



Stewardship Strategies in Private Equity Investments

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Impressum

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Executive Summary

In private equity, a successful engagement strategy for limited partners can follow two distinct channels: contributing to growth (primarily by providing additional capital and technical assistance) or enabling transformation (by addressing gaps in predefined sustainability goals). Given the investment structure, such strategies necessarily rely on collaboration with the private equity management company. As in public equity stewardship, the success of engagement depends on the business case and the credibility of those presenting it. However, escalation mechanisms differ: they are typically more limited, depending on voting rights and divestment options. Forming coalitions with like-minded investors may therefore be the most effective response to unsuccessful engagements. Overall, private equity structures lend themselves well to engagement, but the overarching sustainability goals, contribution channel (growth or transformation), key performance indicators, escalation steps, and reporting requirements should be clearly defined in advance. A thorough engagement process also requires dedicated resources at the investor level, ensuring effective interaction with the general partner and alignment on sustainability objectives.

1 Definition of Impact in Private Equity

Investor impact in private equity can be differentiated into contributions to growth or transformation (see, e.g., Brest et al., 2018; Kölbl et al., 2020). These two channels are often described as financial additionality (growth) and non-financial additionality (transformation). Financing growth refers to impact achieved primarily through the allocation of capital to a company or project that makes a genuine contribution to sustainability goals (e.g., the SDGs). This form of investor impact is maximized when the company would otherwise face capital constraints and clearly benefits from additional financial resources, enabling it to expand its contribution to sustainability goals. By contrast, transformation investments refer to the change of a business model toward greater sustainability or the closing of a gap in its contribution to a sustainability goal. Although the literature has primarily linked investor impact in private equity to the growth channel, while associating improvement strategies with engagement in public equity, the latter can also be effectively adapted and applied within private equity contexts.

The distinction between the growth and the transition channel (i.e. between financial and non-financial additionality) is critical across all steps of a meaningful engagement process in the private equity context. In particular, it shapes the selection of key performance indicators and, consequently, influences the due diligence process, investment monitoring, engagement strategy, and reporting practices.

The investor needs to evaluate whether the target company (i) meets predefined sustainability goals and, if not, the severity of gaps in its contribution to these goals, and (ii) assesses its financing situation. These assessments determine whether an investment qualifies as both investable and impactful in terms of growth or transformation. For clarity, we distinguish two conditions for (i) and (ii): contribution to predefined sustainability goals or alignment with a theory of change (Yes/No), and financing constraints (Yes/No).

The following situations can be differentiated

1. Financing constraints and clear contributions towards sustainability goals
2. No financing constraints and clear contributions towards sustainability goals
3. Financing constraints and no clear contributions towards sustainability goals
4. No financing constraints and no clear contributions towards sustainability goals

Accordingly, we can distinguish four situations in which investors may achieve impact.

(1) Financing constraints, no sustainability gap:

Here, the investor can resolve financing constraints and thereby generate financial additionality by enabling the company's growth.

(2) No financing constraints, no sustainability gap:

In this case, the mere provision of capital is unlikely to create investor impact. While sustainability improvements are not central, non-financial engagement may still play a role. In private equity, such engagement can extend beyond sustainability improvements to include technical assistance or consulting. Small-scale companies, for instance, often lack the expertise or resources to exploit their growth potential and may benefit from investors' experience, e.g., in capitalizing on economies of scale.

(3) Financing constraints and sustainability gap:

If both gaps exist simultaneously, the likelihood of achieving investor impact is high. However, capital allocation alone is insufficient, as closing the sustainability gap is essential. A dedicated engagement strategy therefore becomes central in this case.

(4) No financing constraints, but sustainability gap:

Here, the effect of capital allocation is secondary. Instead, the scale of the investment—and the corresponding ownership stake—determines the investor's ability to exercise influence in the engagement process to close the sustainability gap.

