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THE ESG POWER OF THE BOARD SEAT

Comparative case studies of how private equity firms implement ESG strategies within their portfolio companies and manage them through the use of control systems

Sanna Sabir (24990) **Jonatan Persson (25135)**

Abstract

This thesis aims to investigate how private equity firms use control systems to implement ESG-focused business activities within their portfolio companies. The chosen method was comparative case studies, with interviews and documents from two private equity firms. Using Simons' Levers of Control as a theoretical framework, we found that informal and frequent communication may be more important in majority equity arrangements for ensuring strategy implementation in portfolio companies than has previously been recognized. Additionally, our findings suggest that company owners place less emphasis on ESG integration into formal belief systems compared to previous research. Furthermore, our data revealed that ESG is incorporated into the management incentives implemented by PE firms to align interests, which has not been emphasized in earlier research.

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Key words: Private Equity, ESG, Management Control Systems, Levers of Control
Supervisor: Johan Graaf

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1. Introduction

1.1 Background

Environmental, social, and governance (hereon ESG) issues have received increased awareness and have become frequent topics of discussion in today's society (OECD, 2020). The 17 Sustainable Development Goals (hereon SDGs) developed and adopted by the United Nations Member States is just one example of this increased recognition (United Nations, 2015). As outlined by the SDGs, the ESG challenges facing the world today emphasize the importance of overall responsible corporate actions and pressure companies to not only care about monetary profit but to also contribute to the greater good. Further, studies show not only that companies play an important role in sustainability matters, but also that there might even be a business case for sustainability (Porter & Kramer, 2006).

The private equity (hereon PE) industry has grown substantially over the recent years, with deal volume increasing by three times since 2012, totaling a global deal volume of $2.04 trillion as of 2021 (McKinsey & Company, 2022). The PE industry thus also has a large impact on sustainability-related issues through their investments and management of portfolio companies. Due to the increased attention given to ESG as a sustainability concept (OECD, 2020) as well as the currently existing gap in the combined PE and ESG research, a further investigation of the topic could prove useful for the research area.

1.2 Problematization

The present thesis identifies several issues with earlier research, all concerned with the lack of knowledge in the implementation of ESG specifically within the PE sector. Firstly, previous PE literature has not focused on investigating ESG implementation in portfolio companies specifically, thereby missing an interesting perspective. For example, Bedford and Ditillo (2022) examine the role and characteristics of controls implemented by PE firms, as well as the contextual factors that contribute to the relative importance of different control mechanisms. They further identify four control mechanisms in PE relationships: contractual, results, behavior, and social controls. Contractual controls are mainly concerned with binding legal agreements, results controls with the achievement of predetermined objectives, behavior controls with specifying methods for performing tasks or restricting behaviors, and social controls with fostering socialization and interaction. However, Bedford and Ditillo (2022) do not investigate ESG. ESG implementation may have different characteristics than regular business activities, thus requiring different control arrangements. By not considering ESG, earlier PE research misses certain controls implemented by PE firms into portfolio companies. Therefore, further research investigating PE control in terms of ESG is needed.

Secondly, earlier research within the ESG field has mainly examined ESG implementation from a management perspective. For example, Arjaliès and Mundy (2013) examine how organizations make use of management control systems (hereon MCSs) to manage corporate social responsibility (hereon CSR) strategy. Further, they employ Simons' Levers of Control (hereon LOC) as an analytical tool and show how the use of formal communication systems is implemented by the management teams of the investigated companies. Thereby, they investigate the issue from the management level and without taking company ownership type into account. The lack of studies examining ESG in a new setting, such as the board-setting, thus calls for a study investigating from this perspective. Additionally, this perspective is needed because it provides valuable insight into how PE firms leverage their influence on the board in driving ESG changes.

Lastly, previous research on the combined topic of PE and ESG is lacking in using a theoretical framework as a lens when analyzing data. Thus, there could be limitations to their findings. For example, Süsi and Jaakson (2020) investigate how PE designs corporate governance bundles to achieve CSR goals. Multiple corporate bundles are found to be implemented, where corporate governance bundles are defined as the mechanism used by owners to direct and control a company. Part of a corporate bundle identified in the study is incentive systems. Incentive systems are implemented through PE control as the management teams of the portfolio companies become minority owners, either by co-investing with the PE firm or by receiving stock options. However, the incentive systems identified by Süsi and Jaakson (2020) are not found to be explicitly connected to any CSR factors. Since previous research has mainly investigated the combined field of PE and ESG without using a theoretical framework, they might miss findings on for instance the design of ESG incentive systems. Thus, there is a need for a study within the combined topic that applies a framework, such as Simons' LOC, when analyzing data.

1.3 Aim and Research Question

The present thesis aims to investigate how PE firms implement ESG strategies within portfolio companies and manage them through the use of control systems. By studying this process within PE firms, we hope to gain an understanding of how they work with ESG and simultaneously achieve the financial return they require. This will be done by drawing on existing research on the relationship between PE and ESG and applying a theoretical framework based on MCSs. Thus, the research question of the present study is: *How do private equity firms implement ESG strategies within their portfolio companies and manage them through the use of control systems?*

1.4 Contributions

The present thesis makes several contributions to the combined and separate literature on PE and ESG. The first contribution is to the PE literature in identifying that social controls are part of the control exerted by PE firms. Thus, the understanding of PE firms' implementation of control within portfolio companies is extended. In addition, social controls may be more important in majority equity arrangements than has previously been recognized, suggesting that both social and formal controls are important in ensuring strategy implementation in portfolio companies. The second contribution made by the present thesis is to the ESG literature in showing that ESG integration into formal belief systems is less emphasized by company owners compared to what has previously been shown. Lastly, the third contribution is made to the combined PE and ESG literature in showing that ESG can be part of the management incentives implemented by PE owners to align interests. This has not previously been emphasized by earlier research.

1.5 Delimitations

The present thesis is delimited to buyouts. The rationale behind this constraint is that other types of investments, such as venture capital and growth capital, usually occur in firms' earlier life cycle stages, where the focus typically is on growth and expansion rather than ESG (Robertson, 2009). Furthermore, in buyouts, the acquisition is of a controlling stake in the firm (Nama & Lowe, 2014). Thereby, the PE firm can affect the portfolio company's strategy to a larger extent than should they acquire a minority stake (Nama & Lowe, 2014). Moreover, due to accessibility reasons, the study focuses on Scandinavian PE firms.

2. Theory and Previous Research

This section contains a review of earlier research considering PE and ESG, both separately and combined. Furthermore, management controls systems will be further developed, and the theoretical framework used will be presented.

2.1 Earlier Research

2.1.1 Private Equity

PE firms acquire companies through leveraged buyouts, which are financed through a substantial amount of external debt and a limited amount of equity, typically to obtain majority control (Kaplan & Strömberg, 2009). The companies acquired are either private or taken private, with the belief that a change in ownership structure allows for decision-making that is not constrained by quarterly earnings pressures and diverse shareholders found in publicly traded companies (Robertson, 2009). The equity capital is raised through closed-end funds where institutional investors and wealthy individuals serve as the main investors (Kaplan & Strömberg, 2009). Additionally, the life of a fund is usually fixed at ten years but can be extended for up to three additional years (Kaplan & Strömberg, 2009. Afterward, the PE firm terminates the fund and returns the investors' capital (Kaplan & Strömberg, 2009). Moreover, PE firms generally aim to generate returns higher than those of the public markets (Nama & Lowe, 2014). Further, they are pressured to generate high returns since they charge investors at least two fees (management fees and performance fees), and in some cases, additional fees such as deal fees and monitoring fees (Nama & Lowe, 2014).

Moreover, PE firms apply three types of changes to the companies they invest in, changes which can be categorized as financial, governance, and operational engineering (Kaplan & Strömberg, 2009). Financial engineering involves PE firms providing equity incentives to the management teams of their portfolio companies (Gompers et al., 2016). Simultaneously, leverage pressures managers to avoid wasteful spending (Gompers et al., 2016). In governance engineering, PE firms exert control over the boards of their portfolio companies and provide more active management than public company directors and shareholders (Gompers et al., 2016). Furthermore, in operational engineering, PE firms create value for their portfolio companies by developing industry and operating expertise (Gompers et al., 2016). Moreover, ways of adding value to portfolio companies include but are not limited to reducing costs, improving revenues organically or inorganically, and changes in procedures, incentive systems, and operations and/or management teams (Nama & Lowe, 2014; Gompers et al., 2016).

Furthermore, Bedford and Ditillo (2022) suggest that control mechanisms are critical aspects of managing portfolio companies, and there is substantial variability among PE firms regarding the controls they employ. Bedford and Ditillo (2022) further suggest that the equity arrangement and the perceived cognitive style of the portfolio companies' management teams affect the control combinations employed by PE firms, which are used to influence the strategic direction of the portfolio companies and accomplish their goals. Concludingly, each PE firm has its own unique approaches to enhancing the values of its portfolio companies and focuses on a few strategies based on the expertise of its team (Nama & Lowe, 2014).

