs due to inability to meet the impact targets?

In the cases when the impact targets are not met, approaches across funds vary. In general, if impact targets or objectives are not met, a portion of money in the pool of available compensation is forfeited. Two main approaches to handling the forfeited funds identified are as follows:
1) The GP returns it to LPs, or
2) the GP donates it to an independent third-party entity that supports a social or environmental objective similar to that of the fund.

In most cases, forfeiture involves assessing the accrued amount of carried interest against impact targets at fixed intervals, typically following a fund's annual impact assessment. An alternative forfeiture model defers the payment of carried interest to the sponsor until the impact goals are met, with annual evaluations. If the goal is not met by the end of the fund's life, the carried interest is ultimately forfeited.

Additional approaches include the option of purchasing carbon credits (relevant for environmental and climate objectives). While this approach allows LPs to achieve the expected financial returns and impact on their net-zero targets, it carries a high risk of genuine greenwashing or the perception of it, particularly the poor track record of carbon credit schemes and their credibility and given recent media backlash on the topic of carbon credits. In some cases, the term sheet provided by the GP specifies from the outset whether carbon offsets or carbon credits will be used. In one case, a general partner specified in the final fund set up and documents that no carbon credits will be used due to pressure from limited partners who expressed their concern about greenwashing risk.

How and by whom are social and environmental performance metrics and targets defined?

Various stakeholders can be responsible for determining the metrics and targets used in impact-based incentive structures. A common practice identified in terms of governance and oversight of the ESG-linked carry set up and definition of the KPIs and impact targets is through an independent board. Typically, the board would consist of a GP representative and relevant experts experienced in impact assessments on specific topics – this is especially crucial for social impacts where measurement methodologies are not as rigorous as, for example, for CO_2 emissions. Oversight levels and responsibilities may vary, from validating impact assessments to directly measuring the impact.

The independence of selected stakeholders is crucial to ensure credibility of impact and KPI selection. It is essential to ensure that there are no conflicts of interest between the selected board members. Involving independent experts from think tanks, academia, and other not-for-profit entities is considered best practice.

Another approach is for GPs and LPs to collaboratively determine a fund's impact targets, agreeing on impact goals and performance measurement approaches. In some cases, the general partner can seek a second opinion about its ESG-linked carry mechanism set up or about its chosen targets and

KPIs from an expert organisation, a company offering advisory services on ESG performance, or an opinion provider that specialises in ESG-related benchmarking and target setting.

Setting up the impact measurement and reporting process

The GP is responsible for ensuring credible impact measurement and validation. In certain cases, the fund along with LPs contributed to a technical assistance (TA) facility, which exists alongside the fund and is used to pay a third party to measure and validate the social and/or environmental impact achieved.

Engaging a third-party expert brings the added benefit of sharing knowledge and best practices in specific impact themes and their measurement. Partnering with LPs builds trust in the assessment and overall mechanism, preventing challenges or doubts about KPI selection. Over time, it also improves the GPs and LPs understanding of sustainability performance and measurement.

In the CEE region, there is a notable gap in understanding, expertise, and experience with ESG topics and particularly in using rigorous methodologies for selecting and measuring indicators. This means that there is an opportunity to use an ESG- linked carry mechanism as an educational initiative. To attract partners, it is crucial to emphasise the ways how focusing on an ESG-linked carry mechanism can have advantages for business risk management. This includes reduced exposure to fossil fuels, decreased sensitivity to climate-related regulations or policy changes, increased investment flows towards high performing businesses, etc.

Alternatively, the GP can analyse and measure the collected impact data in-house. However, in this case, it is a common practice is to appoint or hire a person with a specific focus on ESG and impact management. The person would oversee the coordination of data collection, reporting of the portfolio companies, validation of provided information, as well as tracking and monitoring of the progress towards the impact targets. Although this approach is feasible, market preferences lean towards third-party oversight for the carried interest structure to mitigate potential conflicts of interest. Nevertheless, development of in-house capacity is valuable for future products ensuring consistency and demonstrating a genuine commitment to impact. It also helps the GP to work with third party experts or expert organisations measuring or verifying the impact/ ESG-related performance.