2 Framework

Research on engagement and stewardship in private equity is still limited. One of the few existing accounts is provided by UN PRI (2024), which reports on stewardship practices from the perspective of general partners. We extend this analysis by considering limited partners, who – unlike general partners – have only restricted access to portfolio companies (see Figure 1).

While stewardship and engagement strategies are generally understood to drive change and seek improvements (see, for example, UN PRI, 2024), we adopt a broader understanding of thorough stewardship by also considering engagement approaches that foster growth. To do so, we develop a framework (see Figure 2) that constitutes of four different phases, namely strategy, due diligence, definition of indicators, and the engagement process, and discuss the individual steps in detail below.

2.1 Strategy

Successful impact investing must be embedded within the broader investment and sustainability strategy of an investor, ensuring consistency with its overarching objectives. In particular, the design and implementation of stewardship depend critically on the goals set by the asset manager and on whether the institution pursues a transformation-oriented approach or a growth-driven case.

If the strategy is to contribute to transformation, a clear theory of change needs to be defined. This includes the definition of specific motives and a thematic focus as well as key performance indicators to monitor progress.

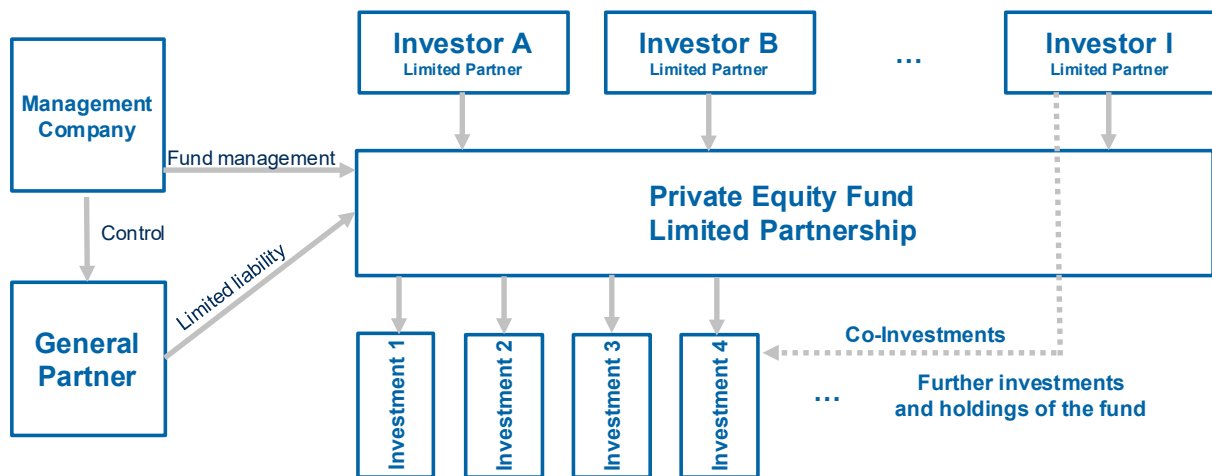


Figure 1 Private equity investment structure

Experience from the public market suggests that the success of an engagement depends heavily on the business case and the credibility of the staff presenting it (see below). Since the engagement process in private markets is similar, this is likely true for this market segment as well. This means that investors must ensure that the specialists needed to advance the business case are available, either within their own staff or at the PE management company. In the growth case, it is inevitable that the GP / PE management company will provide the necessary resources to advance the business case because this is the core value proposition of an early-stage private equity company. In the case of transformation-oriented engagement, investors must allocate dedicated resources to effectively structure and implement the engagement strategy. A careful assessment of the associated costs relative to the potential benefits is essential. In addition, the involvement of external resources may be considered to complement internal capacities.

Another area that needs to be strategically addressed is data management and reporting. Key figures required for overall portfolio steering and for the impact measurement must be provided. For listed companies these two processes are typically performed using third-party ESG data which, however, are not available for private equity firms. So, a credible PE stewardship process contains a strategy for the data collection.