2.1.2 ESG

A growing sustainability awareness has resulted in the emergence of multiple definitions regarding the concept of sustainable business. One of these concepts is CSR, which Carroll (1991) provides a definition for. Carroll (1991) proposes that CSR consists of four kinds of social responsibilities: economic, legal, ethical, and philanthropic. These four components outline that businesses should always strive to simultaneously "be profitable, obey the law, be ethical, and be a good corporate citizen" (Carroll, 1991). When taken together, these components constitute the essence of CSR (Carroll, 1991). Moreover, ESG is another widely used concept and is defined as the environmental, social, and corporate governance issues that should be taken into account, both as risks and opportunities (OECD, 2020). Furthermore, ESG investing is stated as an area that has grown rapidly and has attracted considerable attention among investors during the past decade (OECD, 2020). Eccles et al. (2018) also highlight the popularity of ESG amongst investors, showing that the largest and most sophisticated investors in the world are now adopting environmental, social, and governance principles in their investment practices. Due to analytical reasons, the present thesis will use the terms CSR and ESG interchangeably.

Furthermore, multiple studies have explored the relationship between ESG activities and financial return. Eccles et al. (2014) investigate the effect of corporate sustainability on organizational performance. Further, they find that organizations characterized by a high degree of sustainability outperformed their competitors over a longer period, both in terms of stock returns and accounting performance. Porter and Kramer (2006) also elaborate on the topic by suggesting that corporate social responsibility can be a source for gaining a competitive advantage. Porter and Kramer (2006) show that if companies were to approach social responsibility with the same framework as they do with regular business decisions, it would prove to be a source of innovation and thus important for long-term competitive success and financial return. An alternative view of why firms would engage in corporate responsible actions is raised by Eccles et al. (2014), suggesting that it could work as a tool for risk management. By applying corporate responsibility, companies can manage a wide range of risks and avoid external costs that would impact not only their financial performance but also their reputation (Eccles et al., 2014). Although the causes for why firms choose to engage in ESG activities may vary, there still seems to remain the case that ESG has a positive impact on organizational performance and financial return (Khan et al., 2016; Eccles et al., 2014; Porter & Kramer, 2006).

Moreover, while existing studies have focused on the relationship between ESG and financial return, few studies have emphasized the process of implementing ESG within organizations. Khan et al. (2016) identify a need for further research on the topic of ESG implementation, to gain a deeper understanding of how companies can embed sustainability practices in their operations and decision-making. Additionally, Arjaliès and Mundy (2013) investigate the implementation of CSR strategy through the use of MCSs and suggest further research be aimed at understanding the implementation of CSR strategy.

2.1.3 Private Equity and ESG

Zaccone and Pedrini (2020) state that despite facing significant obstacles such as limited experience, time, and a lack of comprehensive measurements, PE firms are increasingly integrating ESG considerations into their strategies and actions. Furthermore, Indahl and Jacobsen (2019) refer to today’s movement of an increasing number of PE firms adding the management of ESG factors to their existing capabilities as “Private Equity 4.0”. The essence of the PE 4.0 investment model implies successfully integrating ESG risks and opportunities into the investment strategy and value creation approach, and as a result being more likely to improve returns while simultaneously reducing risk vulnerability (Indahl & Jacobsen, 2019).

Moreover, Süsi and Jaakson (2020) find that adhering to CSR principles, including fair treatment of business partners, employees and community, and respecting the environment, can lead to an improved financial outlook for the firm, thus increasing the potential value for the owners.

Furthermore, ethical investing initially focused on for instance negative screening methods to exclude investment in companies in particular industries or sectors because of ethical concerns (Crifo & Forget, 2013). However, due to concerns over the limitations of negative screening, ethical and socially responsible investing gradually progressed toward ESG integration (Zaccone & Pedrini, 2020). Moreover, Crifo and Forget (2013) state that PE firms promote ESG issues for strategic reasons rather than ethical ones, which is driven by a need for new value creation sources, improving risk management, and differentiation. However, Zaccone and Pedrini (2020) and Indahl and Jacobsen (2019) suggest that most PE firms are integrating ESG factors as a result of pressure from for instance investors, regulators, and the media. These pressures may cause PE firms to consider ESG factors as means of mitigating the risk of adverse events, rather than an opportunity to discover valuable new opportunities (Zaccone & Pedrini, 2020). Furthermore, Geczy et al. (2021) highlight the importance of incorporating impact investing into the design of private investment contracting since the parties in the PE fund know little about the most promising impact opportunities until the fund is well-established. Geczy et al. (2021) further suggest that impact goals are easier to observe than to measure, hence oversight committees and similar mechanisms are important in the implementation process.

Moreover, managing ESG issues becomes an essential part of a portfolio company's strategy, and progress toward improving its positioning is tracked and evaluated (Indahl & Jacobsen, 2019). Further, Zaccone and Pedrini (2020) find that the tools mainly used by PE firms to assess ESG factors are checklists and that only a modest number of PE firms use external advice from industry experts. However, Zaccone and Pedrini (2020) suggest that if PE firms want to explore market opportunities and drive innovation, they should indeed consider using external advisors. Moreover, Indahl and Jacobsen (2019) propose using the UN SDGs as a framework to manage ESG factors. The SDGs include, among others, health and well-being, responsible consumption and production, and climate action, and these can help with understanding the investments' potential for value creation as well as their riskiness (Indahl & Jacobsen, 2019). Furthermore, Süsi and Jaakson (2020) suggest that the portfolio companies' boards have both controlling and advisory roles, and find that CSR issues are discussed explicitly or implicitly during board meetings. Süsi and Jaakson (2020) also find that the board is active in providing advice to the management teams. Additionally, they find that portfolio companies are required to compile ESG reports and clearly communicate responsibility issues to the owners.

2.2 Theoretical Framework

2.2.1 Management Control Systems

A definition of MCSs, as presented by Malmi and Brown (2008), is the "systems, rules, practices, values, and other activities management put in place in order to direct employee behavior". MCSs work as useful tools in implementing intended strategies and also function as useful tools in the emergence of new strategies (Simons, 1995; Henri, 2006). Previous research suggests that MCSs consist of multiple integrated control systems working in conjunction (e.g. Simons, 1995; Widener, 2007; Malmi & Brown, 2008). Furthermore, multiple studies (e.g. Arjaliès & Mundy, 2013; Simons, 1995; Widener, 2007) demonstrate the importance of balancing the different uses of MCSs, showing one must balance the different controls in order to manage both the implementation and emergence of strategies.

The present thesis looks at MCSs since the aim is to investigate strategy implementation, which MCSs provide tools for managing. As mentioned above, MCSs play an important role in the strategic process, both in implementing strategies and seeking new ones. Furthermore, a prerequisite for looking at MCSs in the present thesis is that these types of structures (MCSs) are used by PE firms when implementing strategies, particularly ESG strategies, in their portfolio companies.

2.2.2 Simons' Levers of Control

The Levers of Control framework (Simons, 1995) consists of four control systems: *belief systems*, *boundary systems*, *diagnostic control systems,* and *interactive control systems*. These levers, or systems, are used by managers to handle and spread information within firms. Control systems emerge when these information-based systems are used to uphold or revise patterns in organizational activities. Furthermore, central to the framework (see Figure 1) is business strategy, which is the way in which a firm competes and positions itself in the competitive landscape. Moreover, core values, risks to be avoided, critical performance variables, and strategic uncertainties pose the next layer in the framework. Analyzing and comprehending these key constructs is necessary for a business strategy to be successfully implemented. Furthermore, the four levers constitute the final layer of the framework, each controlling a different key construct.

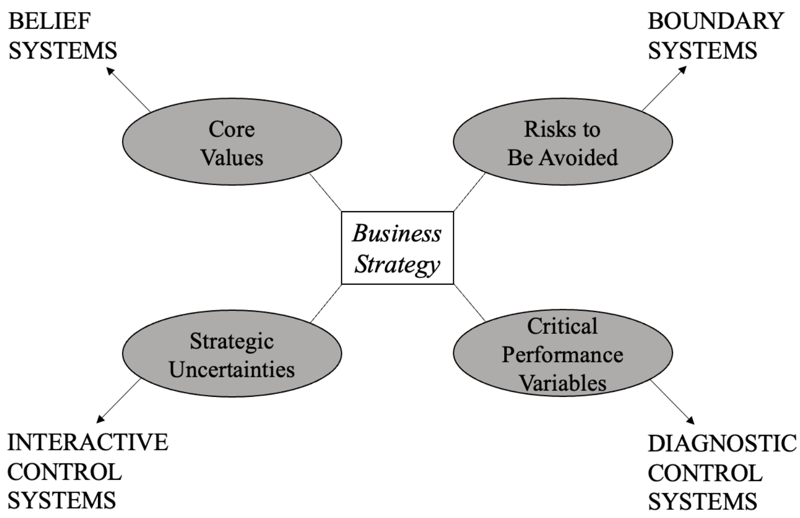

Figure 1: Controlling business strategy (reproduced from Simons, 1995, p. 7)

Moreover, belief systems are the positive systems within an organization that motivates the search for new opportunities. Specifically, it is defined as the *values, purpose, and direction* of the organization that managers communicate. Thus, the main purpose of belief systems could be described as a way of inspiring and guiding the discovery of new strategies. Tools for belief systems could for example include mission and purpose statements. The idea is that if individual capabilities are to transform into the achievement of organizational goals, it is crucial that the organizational members are fully aware of the purpose of these goals and the members' own contribution to that purpose. Further, if belief systems are to be successful in setting the direction for the organization, it is critical that the values promoted appeal to all organizational members. Belief systems must thus be broad so that everyone within the organization is captured, while at the same time being inspiring.