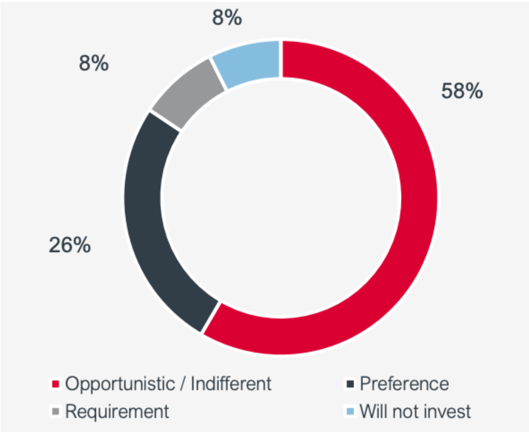
What are the main risks and due diligence considerations?

The structure of the ESG-linked carry must be carefully crafted to avoid unintended consequences and misaligned incentives that could result in financial implications for both GPs and LPs. Therefore, the structure of the ESG-linked carry must be thoughtfully designed to align the interests of all stakeholders.

Implementing impact-based incentive structures requires stakeholders to weigh many different factors. Therefore, it is crucial to design a system and process that is simple and manageable to avoid overcomplication, unnecessary administrative burdens for the GP, and potential due diligence issues.

A report published by Rede Partners showed that many impact-focused LPs worry about the overly complex ESG-carry set up, and especially about whether person gain considerations end up potentially affecting how ambitious the impact targets are or whether they are skewed. To address this, GPs can use a second party opinion or an expert opinion from a third party or an expert organisation to reaffirm their targets and the ambition level.

LP preferences for impact-linked carry



Source: Rede Partners Private Markets Sustainability and Impact Report

The concerns reflect apprehension about a major risk related to the selection of specific and accurate KPIs. CO_2 or GHG emissions are commonly used as an environmental impact KPI, aligning with the EIF's and EBRD's mandates and the Paris Agreement. However, measuring biodiversity impacts, pollution, circular economy, or water management can be more challenging due to the limitations of existing calculation methodologies and standards. These areas may lack robust standards or assessment methods, leading to difficulties in obtaining quality and comparable data, and necessitating additional engagement and education. This complexity can also appear riskier to LPs.

As noted above, another issue may be data collection and whether to conduct it in-house or use an external provider. Depending on the provider this may also impact the accuracy and reliability of numbers.

Another concern is the risk of impact washing where investments may be portrayed as more impactful than they actually are. Robust due diligence is essential to substantiate sustainable claims and ensure alignment with the ESG-linked carry mechanism's goals.

Lastly, regulatory and compliance risks, such as non-compliance with sustainability regulations, can lead to legal and reputational damage.

SFDR Article 9 and ESG-linked carry mechanism

BOX 2: A way forward in reporting sustainable investment objective under SFDR?

Although SFDR outlines core areas for disclosure: objective of positive contribution to the environment or society, do no significant harm, and good governance, it does not prescribe specific investment strategies for Article 9 products any further. Most funds classified under SFDR 9 focus on achieving sustainable investment objectives by setting environmental and/or social targets and comparing them with relevant index benchmarks and the broader market. However, this may be challenging in the private equity market, often due to the absence of relevant benchmarks. For this reason, implementing ESG-linked or more particularly impact-linked carry emerges as a crucial instrument to bridge this gap and allow aligning PE funds with SFDR 9 requirements for delivering impact, if all else is fulfilled.

SFDR mandates regular reporting about how sustainable investment objectives are met, the methodologies used, and the impact achieved. To both regulatory bodies and investors, an ESG-linked carry mechanism can provide clear evidence of the fund's commitment to sustainability and its alignment with SFDR 9. Furthermore, ESG-linked carry can enhance transparency in performance evaluation and serve as an impact measurement tool, aiding in the fulfilment of the fund's sustainability objectives. This is ensured by continuous and regular monitoring and documentation of progress towards those set objectives. By aligning the financial incentives of fund managers with the sustainable investment objectives of the fund, ESG-linked carry ensures that both financial performance and impact outcomes are prioritised and achieved. Therefore, PE funds and more broadly GPs should consider adopting ESG-linked carry mechanism for alignment with SFDR 9, especially in cases when index benchmarks are not readily available.