With respect to the engagement approach, the specifics of the escalation strategy need to be defined, while recognizing that escalation options in private equity differ from those available in public equity. Moreover, certain core elements of escalation – such as the exercise of voting rights – can only be undertaken by the private equity management company rather than by the investor. From the perspective of limited partners, a core component of implementing engagement strategies is therefore an active involvement of the general partner, or private equity management company, as the intermediary with direct access to portfolio companies (see Figure 1). This requires, first, the careful selection of an implementation partner who is receptive to sustainability issues, and second, close collaboration throughout the engagement process

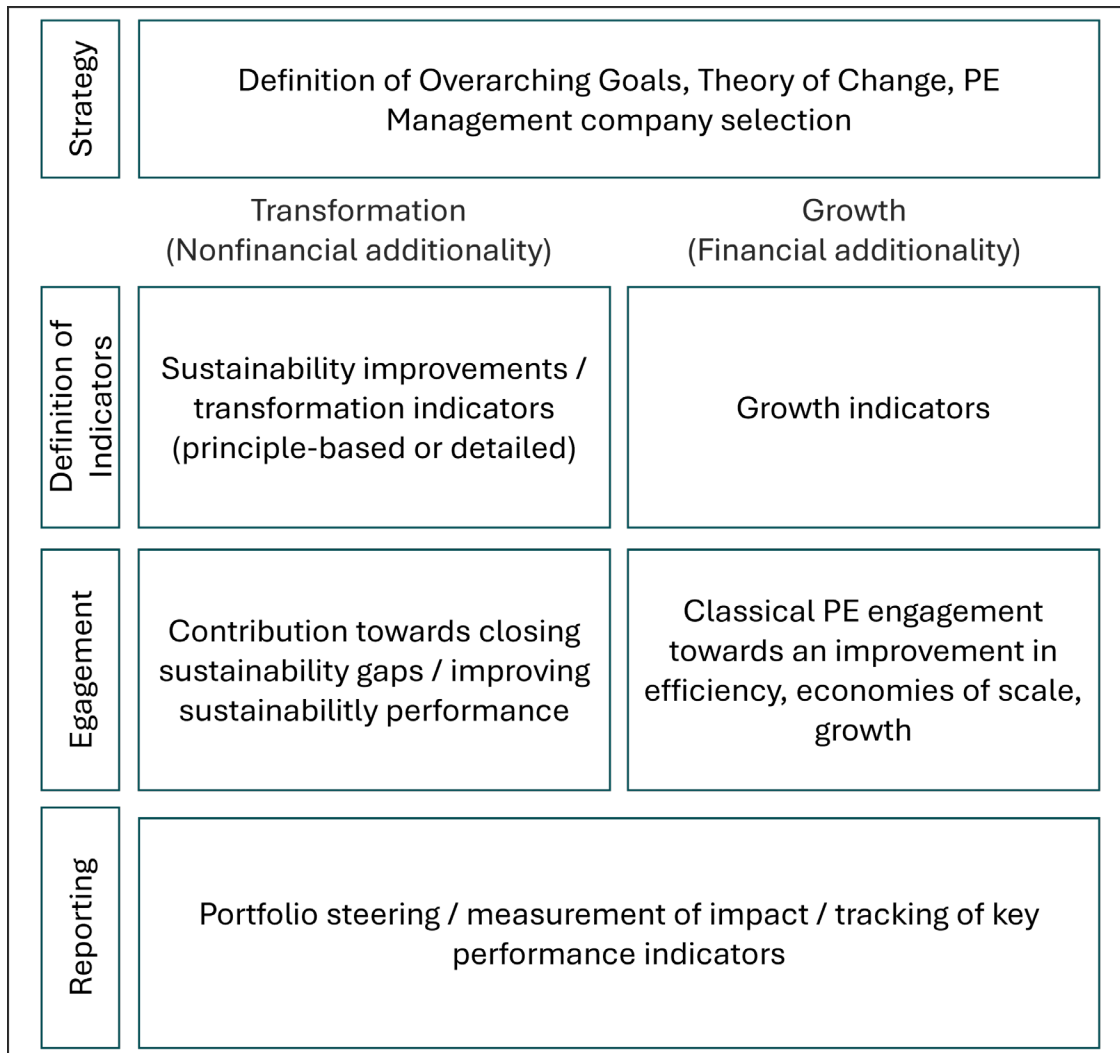


Figure 2 Framework for engagement strategies of limited partners in private equity

2.2 Definition of Indicators

The pre-investment screening process – specifically, thorough due diligence – is an essential step in any private equity strategy. Given data limitations, this process is typically long-term and involves close interaction with the target company. As a result, the PE management company gains a deep understanding of potential gaps in the achievement of sustainability goals as well as possible financing constraints. Moreover, investors can make deal closure contingent on the portfolio company first addressing specific sustainability-related issues (UN PRI, 2024).

With respect to indicator definition, these should be classified according to the degree of additionality specified for the respective investment target. For achieving non-financial impact, monitoring improvements in specific, predefined impact categories is central. By contrast, the success of financial additionality can be assessed using growth indicators such as sales, customer numbers, or market expansion. With respect to monitoring a sustainability transformation, two broad approaches to impact assessment can be distinguished: principle-based assessments and detailed, metrics-driven assessments.

Principle-based approaches rely on qualitative judgments and broad alignment with sustainability values. These frameworks often emphasize intentionality, additionality, and contribution to positive outcomes. Examples include the *Operating Principles for Impact Management* and the IFC's *Impact Investing Principles*. Such approaches are particularly relevant when quantification is difficult, for instance in social interventions or early-stage ventures. They are typically predicated on the definition of a theory of change, which is then closely monitored at the level of individual investments.