Furthermore, as belief systems are concerned with inspiring and setting the organizational direction, there emerges a need for a system that transforms this into desired actions. Boundary systems promote action by establishing boundaries which the organizational members are to act within, thereby setting limits on opportunity-seeking behavior. Additionally, boundaries are expressed in negative terms. Therefore, the focus is on what should *not* be done rather than the opposite. Furthermore, boundary systems can be divided into *business conduct boundaries* and *strategic boundaries*. Business conduct boundaries provide standards for ethical behavior and are typically formulated in explicit codes of conduct or similar policies. Strategic boundaries are rather concerned with the achievement of strategic goals and serve the delimiting role of the opportunity-seeking process. Strategic boundaries could for example help in defining what markets and customers to focus on.

Moreover, diagnostic control systems are negative feedback systems designed to motivate, monitor, and reward goal realizations. Managers employ these systems to oversee firm outcomes and to rectify any deviations from predetermined performance standards. The generic process of how diagnostic control systems function and is used to implement strategy takes several steps. First, a production or service process takes in inputs and transforms them into valuable outputs. The quantity and quality of the outputs are periodically measured and compared to predetermined standards, which are based on the business strategy of the firm. Feedback then enables the adjustment of the inputs or the refining of the process. Further, the output variables that represent important performance aspects of a strategy are referred to as *critical performance variables*. Diagnostic controls attempt to measure these variables by focusing on mistakes and shortfalls against goals. Moreover, goal achievement is linked with extrinsic rewards since it stimulates individual initiative and the seeking of opportunities.

Furthermore, interactive control systems direct attention toward strategic uncertainties and stimulate the emergence of new initiatives and strategies through discussions and learning in the interactive process. Additionally, these systems promote dialogue throughout the organization and encourage information gathering beyond typical channels. Moreover, *strategic uncertainties* are contingencies that may threaten the assumptions on which the current strategy is based, hence they require the organizational search for disruptive adjustments and opportunities. In addition, interactive control systems are not a particular type of control system since various types can be used interactively by management's active involvement. Moreover, interactive control systems consist of incentives where rewards are subjective and effort-based, thus enabling managers to acknowledge innovative behavior otherwise challenging to define beforehand and/or measure retrospectively.

Furthermore, the balancing of the four levers is fundamental to the LOC framework. Looking at the underlying foundation of the framework, three organizational dynamics are central: (1) *the dynamics of creating value,* (2) *the dynamics of strategy making,* and (3) *the dynamics of human behavior*. These dynamics highlight the importance of controlling the available opportunities, balancing new strategies and established ones, as well as recognizing the inherent self-interest of individuals. This interplay can be noticed in the four levers. While belief systems and interactive control systems are positive with the aim to inspire, boundary systems and diagnostic control systems are negative by their nature and have the purpose of establishing constraints. These opposing forces must be managed in order to achieve the desired strategy implementation.

2.2.3 Earlier Research Using Simons' Levers of Control

Simons' LOC framework is a prominent framework frequently used within the management control systems research field to look at the management of strategic implementations (e.g. Tuomela, 2005; Mundy, 2010; Bruining et al., 2004; Widener, 2007). Moreover, numerous studies have looked at the processes through which MCSs integrate sustainability as a strategy within organizations using the LOC framework. For instance, Gond et al. (2012) investigate how MCSs and sustainability control systems can be used in the integration of sustainability within a business strategy. Further, Gond et al. (2012) build on Simons' LOC framework to identify eight organizational configurations that reflect different types of uses of sustainability control systems and MCSs. Similarly, Arjaliès and Mundy (2013) explore the role of MCSs in the integration of CSR within a strategy by applying the LOC framework to investigate how managers balance intended and emergent strategies. In doing so, Arjaliès and Mundy (2013) find evidence for MCSs being suitable tools for organizations in their contribution to sustainable development, enabling better communication, reporting, and identification of threats and opportunities, as well as facilitating innovation.

2.2.4 Levers of Control in a PE and ESG setting

The present thesis acknowledges that previous research has mainly used the LOC framework in the setting of management teams and their implementations of business strategy (e.g. Gond et al., 2012; Arjaliès & Mundy, 2013; Widener, 2007). Furthermore, Simons (1995) suggests that the LOC framework was developed from the question "How do managers balance innovation and control?". Thus, it could be argued that the framework has been developed to be used on management teams. However, this study explores the LOC framework at the above level – in the setting of board members – which is where PE firms exert control. The reason for using the LOC framework in this context is that it is interesting to explore how strategy implementation can be made with the PE firms being in a special setting, i.e. not in-house. Furthermore, it is of interest to use the LOC framework in the ESG setting since ESG in the context of the present thesis is a strategy that can be integrated into business strategy (see Figure 1). Moreover, the PE firms are responsible for setting the portfolio companies' ESG strategies through their majority positions on the portfolio companies' boards. Additionally, the PE firms provide oversight and guidance to the management teams regarding the implementation of the ESG strategy. Thereby, they can suggest how implementation can be made without executing it themselves. Concludingly, using the LOC framework in this setting could generate a comprehensive understanding of how PE firms through their above perspective from the day-to-day operations manage ESG risks and opportunities and build value-creating sustainable business models.

3. Methodology

In the following section, a description of the design and implementation of the empirical study is described. Firstly, the selected research approach and the reasoning behind the chosen cases are presented. This is then followed by a detailed description of the data collection and analysis processes.

3.1 Research Design

The present study takes the research approach of qualitative comparative case studies on two private equity firms. The data has been gathered mainly through interviews, but also through document-based research. The decision to perform qualitative case studies building on interviews and company documentation is based on the study's purpose and research question (Ryan et al., 2002). The aim is to gain a deeper understanding of how private equity firms work with the portfolio companies they choose to invest in. Additionally, research indicates that performing interviews from a qualitative perspective can provide a more nuanced discussion, thus allowing for a deeper understanding of the stated research question (Jacobsen, 2002). The logic underlying the decision to perform qualitative case studies comparing and investigating two companies is thus to gain an in-depth understanding of the selected cases and the research question. However, it is important to recognize that the selected case companies might not necessarily provide an accurate indication of how the private equity industry as a whole deals with these matters.

Furthermore, Yin (2003) states that interviews are one of the most valuable information sources in performing a qualitative study, thus proving a valuable information-gathering source for the current study. Moreover, an abductive approach has been adopted in the making of this thesis because theoretical material is set against the empirical data gathered from the interviews and company documentation. The study thus shifts between empirical data and theory in order to gain an understanding and find a possible answer to the proposed research question.

3.2 Case Selections

The two selected cases are based on multiple criteria. Firstly, the firms are based in Scandinavia, where they also have their portfolio mainly focused. Secondly, the firms work with buyouts. Lastly, the case companies are among the larger actors in Scandinavia. The reasoning behind this is that leading PE firms have more resources and capabilities to work with sustainability implementations in their portfolio companies. Further, it is assumed that this increases the likelihood of the firms having management control systems in place for their portfolio firms. Thus, they have more to elaborate on regarding their ESG work and they also publish ESG reports which can be used for additional data. The two selected companies are anonymous and will be referred to as PE firm 1 and PE firm 2 in the present thesis.

Moreover, when selecting interviewees at the respective companies, the aim was to end up with a diverse selection to gain answers from multiple perspectives on the ESG implementation and increase the validity of our conclusions. However, it was important that the representatives from the firms had sufficient knowledge about the ESG implementations in their portfolio companies. Each firm had a manager that set up the interviews for us based on whom they recommended to be a suitable fit for our aim and research question. PE firm 1 was able to provide us with 6 interviews and PE firm 2 was able to provide us with 4 interviews (see Appendix 1). Furthermore, no portfolio companies of the PE firms were interviewed due to representative reasons. It could create a skewed impression and not constitute an overall holistic view if for instance only one portfolio company would be interviewed, since the portfolio companies operate in industries with different characteristics.

3.3 Data Collection

3.3.1 Initial Contact and Interview Context

Based on the case selection criteria, several PE firms were contacted mainly through email, but also via LinkedIn. This was preferred as it would allow for a reply when possible, instead of interfering with the potential interviewees' daily work. In the initial email were a short description and background of the present thesis, as well as a request for participation in the empirical study. Then, once the PE firms agreed to participate, they provided us with access to the interviewees.