Case studies

Planet First Partners (PFP)

Website: https://www.planetfirst.partners/

- Planet First Partners (PFP) have a sustainable investment strategy designed in line with the Sustainable Finance Disclosure Regulation (SFDR), using the EU Taxonomy as a key reference for the development of sustainable investment theses.
- PFP operates with four themes (energy transition, green cities, industry 4.0, and farm to fork), with the possibility of engaging with consumer health.
- **Sustainable investment process was designed to target any of the six environmental objectives outlined by the EU in its Taxonomy regulation.** PFP also created an internal framework with five social objectives, inspired by the latest report on social taxonomy by the EU Platform on Sustainable Finance.
- Each portfolio company is evaluated by a bespoke sustainability thesis that binds the carried interest paid to the GP.
- The sustainability thesis will use an EU Taxonomy reference for environmental objectives and PFP's own internal framework for social objectives.
- Performance is measured for each individual company at exit and is based on the thesis. It is based on:
    - Assured transparency and reporting by the portfolio companies (on aspects required by the SFDR and PAIs[3]), requiring PFP to work closely and strengthen governance on the topic.
    - And is calculated following a structure of turnover alignment or as a conditional CAPEX/OPEX investment.
- 25% of the carried interest remuneration to the GP is linked to sustainability performance, assessed internally, and evaluated by dedicated sustainability committee chaired by an independent expert.
- Ultimately, the team is incentivised to meet the thresholds for every company since **overperformance in one company does not compensate underperformance in another.**
- Missed carried interest remuneration will be allocated for a third-party institution to develop projects linked to each sustainable investment thesis objective. The project will be proposed by PFP's team and approved by the sustainability committee.

Carried Interest by Verified Impact Calculations (CIVIC)

Full case study: https://www.impactterms.org/case-study-carried-interest-by-verified-impact-calculations-civic/

3 Principal Adverse Impacts

Verdane

Website: https://verdane.com/

- Verdane uses dual goal of financial and what they call "elevated" impact criteria.
- Impact is defined as addressing at least one of the SDGs[4] and qualifying inside Verdane's own, proprietary impact framework (built on the Impact Management Project or IMP).
- On portfolio level, each portfolio company regularly reports on bespoke sustainability KPIs, and both the Fund's carried interest and credit facility are linked to goal attainment.
- Verdane experienced huge interest in its fund, especially from family offices, institutional investors, pension funds, and endowments.