Detailed impact assessments, by contrast, rely on the systematic measurement of outcomes using clearly defined indicators. Examples include estimating avoided emissions, tracking job creation, or assessing health outcomes. Frameworks such as IRIS+ or the Impact Management Platform provide guidance on the selection of indicators and the design of data collection processes.

Each approach has distinct strengths and limitations. Principle-based frameworks provide flexibility and are easier to apply across diverse investments. They are particularly useful for early-stage engagement and portfolio screening, but their reliance on subjective interpretation can reduce comparability and rigor. By contrast, detailed approaches offer greater precision and accountability but require robust data systems, technical expertise, and long-term tracking. In private equity, where data collection can be costly and resource-intensive, detailed assessments are often restricted to a subset of metrics or to high-priority investments. Furthermore, accountability of outcomes or impacts observed is a challenge due to many factors that are at play simultaneously (other investors, political situation, market trends etc.). A growing trend is the hybridization of the two: principle-based approaches are used to guide strategy and engagement, while detailed metrics are applied where feasible. This allows for a balanced approach that combines strategic direction with operational accountability. For example, a principle-based approach may be supplemented with periodic evaluations (e.g., every five years) by an independent third party, which collects a predefined set of key performance indicators.

For stewardship to be credible in private equity, impact assessment must be embedded throughout the investment process – from sourcing and due diligence to ownership and exit – ensuring that impact is not an afterthought but a core component of value creation. Notably, public sector investors and donors often rely more heavily on principle-based approaches to impact measurement.

2.3 Engagement

Two levels of engagement

From the investor's perspective, the engagement process in private equity unfolds in two steps: (1) the investor engages with the general partner or private equity (PE) management company, and (2) the PE management company engages with the portfolio companies based on the criteria agreed on with the investor (see Figure 3). While investors are typically several steps removed from portfolio company operations, PE management companies maintain close relationships with their portfolio firms and often hold the right to appoint one or more board members (IIGCC, 2022).