The interviews were conducted using a semi-structured technique, enabling the opportunity for follow-up questions to further discuss topics of conversation. When conducting semi-structured interviews, it can be difficult to comprehend the discussion and formulate relevant follow-up questions, whilst simultaneously staying mindful of the theoretical framework (Marginson, 2004). However, both interviewers attending all of the interviews allowed for one of the interviewers to focus on the pre-written questions, whilst the other could listen more carefully to the conversation and thus easier come up with relevant follow-up questions. Additionally, thorough research about the PE firms was made prior to the interviews, which simplified coming up with follow-up questions. A deep understanding of the PE firms was enabled with the use of secondary data from their website, which is not included in the reference list due to maintaining the PE firms' anonymity. The use of secondary data was in line with Ryan et al. (2002) who suggest that utilizing multiple information sources when conducting case studies can be advantageous. Furthermore, prior to the interviews, an interview template was made which was revised constantly during the study as new discoveries were made (see Appendix 2). All interviews were conducted individually and digitally through Microsoft Teams.

Moreover, all interviews were recorded after ensuring the interviewees' acceptance. Recording the interviews enabled both interviewers to be engaging during the interviews and listen to the interviews several times, leading to discoveries not noticed at first. An alternative approach would have been manual recording with notes. While Hayes and Mattimoe (2004) suggest that note-taking during interviews can decrease transcription workload, we believed it would have reduced the active listening during the conversations and potentially hinder our ability to ask relevant follow-up questions. Furthermore, Hayes and Mattimoe (2004) note that interviewees may feel uncomfortable when being recorded, which could lead to limited or restrained responses. However, this was not an issue as the interviewees who might have felt uncomfortable with being recorded were given the option to oversee the quotes used.

3.3.2 Document Study

Data has also been gathered by screening publicly available documents from the PE firms' websites (see Appendix 3). The intention of the document analysis was to gain additional examples and clarifications if needed from the interviews. Hence, the data from the documents complemented the data from the interviews. Therefore, the document study was performed after conducting the interviews.

3.4 Data Analysis

After an interview had been conducted, an initial reflection was immediately made. Further, the interviews were transcribed within a week. Olsson and Sörensen (2007) suggest that it is appropriate to include spoken language expressions and pauses when transcribing, and that was the method we chose. However, to make quotes more readable and exclude potentially personal expressions, these were excluded from the citations. The exclusion was also made to avoid a less serious impression, as Brinkmann and Kvale (2009) suggest. Beginning the analysis by transcribing all interviews had the advantage of an increased understanding of the material.

After transcribing all of the interviews, the analysis began with the lens of Simons' LOC framework. This method was viewed as identifying for instance themes would have resulted in a similar analysis as to using the LOC framework directly, considering that the themes would have been part of the framework. For instance, having "visions" as a theme would have been part of belief systems, and using "measures" as a theme would have been part of diagnostic control systems. The separate sections on the empirical findings and the analysis would thus have been considered repetitive and were therefore merged. Furthermore, the present thesis recognizes that there are multiple control systems that may be implemented in companies and that may not be covered in the present thesis. However, the ones recognized are the ones that were mentioned the most by the interviewees and thus seem to have the largest impact on PE firms' ESG implementation into portfolio companies.

Moreover, the transcripts were thoroughly analyzed, and relevant quotations were extracted and organized appropriately. Some interviews were made in English and some in Swedish depending on what the interviewees suggested. The reasoning behind this was that the interviewees would feel more comfortable during the interview should they choose the language. Furthermore, for the interviews conducted in Swedish, translations of the empirical findings were made.

4. Empirical Findings and Analysis

This section analyzes the empirical findings from the interviews and the documents with the aim to answer the research question. It is organized similarly to the theoretical framework and will be divided into three parts. In the first part, findings on PE firm 1 will be examined. Thereafter, PE firm 2 will be investigated. Lastly, a comparison of the two firms is made.

4.1 PE Firm 1

PE firm 1 is a leading private assets management and investment company in the Nordics that has created value in its investments for over 30 years. Further, their buyout investments are mainly concentrated in the small and medium-sized enterprise segments. Moreover, PE firm 1 has a clear focus on sustainability. With a mission to enrich society through its role as an active owner, PE firm 1 recognizes the need for responsible operations.

4.1.1 Unidentified Formal Belief Systems, However, Visions are Present

The new and revised vision of PE firm 1 is that it should be the most responsible private assets company in the Nordics. This was embraced by all interviewees, stating alignment around the ESG strategy of PE firm 1 and its importance to them. Looking at the LOC framework, the values and purpose that are communicated to the portfolio companies can be described as belief systems that are formalized through the use of vision and mission statements. Moreover, data indicated that actions are taken to establish shared ESG values and beliefs together with the portfolio companies. Being aligned and sharing common values is expressed as an important part of the investment decision.

> *"We want to invest in companies that are on a good course [...]. Regarding company values, it is rather a matter of making them more explicit and clear. If we see a company with bad values, then we would not make the investment as making cultural changes takes a lot of time."* (Interviewee 6)

Furthermore, an important aspect in the drawing up of an ESG vision and strategy for the portfolio companies is the materiality assessment that is conducted by PE firm 1 in the due diligence phase prior to acquiring a company. The materiality assessment is done through an internal tool that is based on industry-specific ESG characteristics. Moreover, multiple respondents described the thorough process of sitting down with the companies after the acquisition to discuss the vision and to understand their material ESG topics, which then guides what ESG strategy and goals are put in place.

> *"We sit down with the companies to figure out what their values are and what they want to achieve. We have our top-down approach with PE firm 1-wide goals, and then we try to meet the company halfway and also get their bottom-up approach. This consists of many meetings and talking with the companies to figure out where they are and what they want to do."* (Interviewee 5)

> *"We do not tell companies what to do. The relationship between us and the company must be based on mutual respect, trust, and understanding, so how we communicate ESG factors is very important. Rather than us coming in and telling them what to do, we work together to come up with something."* (Interviewee 3)

The communication that is illustrated by the above citations provides examples of how belief systems are established in the relationship between PE firm 1 and their portfolio companies. By discussing vision and strategy with the management teams, goals and values are aligned between the two organizations. However, the interviewees' responses indicated a lack of implementation of formal belief systems within the portfolio companies. Formal belief systems are the documents used within an organization to clearly communicate organizational core values, where the ESG agenda can be integrated. Examples of such documents are mission or purpose statements, none of which the interviewees highlighted as being implemented by them as an owner. Thus, the use of formal belief systems that motivate the search for new opportunities is not as visible. The exploration of new ESG opportunities thus currently seems to be driven by initiatives from PE firm 1.

> *"Suggestions for ESG opportunities have typically come from our side. We are also lucky to be able to look broadly for opportunities and are thus good carriers of knowledge in a way that is more difficult for the companies themselves to be. Regarding what actually gets done, this is handled by the companies. Our role is mainly to come up with ideas and set targets."* (Interviewee 6)

It is clear that PE firm 1 has a steering role over their portfolio companies, which can be achieved through their engagement in the board. Numerous respondents mentioned the use of board positions as a tool for getting through desired ESG changes, while still preserving engagement and alignment. Furthermore, adhering to the LOC framework, the formalization of belief systems can lead to higher commitment amongst the employees, which in turn increases the performance and the realization of the adopted ESG vision. This indicates that even though PE firm 1 is able to exert control through the board, formal belief systems can create value through increased commitment. Moreover, multiple interviewees described the extensive ESG discussions taking place with the portfolio companies in the initial phase of the holding period. The LOC framework indicates that during these formative stages, frequent interaction between the participants keeps the organizational purpose and direction clear. As the portfolio companies grow and mature, defining a clear ESG purpose becomes more important and difficult, suggesting a need for formal belief systems to be developed.

4.1.2 Boundary Systems at the Group Level Influence The Portfolio Companies

Fundamental to boundary systems is the delimitation of organizational members' opportunity-seeking behavior. Regarding ESG performance, delimiting opportunity-seeking is not about restricting improvements and innovations, but rather setting limits on what opportunities not to pursue. Data indicated that such systems are applied in PE firm 1's controlling of the portfolio companies. Further, data suggested specifically the use of business conduct boundaries, which specifies prescribed behavior through, for example, codes of conduct and policies. For instance, as explained by interviewee 5 and elaborated on by interviewee 6, all portfolio companies are required to implement a code of conduct.

> *"We do a yearly survey of what policies the companies have [...]. We follow up quite heavily on these matters and know where the companies are positioned. We also have a policy package available for companies that do not really have such in place."* (Interviewee 6)

This illustrates that PE firm 1 not only makes sure that their portfolio companies use business conduct boundaries, but they also help in setting them up if the companies are lacking. Further, document 1 discusses the topic of policies, stating that all policies that PE firm 1 has at its group level apply also to their portfolio companies. These include codes of conduct, human rights, child labor, anti-corruption, whistle-blowing, data privacy, and cyber-security. PE firm 1 also measures the percentage of women on the portfolio companies' boards and keeps track of whether formal incentives for executives to perform on ESG are put in place. Moreover, all new portfolio companies must have set up and developed processes for human and labor rights policies within one year after acquisition.

