Integrating ESG in Private Equity Secondaries

At Coller Capital, we believe that our funds’ investment performance may be materially impacted by the risks and potential opportunities associated with environmental, social and governance (ESG) factors. ESG integration assists in ensuring our fiduciary duties to investors are discharged appropriately, thereby helping to maximise value to beneficiaries.

Due to the limitations inherent within our mandate as an investor in private equity secondaries, being removed from the portfolio assets, our approach and core objective is necessarily on influencing the underlying General Partners (GPs) into whose funds we invest rather than at the level of a GP’s portfolio.

Secondaries : A new frontier

The private equity secondary market is recording significant growth with the volume of transactions at US$85 billion in 2019 (Source: Coller Capital) and we predict this growth will continue over the long-term. As secondaries have a potential to play a meaningful and important role in integrating ESG into private equity, the opportunity to be an influencer in the sector from an ESG perspective is clear.

Our Approach

We integrate ESG into every stage of our investment process, undertake analysis for every investment and seek to influence the behaviour of managers we invest in. Since 2016 we have analysed and provided bespoke ESG commentary for 1,000+ distinct investment opportunities. Where we could not gain comfort on ESG, we have not proceeded with an investment.

When necessary, our communication with GPs extends far beyond the standard checklist approach to due diligence, and, where Coller has most influence, we often take a more hands-on role by working directly with GPs.

1. A strategy which consists in buying and selling of pre-existing investor commitments to private equity and other alternative investment funds.
We draw upon ESG research relevant to our asset class and a practical understanding of ESG from first-hand experience gained across industry sectors and geographies, enabling us to highlight to deal teams what the issues really are on every transaction and how best to engage post deal.

As one of the world's largest investors in private equity secondaries, we have historically invested in and formed relations with over 400 GPs across our funds. This influential platform places us in the unique position of being able to engage across a wide range of different managers globally. This capability is a key element of our ESG strategy (Fig 1).

Where there might be a post investment opportunity to exert more meaningful influence (e.g. direct secondaries) we seek to engage on material issues. We engage with underlying GPs to develop and/or enhance their own ESG policies and programmes to prompt genuine, on-the-ground change at the underlying company level (see box on the right).

**Deforestation as a material issue in secondaries**

Considering the breadth of sectors and portfolio companies we are exposed to indirectly, we need to be mindful of a wide range of ESG issues, each with potential financial implications. Coller champions research on multiple topics, including FAIRR’s work on protein production (see Further readings) but in 2020, one particular issue we have decided to engage on was deforestation.

In incorporating ESG within secondaries, the principal challenge was the existing view that secondaries investors could do little in practice. By utilising our platform as investors in many underlying GPs, we have taken on an influencing role to support many underlying managers in addressing ESG risks and opportunities.

Adam Black
Head of ESG & Sustainability
COLLER CAPITAL

The extensive impacts of deforestation are not only ecological (biodiversity loss, climate change and other physical risks) but also social (impacts on livelihoods, on indigenous people’s rights). Besides sustainability concerns, this may lead to a number of business impacts (in the form of operational, regulatory and reputational risk). As deforestation risk in a company may be present directly (in operations) or indirectly (in the supply chain), it is important for investors to understand where exposure occurs.

**ESG integration outcomes**

- Developed or enhanced ESG policies and programmes across private equity managers globally
- Developed and shared ESG notes on a wide range of topics (including deforestation)
- Supporting on ESG crisis management
- Provision of ESG awareness sessions
- Visiting underlying GP portfolio companies with managers and providing detailed commentary on possible improvement steps (value creation, protection and risk management).
Engaging on deforestation

In respect of deforestation, we might ask specific questions related to asset level deforestation policies, provide information/signposting to an underlying GP and establish whether there might be an opportunity for more granular engagement (e.g. workshops or visits).

Typical information or signposting in respect of deforestation would include formal notes (GP prompts) on the topic and/or highlighting the work of partners such as SPOTT, or of CDP Forests (of which we are a supporter and “Forests Champion”).

Thematic prompt: Deforestation

We have built a powerful platform to reach underlying GPs and to some extent their underlying portfolio companies.

