GOLDING

Level of detail and individual criteria: ESG screening in Secondaries

Christian Schütz and Thomas Hallinger, Golding Capital Partners

Translated from German – Initially published in Bundesverband Alternative Investments e.V.

In a Secondaries strategy, meaningful ESG due diligence requires in-depth analysis at both the general partner and portfolio company level. It leads to significantly greater selectivity in the investment process.

A classification according to Article 8 of the EU Disclosure Regulation, and thus a certain transparency with regard to ESG-related aspects, is now a prerequisite for many investors to even consider investing in a financial product. Most institutional investors have already integrated ESG issues into their investment process by varying degrees – whether prompted by regulation, changing preferences of their clients or their own codified social mandate. The shift towards greater ESG-orientation in investing is on its way and cannot be reversed.

In this context, managers seeking an Article 8 classification for their products and also investors using this for selecting ESG-oriented investments must bear in mind that the ways in which a manager achieves an Article 8 classification can vary greatly.

The definition of indicators for an Article 8 classification can be very superficial and ultimately not very meaningful in terms of environmental or social characteristics, even if it is sufficient for an Article 8 classification. Or it could be based on a more in-depth analysis of the portfolio and focuses on the material ESG aspects of the investee companies.

During summer 2024, the focus of the further development of ESG processes at Golding was on Secondaries funds. The result: an ESG screening process that puts the portfolio companies at the center of the analysis, that meets the company's commitment to responsible and sustainable investing, and that opens an Article 8 classification of the current Secondaries fund.

The Article 8 classification of the current secondaries generation closed the last gap in the company's fund offering. It positions all current products with a clearly defined focus on ESG and sustainability in line with SFDR's Articles 8 and 9.

Unique challenges of the secondaries asset class

Golding signed the Principles for Responsible Investment (UN PRI) already in 2013 and has since developed a detailed process for the ESG screening of potential and existing investments, which was also the basis for the screening of the secondaries strategy. It is designed to ensure that investments are in line with the company's own responsible investment guidelines and creates the conditions for a possible classification of the products according to Article 8 (promotes environmental or social characteristics) or Article 9 (aims to achieve sustainable investments) of the EU Disclosure Regulation.

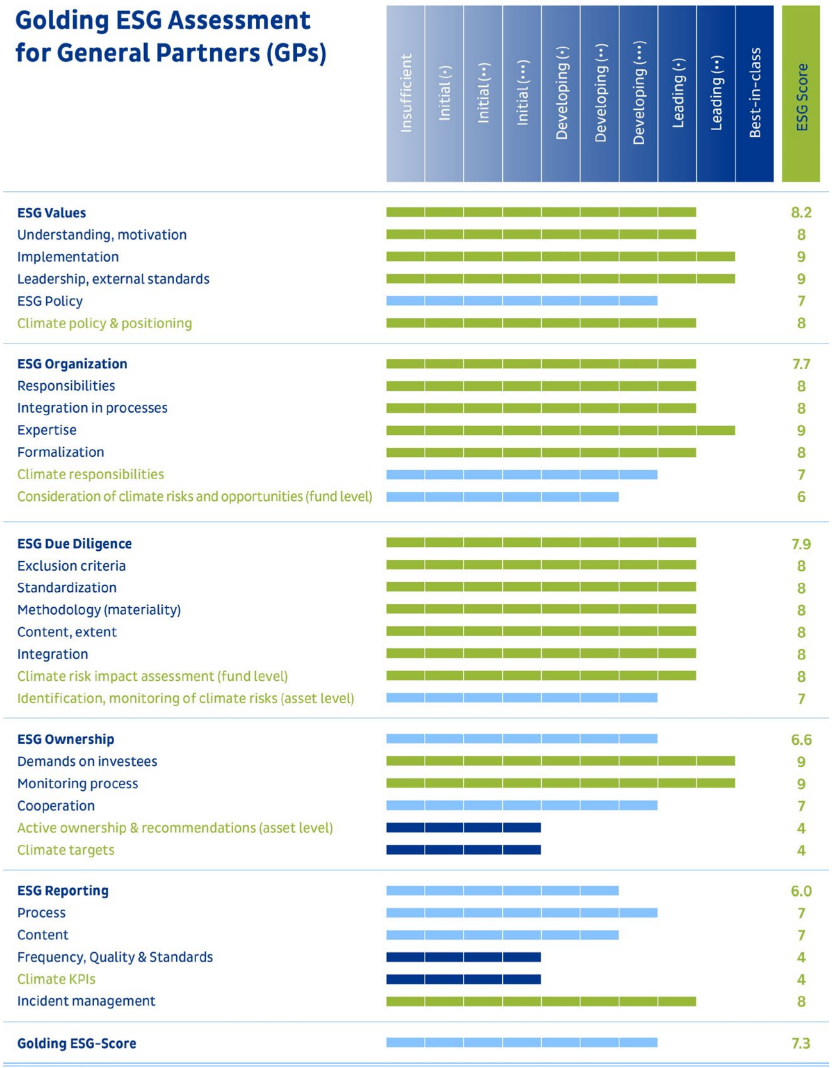
The main challenge in setting up such a process for a secondaries strategy is the likely limited visibility of ESG-related information from portfolio companies. This is particularly true for LP-led transactions, in which a secondaries fund acquires private equity portfolios from existing investors (limited partners, LPs) on the secondary market.