Furthermore, data indicated the use of strategic boundaries within the portfolio companies. These differ from the policies mentioned as they are concerned with setting limits to achieve organizational goals rather than setting boundaries to govern ethical behavior. For example, the usage of a restriction list is denoting what PE firm 1 and its portfolio companies should not invest in. Further, document 2 gives a clear view of what sectors and engagements to avoid. Some of the restrictions include controversial weapons, animal testing, chemical pesticides, fisheries, fossil fuel: peat & thermal coal, gambling, pornography, and tobacco.

> *"We have our restricted sectors. We do not say what the portfolio companies can and cannot do after we have completed the investment, such questions are rather handled later on in the board if needed. However, we would not appreciate it if they made investments in countries where we do not want to operate."* (Interviewee 6)

As described by interviewee 6, any material actions will have to go through the board, where PE firm 1 is active and can influence. Furthermore, boundary system incentives are usually constructed as punitive sanctions since not all conformance with boundaries can be rewarded.

> *"One example of incentivizing ESG performance is that you need to follow the code of conduct or different policies in order to get the bonus."* (Interviewee 4)

Capital budgeting systems are another important aspect within the strategic boundaries as they, according to the LOC framework, help in concentrating the search for new opportunities and guide actions toward strategic goals. However, data indicated that ESG integration into portfolio companies' capital budgeting is lacking. Interviewee 4 mentioned that capital budgeting is done by the companies themselves and that ESG is generally not included as a part of that. Interviewee 3 added that ESG is a new area compared to other matters, and it is thus difficult to determine how the systems should be designed with an ESG component. The lack of ESG integration in capital budgeting systems could imply that the companies take on projects that could carry unforeseen ESG risks not in line with their strategy.

4.1.3 Materiality Forms the Design of Diagnostic Control Systems

Setting targets, which are based on the business strategy, is central to diagnostic control systems. When acquiring a portfolio company, PE firm 1 has performed a materiality assessment based on the SASB Standards which identifies what ESG topics are material for that specific company. Additionally, materiality constitutes the foundation for what targets are set. By analyzing the intended strategy and the specific targets associated with that strategy, the correct critical performance variables can be identified. After determining the critical performance variables, measures are developed. Further, the materiality assessment and some of the ESG goals of PE firm 1 are integrated into the ESG targets of the portfolio companies.

> *"Regarding environmental factors, we are establishing a roadmap for reaching carbon neutrality at PE firm 1. We have committed to the Science Based Targets Initiative and we are trying to get all of our portfolio companies there."*
> (Interviewee 4)

The Science Based Targets Initiative is expanded on in Document 1. The initiative mobilizes companies to set net-zero targets based on science in line with curbing global warming to the limit at which the effects of the climate are still sustainable, which is 1.5 degrees Celsius on average. Moreover, on a portfolio-wide level, PE firm 1 has developed 87 KPIs that apply across all portfolio companies. However, PE firm 1 focuses mainly on those deemed material for the specific company. This aligns with the LOC framework, as the critical performance variables depend on the specific goals and objectives of the portfolio company.

> *"Usually the companies already know what is material for them and have identified their own key drivers. The material topics may not be that formal, however, which is where we help in formalizing the material topics and communicating these internally. We also help in setting up measures and targets for the material topics, as well as setting up action plans."* (Interviewee 4)

Furthermore, establishing action plans may imply setting up processes and structures in the portfolio companies, which is done from an early stage according to interviewee 1. More often than not, portfolio companies do not have any ESG systems in place prior to the acquisition, depending on their ESG maturity. When acquiring a company, PE firm 1 sets up an action plan for the entire holding period, which is updated annually. Further, the portfolio companies can receive advice from PE firm 1 on how ESG implementation can be made. PE firm 1 can also appoint the CEO of the portfolio companies to ensure ESG execution, and the board to ensure strategic alignment. Additionally, setting up targets with defined time frames forces managers to regularly follow up with the portfolio companies. The measurements used by PE firm 1 focus on shortfalls against goals, and having these feedback systems in place allows PE firm 1 to achieve portfolio company goals without constant management oversight. Furthermore, it is required that all portfolio companies report on the 87 KPIs annually.

> *"We have developed around 87 ESG KPIs which our companies report on annually. These KPIs are not necessarily material for every portfolio company because companies are different. Although we collect that information, we do not require all portfolio companies to improve on all 87 KPIs."* (Interviewee 3)

Moreover, the annual reporting is done through an ESG survey on a platform, which is where PE firm 1 receives the data for the different KPIs. In addition, the non-financial ESG measures are followed up on through various questionnaires and interviews with employees. The portfolio-wide review, questionnaires, interviews, and other tools for measurement provide PE firm 1 with an understanding of how successfully the strategy is being implemented and what new targets should be set for the companies. This is in line with the LOC framework, suggesting that goal-setting provides benchmarks for identifying problems, as underperformance can trigger remedial action.

> *"The investment team meets with the portfolio companies to discuss if they have reached the targets, and if they have not, then it is discussed why that is the case […]. The portfolio companies can also contact us if they for example have reached a target ahead of time. We can then discuss together how we should assess the fact that we have set too low of a target."* (Interviewee 5)

Reaching the set ESG targets is on the agenda perhaps due to its linkage to executive remuneration. Linking ESG targets with incentives is also a way of ensuring goal congruence regarding ESG implementation.

> *"It is quite common globally to start with ESG being 5–10% of the bonus and then increase it to 20% which is a fairly good standard that it should be. Furthermore, the remuneration can also be fixed […]. We require ESG to be linked to the portfolio companies' incentive systems, but we do not require them to have a specific way of linking it."* (Interviewee 3)

If a portfolio company performs below set out ESG targets and minimum requirements, remuneration will be affected. This is a diagnostic control system incentive as it is tied to specific goal achievements with the purpose of increasing short-term motivation and ensuring ESG goal achievement. Furthermore, PE firm 1's borrowing costs can be increased if ESG targets are not reached since part of the financing is tied to reaching certain ESG targets. Thus, it is important for PE firm 1 and the portfolio companies to reach the set ESG targets.

4.1.4 Lack of Fully Developed Interactive Control Systems

Strategic uncertainties pose a key construct in the LOC framework. The uncertainties for the ESG strategies that PE firm 1 develops are unique for each portfolio company and depend on the chosen ESG strategy and vision of the board members. The question is if a company can adapt to the potential changes strategic uncertainties can bring and if it will be a leader or a follower. PE firm 1 looks at if the firm is a leader or a laggard already prior to making the investment since ESG laggards are deteriorating in value, thus affecting the exit price.

> *"Businesses that are ESG laggards have not made the ESG investments necessary for the future. Thus, the buyer that is going to acquire the company after us takes into consideration that they need to invest a large amount in order to get it up and running at the level it should be."* (Interviewee 2)

According to interviewee 2, it seems as if investing in ESG laggards could itself derail the achievement of the ESG visions PE firm 1 has for their portfolio companies. However, PE firm 1 emphasizes that they are not necessarily an impact investor, although they can be. Nonetheless, PE firm 1 rather focuses on transition and can thus enter an ESG immature company and help them transition in the way that suits them. Furthermore, based on unique strategic uncertainties, interactive control systems can be used to focus attention and drive dialogue throughout the portfolio company. From the data obtained, it seems as if PE firm 1 does not have any control system that can be fully categorized as interactive. However, certain elements of interactive control systems are acknowledged from the interviews.

> *"It is important to integrate the ESG objectives into the process itself and do the materiality analysis in order to set up objectives that are relevant for that particular company and that lead to the desired outcome [...]. Then make sure that this is followed throughout the process and that there is a dialogue with the company's management about how to measure this. Also to communicate with the company's employees so that there is an understanding within the company why it is important to follow up with, for example, supply chain issues."* (Interviewee 1)

From the above citation, it is clear that PE firm 1 works with ESG implementation partly interactively by participating in meetings with subordinates where ESG data become an important and recurring agenda. Thus, owners involve themselves regularly and personally in the decision activities of the portfolio companies' management teams. PE firm 1 also performs ESG training, which could be considered somewhat formalized. Providing the management teams of the portfolio companies with the knowledge and skills needed to follow and measure their ESG targets, a feedback loop that enables decision-making and adjustments could be created. However, none of the above-mentioned activities are considered formalized processes and thus do not constitute a fully developed interactive control system. Further, the LOC framework states that having an interactive control system can guide the bottom-up emergence of strategy. Although the portfolio companies' management teams are partaking in the emergence of their ESG strategy, it is the board that is responsible for setting the strategy and monitoring its implementation. Thus, there is a limited number of lower-level initiatives to seize unexpected opportunities that lead to new strategic initiatives.