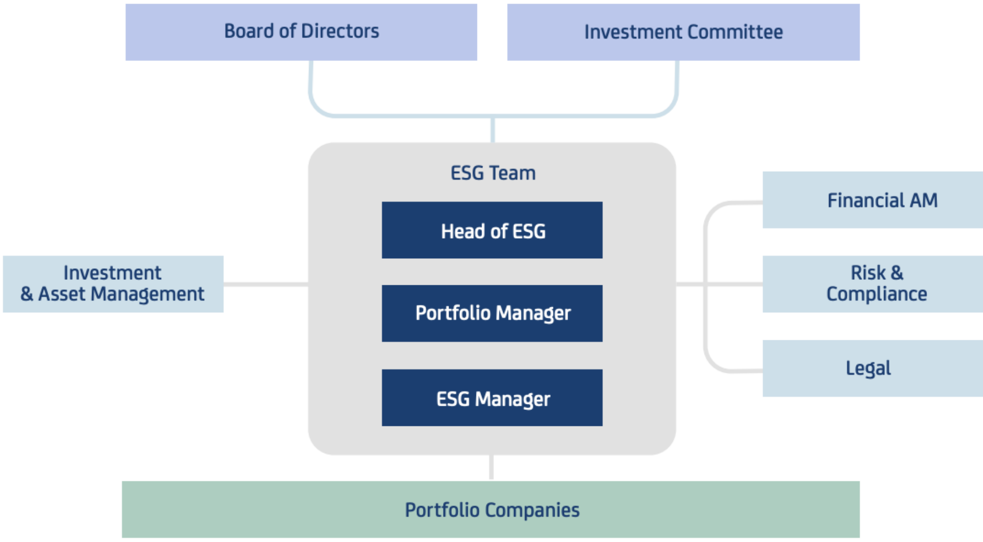
Marguerite

Website: https://www.marguerite.com/

- Marguerite is a pan-European infrastructure fund manager focused on investments that contribute to sustainable economic growth and climate protection.
- Marguerite states that it uses EIB's Guidelines, UN SDGs to quantify and monitor sustainability contribution, and that it adheres to the UN PRI principles and is committed to evaluate investments against the Equator Principles among other activities.
- The investment selection follows the following steps: 1) **Selection of investments against rigorous ESG criteria**, 2) **Compliance with European laws and regulations and UN guidelines, 3) Forgoing of projects based on exclusion criteria that don't meet sustainability goals, 4) Continuous review of eligibility criteria and anticipation of new regulations.**
- Marguerite ensures transparency on sustainability risks with its investors by communicating ESG indicators at least twice a year. Investments are required to provide reports on a monthly or quarterly basis with key operational (including ESG) and financial performance data, such as financial statements, benchmarking, updates on construction/capex, as applicable, operational information (ramp-up), ratio compliance, ESG Focus Points, and/or other specific data requested by the investors (as explained in Marguerite's 2023 Sustainability-related disclosure linked to the Sustainable Finance Disclosure Regulation).
- Fund's investors are the only ones who receive detailed information about the carry mechanism or sustainability performance, with quarterly and annual reports.
- Funds are audited by Deloitte, according to IFRS standards.

4 Sustainable Development Goals

Governance at Marguerite & the role of ESG team



Source: Marguerite's 2023 Annual Public Sustainability Report

- In its 2023 Sustainability Report, Marguerite states that it pledges to be aligned with a Net Zero economy in 2025.

Kandeo Asset Management (USA)

- Kandeo uses UN PRI guidance, as well as IFC and IDB performance standards for its funds and for due diligence.
- Kandeo also uses identification process to find investment opportunities, checking if a company has registered incidents, fines, or scandals associated with ESG issues.
- An action plan with KPIs is established together with the company management, along with the KPIs defined and to be monitored.
- **The company action plan contains 6 indicators:** 1) Environmental and Social Management System or ESMS, programme that is documented, 2) ESG committee, 3) annual work plan, documented and with ESG KPIs, 4) ESG team – people at each company to meet each programme step, 5) Annual reports provided to external parties, 6) training – necessary / essential training provided.
- Kandeo has also focused on social indicators – specifically, on gender-related KPIs, publishing a special case study that explores its approach to gender and female leadership, and why and how the fund has improved gender-related performance.

EV Private Equity

Website: https://www.evprivateequity.no/

– EV Private Equity opted for a “carry at risk” structure with targets that take into account CO2 avoided and how much portfolio companies contribute to greenhouse gas (GHG) emissions. However, the fund did not disclose which scopes were included, but judging from their prospectus and other available information, it appears to be only Scope 1 and Scope 2.
– EV Private Equity opted for buying carbon credits with forfeited carry if the fund does not meet its target.
– The options were chosen because of their wish to reduce the difference in incentives between LPs and GPs if targets cannot be met.

Trill Impact

Website: https://www.trillimpact.com/

Trill Impact has developed its own ESG principles to streamline the approach and assessment. It is important to note that Trill Impact is an impact investor and identifies as one.

Principles embedded in the process are as follows.

1) Incorporate ESG issues into investment analysis and decision-making processes
   - ESG and Impact assessment are at the core of Trill Impact's analysis and decision-making process. The entire team is updated/educated weekly on ESG and Impact matters. Extensive impact and ESG analyses are mandatory in the due diligence process. The Impact Partner is a voting member of the Investment Advisory Committee.
   - Trill Impact sets ESG targets across all portfolio companies on three areas: 1) % GHG reduction, using science-based targets, 2) Gender equality targets using the SHE index, 3) Code of conduct targets based on the UN Global Compact principles.
   - For each investee company, Trill Impact sets unique Impact KPIs and targets; the ESG KPIs and targets are also tailored to each company based on materiality

2) Trill Impact uses IMPACT approach, with the following steps:

– **“I” -** IDEATE: identify impact and value creation opportunity, guided by the SDGs, with the aim to grow and develop the business. The investment must fit with our theory of change.
– **“M”**- MATERIALISE: Explore each company’s starting point and full value creation impact potential using own Impact Rating Model and globally recognised impact and ESG frameworks.
– **“P”** - PARTNER: Partner with management to align on an indicative Value Creation Impact Plan, including preliminary KPIs.
– **“A”**- ACCELERATE: Finalise a Value Creation Impact Plan, with KPIs and targets to meadsure success with customers.