At the same time, for reporting purposes, the information flow is opposite, from the portfolio company to the PE management company back to the investor.

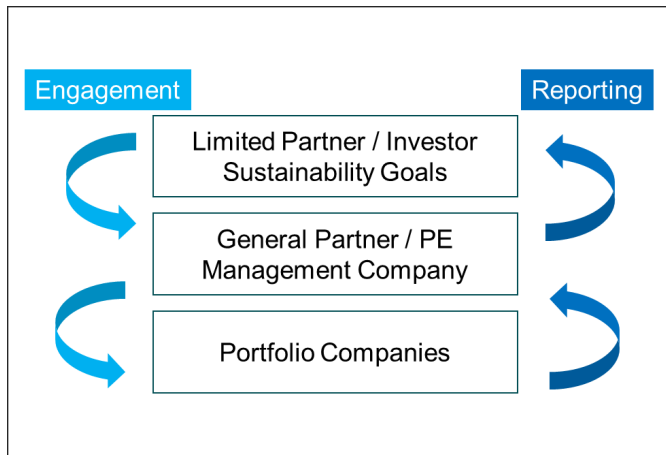


Figure 3 Engagement process along the PE structure, adapted from IIGCC, 2022

The transformation case

Questioning and sceptically reviewing management's business plan lies at the heart of value creation in private equity. Successful deal partners craft superior value creation plans and execute them more effectively (Heel & Kehoe 2005; Matthews et. al 2009). In the PE context, engaging with portfolio companies is a natural and core function of the management company.

Empirical studies on shareholder engagement reveal that similar skills are required for successful engagements. Tom Gosling (2023, 2024) highlights that engagement requests must present a compelling business case made with precision and care to ensure campaign success. Similarly, Bauer et al. (2022) argue that engagements must be financially material to succeed. In a comprehensive overview study, Sjöström (2020) identifies several success factors for corporate dialogue that reinforce this perspective, including "presenting a strong business case," "enhancing the business case by providing the company with new information on emerging issues," and "demonstrating a willingness to understand the company and its complexities."

When financial materiality is lacking, asset managers face significant obstacles in supporting engagement campaigns, both for fiduciary reasons and to avoid internal conflicts (Gosling 2023, 2024). Asset owners, particularly Swiss pension funds¹, face similar tensions.

The importance of addressing financially material issues becomes even more pronounced in PE engagements. While arguing through universal ownership theory is already challenging for broadly diversified investors (Gosling 2024), it becomes impossible in private markets due to the concentrated stakes investors hold in private companies. Even the prerequisites for universal ownership are absent in this context.

It follows that, predominantly impact-oriented engagement that lacks financial materiality works against both the interests of the engaged company and its management, as well as the financial interests of the GP and co-investors². This strong resistance reduces the chances of success for the engagement initiative.

¹ Swiss pension funds must strive for market-adequate returns (BVV 2, Art. 51).

² Evergreen structures could reduce the need for the medium-term upward revaluation that is inherent in closed-end funds, shifting the focus more toward long-term value creation.

Consequently, successful engagement in PE must be financially material and leverage the GP's expertise in rebuilding and strengthening business models. Moreover, it is to a large extent an engagement with the GP.

The growth case

Engagement in the growth case is far less controversial because the (financial) success of the company is the inherent impact so that financial goals and impact are aligned. It is mainly exchange-oriented dialogue and providing technical assistance and consulting are important elements.

The dialogue also has the function of monitoring the performance of the company and to ensure that the sustainability goals originally defined continue to be pursued without restriction.