4.2 PE Firm 2

PE firm 2 is a leading private equity firm that was founded over 30 years ago. The firm has a clear vision of developing market-leading companies while also contributing positively to society. Their investments are mainly focused on sectors where they have a proven history and experience. Having sustainability as an integrated part of their strategy, PE firm 2 invests in companies that drive transformative change.

4.2.1 Shaping ESG Attitudes Without Formal Belief Systems

The interviews conducted with PE firm 2 showed how ESG is viewed as an important part of their portfolio companies' visions and business strategies. Further, a key part when integrating ESG into portfolio companies is to include ESG in the visions created.

> *"When we take ownership, we create a vision for where we want to take this company, as it must be included in our investment case. And that vision also includes the ESG analysis so that we have an idea of the sustainable impact that the investment will bring, as well as a vision of how we can address it during ownership."* (Interviewee 7)

The respondents further described that prior to making any investment, due diligence is conducted where ESG risks and opportunities are assessed. A similar process is also performed together with the management teams of the acquired portfolio companies, where the focus is to find material ESG topics. Engaging management to find materiality that then creates a vision helps PE firm 2 to shape the belief systems of their portfolio companies.

"When we perform due diligence, we form a hypothesis of what the value creation plan should look like for the company, which ESG is integrated as a part of. We are trying to think about how we can build ESG into the business model and the value creation plan in order to get a vision of how the company can position itself and also do good things." (Interviewee 9)

Furthermore, signs of using belief systems can be seen in PE firm 2's ESG communication towards the portfolio companies. For example, PE firm 2, together with its internal sustainability function, has a presentation for the management teams of the portfolio companies. The focus of the presentation is for the management teams to understand the importance of ESG to PE firm 2 and to achieve alignment on the topic. Further, interviewee 8 mentioned that although an ingrained company culture often is difficult to change, people usually respond positively to ESG agendas since they can identify with it, and it creates a meaningful purpose. This is in line with the LOC framework, suggesting that the modern workforce to a large extent desires the ability to contribute to a positive endeavor. However, although PE firm 2 emphasizes ESG communication towards the management teams, data does not demonstrate the use of formal belief systems being implemented within the portfolio companies. Formal belief systems are typically created and communicated through documents such as mission and purpose statements. The use of such documents within the portfolio companies does not seem to be required or advised by PE firm 2.

"No, we do not really change their mission statement. We want the company to care about ESG issues of course, but we do not change anything through the use of mission statements." (Interviewee 8)

Furthermore, the informal belief systems can still work to shape the ESG attitudes of portfolio companies' management teams. However, not including ESG changes in formal belief systems could, for example, cause the portfolio companies to receive less guidance and inspiration regarding organizational search and discovery, as organizational members do not know what problems to tackle and what solutions to search for. Moreover, belief systems should be used and updated in situations where there is a desire to change the strategic direction of an organization. PE firm 2 does this through its majority ownership and presence on the board. Additionally, interviewee 7 mentioned how they can sometimes make investments in poorly ESG-performing companies, with the aim of making improvements during the ownership period. Such situations require a change in the strategic direction of the portfolio company, thus proving that the use of formal belief systems would be appropriate.

4.2.2 Establishing Boundaries Through Restrictions and Policies

Boundary systems are the systems that define the acceptable domain of organizational activity, which seems to be applied by PE firm 2 given the data obtained. The interviewees described how there is both PE firm 2's own ESG strategy and then there is one at the portfolio company level. Policies and codes of conduct are tools implemented at both levels, which establish expectations for behavior. Furthermore, respondents described the broad range of policies that are implemented in the portfolio companies.

> *"We require a code of conduct in the portfolio companies. This code of conduct must be approved by the board. We also follow up on anti-corruption policy, trade-sanction policy, antitrust policy, cyber security, data protection, tax policy, diversity policy, and supplier code of conduct."* (Interviewee 7)

Moreover, data suggests that the use of policies and codes of conduct can depend on what industry the companies operate in. For example, interviewee 9 mentioned that portfolio companies providing financial services typically already have the requested policies and codes of conduct in place, as the industry is particularly subject to external regulations. Furthermore, in Document 3, the firm's expectations of their portfolio companies in terms of ESG issues are outlined. Amongst others, PE firm 2 expects all portfolio companies to protect biodiversity, respect internationally recognized human rights, and work proactively against corruption in all its forms. Respondents also stated that they assist the companies in implementing business conduct boundaries if such are not in place, either by using digital tools or personnel expertise. Furthermore, data indicated the integration of strategic boundary systems within the portfolio companies. One identified strategic boundary in PE firm 2 is restricted sectors and activities, which aligns behaviors with the strategic objectives of the firm. Additionally, PE firm 2 is affected by fund investors' restriction requirements.

> *"We have certain sectors that we would not choose to invest in [...]. Typically, these things include gaming, tobacco, weapons, etc. If we see ESG risks, the*

company has to explain how those will be mitigated, otherwise we will not invest in them." (Interviewee 8)

"Our investors have different exclusion criteria such as exposure to certain customer groups [...]. However, we only invest in a certain number of sectors [...], which provides us with certain exclusion in itself." (Interviewee 7)

Furthermore, another example of a strategic boundary system is capital budgeting, as it helps the organization in selecting and allocating resources to investments or projects that are aligned with the strategy. Interviewee 8 suggested that PE firm 2 usually does not integrate any ESG factors into the capital budgeting of their portfolio companies. There can, however, be cases where portfolio companies have an ESG checklist for making investments. Not including ESG factors in capital budgeting could potentially imply that the portfolio companies take on investments that are misaligned with their long-term strategic objectives.

4.2.3 The Board is Central for Diagnostic Control Systems

Establishing ESG materiality enables addressing ESG factors in a strategic and business manner. PE firm 2 conducts a materiality assessment in the due diligence phase prior to acquisition, but also when a portfolio company is onboarded. If a portfolio company has performed its own materiality assessment, then this is reviewed by PE firm 2. However, if a portfolio company has not conducted such an assessment, then PE firm 2 uses the SASB Standards for identifying industry-specific factors which are then individualized on a portfolio company level. Furthermore, establishing portfolio companies' material ESG factors allows the identification of critical performance variables, which in turn enables relevant measures to be set. This way, the desired value creation and impact can be achieved. Furthermore, the process of setting up ESG targets for the portfolio companies is through the board, as PE firm 2 believes that ESG issues must be integrated into the existing decision-making forums for the desired outcome to be achieved.

"We start with developing an ESG strategy. This is done through the board as we have positions on the board from the investment team [...]. Then there are certain sets of tools and processes that we can provide the portfolio companies with,

which can help them determine what ESG measures are the most important and where the biggest risks and opportunities are." (Interviewee 8)

Moreover, the board identifies KPIs. According to Document 4, KPIs include but are not limited to female representation on board of directors (external board members), producing a sustainability report, and implementing a code of conduct. Which KPIs each company has depends on its material issues, however, certain ones apply to all portfolio companies.

"There are a few different sets of KPIs. There are those that you need to have in purely regulatory terms. Then there are those that concern the management team and the composition of the board [...]. Lastly, there are those KPIs that are more business-driven which are always specific to the company, or the type of company rather. The other two sets of KPIs are probably more general." (Interviewee 9)

Furthermore, to reach the ESG targets and fully integrate the ESG strategies, action plans connected to the ESG initiatives are established. Implementing action plans, or value creation plans as PE firm 2 calls them, often implies changes in the organization. For example, PE firm 2 may appoint the CEO and the board of the portfolio companies. Further, the number of changes needed depends on the ESG maturity of the portfolio companies pre-acquisition. Portfolio companies that were listed or owned by another PE firm prior to acquisition usually have some ESG function established. However, if the portfolio companies do not have any ESG system in place upon acquisition, PE firm 2 develops it from scratch, according to interviewee 8. Furthermore, to implement these value creation plans, which ESG is a part of, PE firm 2 offers their portfolio companies support in various ways depending on what the companies need. This support stems from PE firm 2's investment teams and a portal with for instance workshops, playbooks, training sessions, new material, insights, trends, and metrics.

Moreover, interviewee 10 states that it is the responsibility of the portfolio companies' management teams to practically implement ESG into their operations. However, it is the board's responsibility to ensure their implementation, according to Document 3. Using a set of ESG KPIs for measurement, ESG implementation is ensured and deviations from predetermined standards of performance are corrected. Moreover, PE firm 2 tracks targets on an ongoing basis throughout the year, which for some companies implies monthly.

"The KPIs have to be moving to a sufficient extent for them to be interesting to follow month by month. For example, the percentage of female board members is not that interesting on a monthly basis as it does not change that much per month. However, an interesting KPI to look at monthly is for example how much of customers' savings are in sustainable funds." (Interviewee 9)

Furthermore, the management teams report to the board in an annual review where more than 50 KPIs are tracked. Document 3 states that PE firm 2 assists their portfolio companies in collecting the sustainability data and conducting the annual review. In the platform to which the portfolio companies report the annual data, all companies have access to their own sustainability scorecard that contains a strategy, environmental, and governance sector with minimum requirements and individual scores. Additionally, the sustainability scorecards contain recommended actions for each portfolio company based on their degree of maturity and materiality. Furthermore, reaching the set ESG targets is often incentivized.