– **"C"** - COLLABORATE: Collaborative approach, providing support, tools, and expertise to accelerate, measure and communicate impact and value creation.
– **"T"** - TRANSFER: Upon exit, consider how the impact mission can be further developed with new ownership. Assess and analyse the impact generated against the targets.

3) Trill Impact are active owners - incorporate ESG issues into ownership policies and practices. Trill Impact's ambition is to scale and realise the combined value and impact potential of each company.

4) Trill Impact's due diligence model is part of the IMPACT approach described above and covers the Materialise phase, in which the investment's impact potential is systematically assessed and measured. The model is based on Impact Management Project's (IMP) five dimensions of impact, integrated with Trill Impact's own rating approach. Through this assessment, Trill Impact can at a very early stage categorise each investment according to the IMP's impact classifications; benefit stakeholders or contribute to solutions. **The five dimensions of impact help to build an understanding of each investments' value creation potential.** See Nordomatic assessment example.

5) Seeking appropriate disclosure on ESG issues by invested entities. Trill Impact initiated quarterly Impact and ESG reporting per portfolio company back in Q4 2020. In 2021 Trill Impact started implementing a system to track financials and Impact and ESG qualitative and quantitative measures to a broader extent and disclose at an appropriate level to the public in an annual impact report going forward.

Example of how social KPI linked to inequality can be set up

- The common metric tracked across all portfolio companies is the number of low- and moderate-income people served.
- The GP determines portfolio-level impact metrics during due diligence and in investment documents between the fund and each portfolio company. All portfolio companies report both short- and long-term metrics.

Conclusion

The introduction of ESG-linked carried interest mechanism creates a novel incentive for GPs to pay closer attention to the impact of their investments and can be helpful for showing real dedication. To ESG-related performance. However, implementing such structures requires careful consideration of various factors, including KPI selection, compensation structure, and measurement and verification mechanisms. It is also important to assess the additional costs that an ESG-linked carry mechanism will introduce which means that the mechanism might not be as suitable for smaller funds. Addressing these considerations can yield multiple benefits, including strengthening internal capacities, enhancing reputation, diversifying investments, and attracting new LPs.

Our research identified various approaches to setting up ESG-linked carry mechanisms, each with its own set of challenges and considerations. From aligning interests between stakeholders to defining impactful KPIs and designing incentive structures, there are numerous complexities to navigate. Nonetheless, these challenges present opportunities for innovation and collaboration across the industry.

Moving forward, it is essential to address risks such as unintended consequences, misaligned incentives, and the potential for impact washing. Robust due diligence processes, the use of assurance and verification, and adherence to sustainability regulations can mitigate these risks, ensuring the credibility and effectiveness of ESG-linked carry mechanisms. Another area that deserves more attention and exploration is the use of remuneration for the investee company boards to incentivise improvements in the sustainability metrics used in the ESG-linked carried interest mechanism.

In conclusion, ESG-linked carried interest mechanisms represent a transformative opportunity for the private equity sector. By aligning financial returns with impact, these mechanisms not only meet rising market expectations, but they also unlock new opportunities for growth and differentiation. The ESG-linked carry mechanism is also uniquely well-suited for transition efforts, which for an industrialised region with a sub-optimal energy mix (existing dependencies on coal and gas) could be truly transformative, enabling improved public and private sector collaborations. For regions like CEE, this approach offers a pathway to significant market differentiation and investor attraction, fostering a more sustainable and impactful investment environment. An example of this shift is ARX Equity Partners in the Czech Republic, who are about to launch a new fund with an impact-based incentive structure, marking it as one of the first in the region.

DISCLAIMER

The views expressed in this work represent those of the authors only and do not reflect the perspectives or opinions of the any partnering institutions, consulted experts, or any of our funders or collaborators.

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