In contrast, GP-led transactions are initiated by the management of a private equity fund (general partner, GP). In this case, the general partner contributes for example one or more companies from its portfolio to a so-called continuation vehicle, in which it itself retains an interest and in which investors can participate via the secondary market. The advantages of investing via the secondary market can include improved access (assets are not available on the primary market), a higher degree of maturity (avoiding the J-curve) and a more favorable purchase price for the assets.

The due diligence for an acquisition by the secondary fund must cover not only financial but also ESG aspects. It includes both the general partner, since it will determine the portfolio companies' strategies as a (co-)owner i, and the companies themselves. For a meaningful ESG screening, the analysis must provide a realistic insight into their ESG characteristics.

Two-tiered ESG screening: general partner and portfolio companies

In assessing the ESG maturity of general partners, Golding is building on the approach it has been using and refined since 2018. The GP is screened before the investment and at regular intervals during the investment period. It covers categories such as ESG values, ESG organization, ESG due diligence, ESG ownership and ESG reporting. As part of the evaluation, the GP's handling of environmental criteria such as aspects related to climate change or biodiversity plays an important role.



Source: Golding Capital Partners

The screening process for portfolio companies first identifies information in dialog with the general partners, intended to ensure that the companies do not violate the ESG exclusion criteria. Activities excluded from the investment are, among other things, the production of and trade in weapons of war, nuclear energy, the extraction or processing of oil or coal, tobacco or gambling.

In addition, the suitability of the investment is assessed based on the companies' business practices. These include aspects such as compliance with the standards of the International Labour Organization (ILO), compliance with the standards of the UN Declaration of Human Rights or the principles of the UN Global Compact.

Only a granular analysis of the portfolio companies makes a secondaries ESG analysis complete

A robust ESG methodology for a secondaries strategy faces the challenge that the investment opportunities and presumably also an invested portfolio includes companies from a wide range of industries.

At the time of the methodology development, the secondaries fund's portfolio included private equity investments in approximately 50 small and medium-sized companies from various countries and sectors, including the services, IT and communications industries.

An ESG assessment should be able to address the material ESG aspects of different companies, reflective of the industry and origin of the respective company. Nevertheless, scalability and applicability in the context of a secondaries transaction must not be neglected. Aspects related to the regular update of the results determined at the time of investment and reflection of ongoing developments at the portfolio companies also influence the methodology.

To this end, an ESG score has been developed for portfolio companies in which the material ESG aspects of the companies determine a significant part of the result. The basis for this is provided by standards such as those developed by organizations like SASB.

Substantial ESG risks are included in the assessment both through the analysis of possible controversies known to the company and by inquiring about possible warning signals or “red flags”.

The company's ability to report key figures on sustainability aspects is also taken into account. In addition, questions based on regulation (double materiality, structure and sustainability objectives of the transaction in terms of the SFDR) form further aspects of the final ESG score.

The alignment of companies with international standards of corporate governance, but also their targets for reducing greenhouse gas emissions or their contribution to sustainability targets, gives the companies' sustainability strategy scope in the ESG assessment.

ESG scoring for portfolio companies

When applying the ESG assessment methods to general partners and portfolio companies minimum requirements were set in the determination of the fund’s Article 8 disclosure. These requirements must be met in order for an investment to contribute to the strategy's defined environmental and social indicators.

Source: Golding Capital Partners

Selectivity is key

A major obstacle for an Article 8 classification of secondaries funds in the market is the high selectivity of the investment process that is required for this. Very large investment managers with billions of euros of capital to invest may find it difficult to map such a process for their entire portfolio, especially if they regularly acquire large portfolios of a wide range of assets through LP-led transactions. By contrast, a more selective investment strategy with a focus on GP-led transactions is usually characterized by more intensive fundamental analysis of portfolio companies. It enables the necessary visibility with regard to general partners and portfolio companies and allows investment offers to be rejected due to a lack of ESG focus.

The increased focus on the ESG orientation of such a selective strategy goes hand in hand with a lower volume and a smaller number of individual transactions compared to a multi-billion fund. Although Golding thoroughly reviews around 500 deals annually, only about two percent of them, or approximately ten transactions, are actually selected with a handpicked number of portfolio companies and find their way into the fund. The rest of the opportunities do not pass either the financial or the ESG due diligence – sometimes both. As a result, a sufficiently diversified and risk-adjusted attractive portfolio can be constructed.

The process described above provides the management of the secondary fund with all the necessary information and allows a qualified ESG assessment of the investments, so that the fund could be classified in accordance with Article 8 of the EU Disclosure Regulation and meets high internal standards of ESG quality. It also requires a much higher selectivity in the choice of assets than is possible for a fund with an investment volume of several billion euros.

The methodology makes ESG aspects visible and has strong focus on ESG risks. This builds the basis for further considerations. As it is developed further, the question will arise of how portfolio companies are positioned and act in relation to sustainability goals or with regard to planetary boundaries. Positioning a secondaries investment strategy under Article 8 and the associated assessment method is a first step.

Authors and contact details

Golding Capital Partners GmbH
Einsteinstr. 172
81677 Munich
www.goldingcapital.com

Christian Schütz
Managing Director & Head of Sustainable Investing
Phone: +49 89 419997 132
Email: schuetz@goldingcapital.com

Thomas Hallinger
Managing Director Secondaries
Phone: +49 89 419997 251
E-mail: hallinger@goldingcapital.com