"Our incentive programs are [...] essentially the same for all companies. It is a large program that depends on the companies' share value. Thus, it captures everything. It comes back to the value creation plan, where we try to build in ESG. Our view is that if ESG is done well, we get a higher multiple in the end, so we create value through that." (Interviewee 9)

Furthermore, it is not required by PE firm 2 that all portfolio companies link ESG performance to incentives. However, the funds that the portfolio companies belong to have ESG KPIs linked to incentives such as discounts or penalties on the funding. This constitutes incentives for the portfolio companies and for PE firm 2 to reach the set ESG targets. This is aligned with the LOC framework, suggesting that linking achievement with extrinsic rewards can stimulate individual initiative and opportunity-seeking behavior since PE firm 2 and the portfolio companies know what they will be rewarded for and how it is to be measured.

4.2.4 Sector Events Found as a Formal Interactive Control System

The ESG strategy of PE firm 2's portfolio companies is subject to different strategic uncertainties depending on each company. For example, a company operating in the pharmaceutical industry could have strategic uncertainties relating to advances in technology, which could affect the quality of its medicines relative to competitors. By directing portfolio companies' attention to ESG strategic uncertainties, search for disruptive change and opportunities can be made. Additionally, it is noted in Document 4 that PE firm 2 works with understanding structural trends and shifts within their focus sectors as part of their investment strategy. Although this applies to PE firm 2's investment strategy, it could also prepare them to tackle any strategic uncertainties that their portfolio companies might face.

Furthermore, data suggests that PE firm 2 employs an interactive control system. Throughout the year, PE firm 2 organizes various sector events where ESG is a large theme, according to interviewee 9. During these sector events, portfolio companies can share their ESG knowledge with each other. Thereby, the ESG data is interpreted and discussed in face-to-face meetings of PE firm 2, their portfolio companies, and their portfolio companies' peers. Consequently, new ESG insights into strategic uncertainties are made. PE firm 2 makes the control system interactive through their continual personal involvement in establishing new targets, monthly and annual reviews of certain KPIs and action plans, and regular follow-up of new ESG intelligence. Information from these events triggers new initiatives and long-term reviews of the current ESG strategy. Furthermore, PE firm 2 has compulsory employee ESG training which can create a feedback loop that stimulates new ESG ideas and organizational learning. Although ESG training could be considered a slightly formalized interactive control system, it does not fully constitute a formalized process and system.

> *"It is compulsory to attend these ESG courses. They address everything from compliance to responsible ownership and sustainable strategies, and can also be sector-specific. There can also be themes like climate and diversity. We have educated over 1000 people over the years, including the board members and key management executives in our portfolio companies, as well as all employees at PE firm 2."* (Interviewee 7)

Furthermore, the LOC framework states that usually only one control system is used interactively in an organization. Thus, from the data obtained, it seems that PE firm 2 uses the number of formalized interactive control systems in their portfolio companies as suggested by the LOC framework. However, for a control system to be truly interactive, incentives must be subjective and effort-based, as it encourages creative search behavior and testing of new ideas. The obtained data does not indicate that PE firm 2 subjectively rewards participants for

ESG innovative contributions rather than results. Thus, although PE firm 2 has a formal interactive control system in place for all of its portfolio companies, it is not a truly interactive control system.

4.3 Clear Similarities in ESG implementation

Comparing the two studied PE firms, there are certain similarities identified which will also be elaborated on in section 5. Firstly, both PE firms use social controls in their portfolio companies. For example, portfolio companies can receive advice from PE firm 1 on how ESG implementation should be made, and PE firm 2 works together with their portfolio companies to find material ESG topics. Additionally, both PE firms also implement contractual, results, and behavior controls. Regarding contractual controls, both PE firms 1 and 2 state that they for example can appoint the CEO and board of their portfolio companies. Furthermore, since both PE firms' portfolio companies report on certain ESG KPIs at least annually and set strategic targets with clear time horizons, results controls are observed. Moreover, behavior controls are identified in both PE firms 1 and 2.

Furthermore, none of the PE firms emphasize the implementation of ESG into formal belief systems. For example, PE firm 2 described how they generally do not make any changes regarding ESG to portfolio companies' mission statements, and PE firm 1 did not illustrate integration of ESG into documents that would be characterized by the LOC framework as formal belief systems. Moreover, both PE firms 1 and 2 integrate ESG indirectly or directly into the incentive systems of their portfolio companies, albeit in different ways. PE firm 1 requires their portfolio companies' incentive systems to be linked to ESG factors. Contrarily, PE firm 2 does not require its portfolio companies to link ESG performance to incentives. However, the financing costs of both PE firm 1 and PE firm 2 are affected by their portfolio companies' performance on ESG targets which acts as indirect incentives for both of the PE firms as well as their portfolio companies. Additionally, the reason why PE firm 2 does not require their portfolio companies to integrate ESG separately into their incentive systems is that they view ESG activities as a normal element of organizational activities and thus as part of the businesses' overall value.

Concludingly, it is apparent from the above-mentioned findings that PE firms 1 and 2 are quite similar in how they implement ESG into their portfolio companies. Although there are some differences between the firms such as how incentives are connected to ESG, they could thus be regarded as one firm.

5. Concluding Discussion

In this part of the thesis, a discussion of the contributions will be presented. The discussion is structured into three parts, each addressing literature to which a contribution is made.

5.1 Social Controls are Present in PE Majority Equity Arrangements

The present thesis identifies that social controls are a part of the way in which PE firms with majority equity arrangement exert control over their portfolio companies. The social controls recognized within PE firms include informal communication, frequent dialogue, and to some degree joint decision-making. This finding is in contrast to Bedford and Ditillo (2022) who identify three types of control mechanisms for PE firms with a majority interest: contractual, results, and behavior controls. Thus, out of the four types of control mechanisms studied, Bedford and Ditillo (2022) do not recognize social controls being implemented in majority equity arrangements. The reasoning in the article is that PE firms with a majority interest have a larger capacity than those with a minority interest to implement formal controls, thereby reducing their need for social controls.

Furthermore, while the present thesis recognizes social controls unlike previous literature, contractual, results, and behavior controls are also identified as being implemented for majority equity arrangements. Contractual controls such as managerial selection rights and board rights are discovered. Moreover, results controls such as reporting, target setting, and incentives are identified. In addition, behavior controls are observed in both PE firms 1 and 2 by the use of board meetings, drawing up of business plans, action plans, and rules setting through policies and codes of conduct.

Furthermore, the above-mentioned finding of the present thesis contributes to the PE literature in two main ways. Firstly, the results extend on how PE firms implement control within portfolio companies. Besides implementing formal control systems, PE firms develop social controls to build trust and interaction with management. This implies that for instance informal communication, frequent dialogue, and to a certain degree joint decision-making is essential in strategy implementation for PE firms. Secondly, the findings indicate that social controls may be more important in majority equity arrangements than has previously been recognized. Although Bedford and Ditillo (2022) suggest that social controls can be observed as substitutes to formal controls since increasing the emphasis on one control diminishes the benefits derived from the other, the present thesis finds that social controls indeed can exist simultaneously as formal controls without being detrimental to one another. Thus, the present thesis contributes to prior PE literature in showing that social and formal controls are both found important in ensuring strategy implementation in portfolio companies where PE firms are majority owners.

Moreover, numerous factors could prove explanatory of this contribution. To begin with, the present thesis investigates PE control in an ESG setting. The implementation of ESG might look different compared to that of regular business activities and might thus require different control arrangements. In addition, the present thesis is focused on Scandinavian PE firms while Bedford and Ditillo (2022) investigate Italian PE firms. Thus, there could be cultural and regulatory differences between Italy and Scandinavia that may affect the ways in which PE firms exert control in situations of majority ownership.

5.2 ESG Integration Not Apparent in Formal Core Values

In the present thesis, ESG is not found to be integrated as a part of the formal communication of portfolio companies' organizational values and purpose, at least not due to suggestions or pressures from the PE firms as owners. The answers provided by PE firm 1 gave no impression of them as owners integrating ESG into formal belief systems such as mission or purpose statements. Similarly, respondents from PE firm 2 mentioned how they typically make no changes to the portfolio companies' mission statements. This can be contrasted to the findings by Arjaliès and Mundy (2013), which will be elaborated on below.