Target selection (transformation case)

Target selection should be guided by the overarching stewardship objectives and the thematic focus outlined in the investor's sustainability vision. The engagement request must address a material concern derived from the investor's vision. However, it must also be feasible, meaning the company must be receptive to dialogue and have the ability to change its business model to a more sustainable one. In other words, the company must be engageable. (ZHAW, 2024)

The investor must confirm that they have the necessary resources and skills to present and develop a compelling business case. The request must be specific in defining intended outcome. For example, if seeking disclosure improvements, targets such as "better Scope 3 emissions estimates" must be specified. The investor should also use a theory of change to demonstrate how the intervention will create measurable value for the company and its stakeholders by outlining the pathway from engagement to impact.

Gosling's simple litmus test can be helpful, ask

- Can you clearly explain what you're trying to achieve?
- Can you credibly show that your actions contributed to it?

If not, your theory of change isn't a strategy, it's just a story.

Approaching the company and coordination

The target companies are located within the investor's broader network and should therefore be approached through it. Since the GP plays an important role in the engagement process and because it is already in close contact with the target, their involvement is essential. Insofar each engagement is also an engagement with the PE Firm.

Set expectations upfront

When initiating a change-oriented engagement, formally or informally communicate that failure to make progress may result in next-step actions. This creates pressure without an adversarial tone. This best practice from engagement with public companies is even more important in PE engagements because you are acting within your network, where good and fair cooperation is crucial for success.

Focus on dialogue as escalation is limited

Escalation options are particularly limited when the requested change is not supported by the general partner (GP). The voting channel is generally inaccessible, as voting rights in a typical PE structure remain with the GP. This holds true even in co-investments, although in such cases the allocation of voting rights is negotiable and can, under certain conditions, remain with the investor. Furthermore, PE structures make it difficult to withdraw capital, which eliminates the credible threat of divestment. In such situations, building coalitions with other like-minded investors may represent the most viable escalation strategy.

2.4 Reporting

Portfolio steering requires that a minimum set of key indicators is available on the aggregate portfolio level and relies on high coverage of these indicators. As there might not be a standard solution the indicators must be estimated either by the company, the PE management company or the asset manager. As this is a potentially tedious process some pragmatism is warranted, and the set of key indicators can be limited to those relevant for tracking the overarching goals. E.g. one could define quantities as negligible if they are likely to be minimal or one could use sector proxies, e.g. from standard scores.

By contributing to or achieving predefined impact goals, investors cannot automatically claim additionality or causality, as outcomes in complex economic systems typically result from multiple, interdependent factors that are difficult to disentangle. Nevertheless, compared to engagement strategies in listed equity, impact claims in private equity may be considered more credible, since the channels through which investors can influence portfolio companies are more direct and transparent.

However, additionality critically depends on establishing causality, which would require information on whether a specific improvement in a sustainability indicator, or the growth of a sustainable company, can be directly attributed to the actions of a particular investor or private equity management company. Although it may be somewhat easier to track other investors' engagement activities in private asset investments, it remains unrealistic to claim with certainty that one's own actions were the decisive driver of transformation or growth.

Impact measurement approaches must be differentiated between growth (financial additional) strategies and transformation (non-financial additionality).

Transformation case: Impact monitoring in cases of transformation or sustainability improvement should rely on clearly predefined sustainability metrics that are aligned with the overarching objectives and the theory of change established at the investor level. As discussed above, the approach may be either detailed or principle-based. A detailed approach, however, requires high-quality and readily available data as well as broad portfolio coverage to enable meaningful conclusions and effective monitoring over time.

Growth case: As in these cases the product of a company and its success is the sustainability target, financial indicators provide also an impact measurement. Financial materiality goes hand in hand with impact materiality. Topline growth (sales) is the most obvious measure of current impact. But as profitability is important for the long-term success and survival of the company, it should also be tracked.

Beyond this financial tracking, it should also be monitored that the company's product suite remains relevant for the sustainability goals of the asset manager. This is especially important for start-up and early-stage financing, as these companies often opportunistically adapt their business model or product range. Tracking key indicators remains important in the growth case to ensure sustainability standards and for portfolio steering but is barely relevant for impact measurement.

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