One effective tool we use to leverage it are the thematic ESG prompts we issue to underlying GPs. Prompts represent our own observations on issues, often including suggested due diligence questions for the GP and/or their portfolio companies to ask themselves on a topic.

Our deforestation prompt, which was sent to more than a hundred GPs, highlighted the timber and pulp sector as one of several high deforestation risk industries, alongside soy, palm oil, cattle, natural rubber, infrastructure and mining (Fig. 2).

Consumer-facing businesses are listed too, as brands typically face the highest risk, given they are often the target of activist/NGO campaigns to raise awareness of deforestation issues.

<table>
<thead>
<tr>
<th>Commodity</th>
<th>Relevant industries</th>
<th>Relevant industries – consumer-facing</th>
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<td>(...)</td>
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<tr>
<td>Timber and pulp</td>
<td>Timber producing, processing and lumber manufacturing</td>
<td>• Railway companies and construction (e.g. rail sleepers)</td>
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<tr>
<td></td>
<td>Pulp and paper producers</td>
<td>• High end furniture and luxury yachts</td>
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<td>• Furniture retailers. Businesses with significant paper and/or packaging needs (e.g. CGMs, clothing retailers)</td>
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<td>• Garment manufacturers buying or making man-made cellulose fibres (e.g. Viscose/ Rayon, Lyocell, Tencel, Modal, Cupro etc)</td>
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<td></td>
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<td>• Certain fuel plants (biofuel)</td>
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Fig. 2 - Sample section from Coller Capital’s ‘Deforestation’ GP prompt showing industries potentially exposed to deforestation risk through Timber and pulp products

“Where we observe potential exposure to supply chain deforestation risks at an underlying GPs’ portfolio, we raise specific questions on deforestation policies, commitment to reporting (e.g. CDP Forests), or questions on sustainable sourcing practices and certifications.”

Adam Black
Head of ESG & Sustainability
COLLER CAPITAL

2. ZSL SPOTT publications: https://www.spott.org/reports/
3. CDP Forests publications: https://www.cdp.net/en/forests
A Call to Engage on deforestation with GPs and underlying companies

Coller Capital encourages General Partners to engage about deforestation with underlying companies with exposure to high risk commodities such as timber and pulp. GPs may use the following set of questions during due diligence or general risk assessment to help them to make better and more complete decisions and reduce risk surrounding deforestation:

1. Is there board-level oversight of deforestation issues?
2. Does the company have dedicated roles that include responsibility for managing sustainable forestry (including deforestation issues)?
3. Are there performance-linked incentives for managing deforestation issues?
4. Does the organisation have a formal policy on deforestation issues or as an issue covered specifically within broader ESG/CSR policies? Note: many NGOs recommend companies have a strict zero deforestation policy (rather than “no-net”) applying to all operations (for producers) and/or sourcing (buyers) and which should extend to all suppliers. This is the only way to avoid leakage and effectively reduce risks in the company supply chain.
5. Does the organisation have a formal commitment or pledge in respect to managing deforestation issues?
   - If so, for portfolio companies in particular: Is the commitment or pledge quantifiable/measurable? This should be timebound with a base and target year.
   - How much of the organisation’s operations does it cover? E.g. measured by x% of all relevant commodities sourced
   - Does the organisation report on progress against its commitment or pledge? How often is this reported? Is this publicly available? (...)

Fig. 3 - Sample section from Coller Capital’s ‘Deforestation’ GP prompt highlighting engagement questions for GPs to use with relevant underlying portfolio companies.

Further reading

- Coller Capital’s ESG Report: https://www.collercapital.com/research#lesg-report
- FAIRR publications: https://www.fairr.org/research/reports/

ZSL would like to thank Adam Black for preparing this case study.

Developed by ZSL (Zoological Society of London), SPOTT is a free, online platform supporting sustainable commodity production and trade. By tracking transparency, SPOTT incentivises the implementation of corporate best practice. SPOTT assesses commodity producers, processors and traders on their public disclosure regarding their organisation, policies and practices related to environmental, social and governance (ESG) issues. Investors, buyers and other key influencers can use SPOTT assessments to inform stakeholder engagement, manage ESG risk, and increase transparency across multiple industries.

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