As previously discussed, Arjaliès and Mundy (2013) examine how organizations implement MCSs to manage their CSR strategy by sending out questionnaires to the 40 largest companies in France. Furthermore, they show how formal communication systems are being implemented within the companies. Arjaliès and Mundy (2013) also describe how all of the examined companies incorporate CSR objectives in their organizational purposes and values that are communicated to the employees. These values are typically expressed as mission statements for CSR strategy and are communicated in a variety of ways within the companies; for example through strategic documents, a company intranet, or artifacts such as posters. In line with this, Arjaliès and Mundy (2013) describe how the investigated companies emphasize the use of formal communication to express the purpose and values surrounding CSR strategy. For example, one of their respondents describes how the CSR strategy is formally communicated by the board of their company to the local managers through for example corporate communication channels such as an intranet, booklets, e-mails, etc.

However, the present thesis does not find that either of the investigated PE firms employs formal communication systems such as ESG-linked mission statements through their positions on the board. Thus, the present thesis' contrasting finding contributes to earlier research by showing that the integration of ESG into formal belief systems is less emphasized by company owners compared to what has previously been shown. This finding implies that while formal belief systems such as vision or mission statements can be important, they may not be the only way to shape a culture and organizational values around ESG. For example, PE firms 1 and 2 rather seem to focus on close communication with the management in the creation of an ESG strategy, which the management teams then are responsible for implementing and communicating throughout the organization. Arguably, this might be an overlooked approach that could still function as effective in directing the ESG agenda.

Furthermore, there could be multiple reasons enabling the establishment of the above-mentioned contribution to the ESG literature. For instance, there are some significant differences between the present study and the one conducted by Arjaliès and Mundy (2013). Firstly, the present thesis investigates PE owners specifically while Arjaliès and Mundy (2013) investigate the 40 largest companies in France and thus a wide range of ownership situations. Thus, the present thesis applies Simons' LOC framework in a new setting, i.e. the board-setting, since PE firms exert control over their portfolio companies from the board level rather than from the management level. However, Arjaliès and Mundy (2013) rather examine how management integrates CSR, hence looking at the issue from another level and without taking company ownership type into account. Furthermore, the present thesis concerns companies that are notably smaller in size than the companies investigated by Arjaliès and Mundy (2013), which could also cause different results.

5.3 PE Use of Incentives to Manage ESG

The present thesis shows that PE firms implement ESG indirectly and/or directly into the incentive systems of their portfolio companies. In direct linking, PE firms may require portfolio companies to incorporate ESG performance into the incentive systems, while in indirect linking, PE firms have ESG factors linked to their fund financing costs.
Both types of ESG-linked incentives that are identified in PE firms 1 and 2 can be argued to motivate PE firms as well as their portfolio companies.

In contrast to the present thesis' findings, Süsi and Jaakson (2020) do not find that ESG factors are integrated into incentives. They do, however, recognize the use of incentive structures without any connection to ESG-related issues as means of motivation. The identified incentive system is, as previously mentioned, designed to make the portfolio company's management teams minority owners of the company. This implies that the management teams focus on a successful exit over other goals, such as ESG goals. This could in turn potentially threaten the achievement of a long-term ESG vision. Thus, the findings of Süsi and Jaakson (2020) regarding ESG incentives in PE firms' portfolio companies might suggest that PE firms would make their portfolio companies concerned with an exit and increasing their financial figures rather than implementing ESG targets. However, this is not what the present thesis suggests. Since ESG incentives are found to be implemented directly and/or indirectly into portfolio companies, PE firms are assumed to encourage portfolio companies to implement ESG into their operations and not only prioritize a successful exit. This is also important to the PE firms as their own incentives in turn are affected by the portfolio companies' performance on ESG targets. The present thesis thus contributes to the combined PE and ESG literature by showing that ESG can be a part of the management incentives implemented by PE owners to align interests. Additionally, this finding indicates that PE firms may take a more proactive approach to ESG issues than has previously been suggested.

Furthermore, one main reason why the findings of the present thesis relating to incentive systems implemented by PE firms into portfolio companies are contrasted to the findings of Süsi and Jaakson (2020) could be that the article focuses on corporate governance mechanisms and lack in using a theoretical framework when analyzing data. However, the present thesis applies the LOC framework when analyzing data and does not focus on corporate governance mechanisms specifically. This could explain why the present thesis is able to identify that ESG is linked to portfolio companies' incentives.

6. Conclusions

This part of the thesis summarizes the critical findings and contributions to previous research. This is followed by a discussion of what future research could investigate further.

6.1 Summary

The present thesis finds multiple insights that help in answering the proposed research question; *How do private equity firms implement ESG strategies within their portfolio companies and manage them through the use of control systems?* Firstly, the findings from the two investigated PE firms were surprisingly similar. In terms of the control systems integrated, PE firms 1 and 2 seem to rely on roughly the same tools when implementing ESG as owners within their portfolio companies. Moreover, the present thesis contributes and expands on existing research by providing a more detailed understanding of how private equity firms implement ESG into portfolio companies. Firstly, the present thesis shows how informal communication and joint frequent dialogue with portfolio companies is applied by PE firms when having majority ownership, which is contradictory to previous research in the PE field, such as by Bedford and Ditillo (2022). Secondly, the present thesis finds that both PE firms seem to put little emphasis on communicating ESG agendas through formal belief systems. Instead, they focus on conveying the agenda through clear communication with the portfolio companies' management teams. This finding is inconsistent with previous ESG research such as by Arjaliès and Mundy (2013). Lastly, the present thesis finds that PE owners use incentive systems linked to ESG targets to motivate performance on ESG matters, which is in opposition to earlier research in the combined PE and ESG research field, such as by Süsi and Jaakson (2020).

6.2 Future Research

The contributing findings of the present thesis call for future research to further investigate the topic. For example, future research could use the findings of the present thesis to examine if social controls in PE majority equity arrangements apply only in an ESG setting or if such controls can be identified in other settings as well. Future research could also investigate whether there are any unidentified controls being used in situations of majority control in an ESG implementation setting. Lastly, future research within the combined PE and ESG field could further explore in depth which incentive structure is best suited for managing ESG matters from a PE perspective.

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8. Appendix

8.1 Appendix 1: Details of Interview Sample

Interviewee	*Title*	*PE Firm*	*Date*	*Time*	*Duration (ca.)*
Interviewee 1	Head of Communications	PE firm 1	2023-03-20	09:00	60 minutes
Interviewee 2	CFO	PE firm 1	2023-03-20	10:00	60 minutes
Interviewee 3	Head of ESG	PE firm 1	2023-03-20	11:30	60 minutes
Interviewee 4	Investment Manager	PE firm 1	2023-03-21	09:00	60 minutes
Interviewee 5	ESG Manager	PE firm 1	2023-03-22	12:00	60 minutes
Interviewee 6	Investment Manager	PE firm 1	2023-03-28	12:00	60 minutes
Interviewee 7	MD - Head of Communications & Sustainability	PE firm 2	2022-04-03	16:00	60 minutes
Interviewee 8	Investment Director	PE firm 2	2022-04-05	10:00	60 minutes
Interviewee 9	Investment Director	PE firm 2	2022-04-24	10:00	60 minutes
Interviewee 10	Sustainability Manager	PE firm 2	2022-05-02	10:00	30 minutes

8.2 Appendix 2: Extract from Interview Guides

Formalities

- Presenting the aim of the study.
- Asking if it is ok to record/tape the conversation.

Background

- Respondents are asked how long they have worked with private equity.
- Asking about their role at the PE firm.
- Asking if they work within a specific sector, and if so, which one.

ESG implementation in PE

- Do you have an ESG strategy? If so, what is your ESG strategy?
- If and when setting up ESG goals for your portfolio companies, how do you come up with the ESG goals appropriate for your portfolio companies?

- Do your newly acquired portfolio companies usually already have a way of integrating ESG factors or are you the ones who develop it? If they already have one but you want to change it, how do you reason when changing it?
- How do you implement your ESG strategy into your portfolio companies?
- Do you link your ESG strategy to the culture of the company? If so, how?
- Do you specify any ESG opportunities which the company must avoid? If so, what are these?
- How do you work with ensuring goal congruence regarding ESG implementation so that they align with your interests?
- Do you have any type of reward/incentive systems when it comes to ESG performance in your portfolio companies? How is it designed and why is it designed in that way?
- How do you control your portfolio companies? What kind of control systems do you use?
- How do you measure the outcomes of your ESG implementations?
- What are the main barriers to ESG integration within your portfolio companies given that you are a PE firm?

The Interview End

- Are there any additional issues or aspects you want to mention that we have not yet discussed?

8.3 Appendix 3: Details of Documents Used

Document Number	*Type of Document*	*PE Firm*	*Description of Content*	*Number of Pages*
1	Sustainability Report 2021/2022	PE firm 1	Elaborates on the firm's ESG performance during the year as well as how they work with ESG at group- and portfolio company-level.	80
2	Restriction List	PE firm 1	Lists all of the areas that the firm does not invest in if certain involvement type and/or thresholds are exceeded.	3
3	Responsible Investment Policy	PE firm 2	Outlines the firm's approach to responsible investment throughout the investment, ownership and exit phases of the investment process.	3
4	Annual and Sustainability Review 2022	PE firm 2	Expands on the firm's annual results and investment areas, as well as their ESG work.	37