ESG and Private Equity: Phatisa' experience

Author: Anna Lyudvig | Date: Oct. 4, 2015

AGF's Anna Lyudvig sits down with Stuart Bradley, Senior Partner at Phatisa, to discuss ESG (environmental, social and governance) principals and how to apply them to a private equity portfolio

Anna Lyudvig (AL): How do you define ESG and why is it important to Phatisa?
Stuart Bradley (SB): Private equity companies generally define ESG as embedding local and international environmental, social and governance (ESG) standards/ considerations into business strategy, operationsand product and service offerings, to affect positive change.

It is a given that the same term has a different meaning within the investment community, which uses ESG factors to better understand a company's risk profile, performance outlook and value-creation potential.

In light of its sectorial focus, stewardship in ESG matters is critical to Phatisa. All funds under management – African Agriculture Fund (AAF) and Pan African Housing Fund (PAHF) – operate in accordance with the International Finance Corporation's (IFC) Performance Standards and the African Development Bank (AfDB) Environmental and Social Assessment Policies and Procedures. In addition, Phatisa has developed a Code of Conduct for Land Acquisition and Land Use, a Tax Transparency Policy, as well as Anti Money Laundering and Anti Bribery and Corruption Policies. It is important to emphasize, however, that while Phatisa views ESG best practices as key components of sustainable investing, alone, they are not sufficient to deliver impact.

AL: Please tell us about your approach to managing ESG considerations.
SB: We go beyond just ESG considerations. We define ourselves as Development Equity – bringing capital to Africa for both financial and development impact, and demonstrating that financial returns and sustainability can be mutually inclusive.

Intrinsic to Phatisa's investment philosophy is the belief that well-managed, well-governed private sector investment can be a powerful driver of improvements in the livelihoods of people living at the bottom of the economic pyramid (BoP) and lower-income groups. In this sense, Phatisa's overarching objective of 'Driving Development Equity' captures its focus on inclusion, or facilitating access to key goods and services, such as agricultural produce, for Africa's poorest – in other words, those living vulnerable and often subsistence livelihoods, which are most at risk from exogenous shocks.

Phatisa’s equation, **DevEq = PAT *x +i2, or ‘Development Equity (DevEq) = profit after tax (PAT) times a multiple (x) plus impact (i) squared’** attests to the firm’s focus on achieving development equity, not simply alongside investment, but as intrinsic, and a means to maximizing returns in the broadest sense.

AL: How to correctly apply ESG investing practices to a private equity portfolio?
SB: ESG integration is not a template-based exercise, but dictated and driven by the needs of the portfolio company. So, it is less about the right or wrong, and more about proactively implementing World Bank Group Environmental, Health and Safety Guidelines, Equator Principles and IFC Performance Standards. Phatisa employs a full-time qualified ESG Manager with over 10 years of experience in the field. His primary role and main responsibilities include ESG due diligence and risk assessment for nvestments, as well as monitoring and guiding portfolio companies once the investment has been made. The Phatisa ESG Manager also assesses development impact opportunities – creating specific terms of reference where there is a need for ESIAs for category A and B+ investments.

Ultimately, we are guided by and accountable to our investors: quarterly reports and half-yearly valuations are generated for each fund, Advisory Board meetings are held, and annual reports, annual ESG and Development Impact Reports, as well as other ad hoc reporting required by investors are produced.

ESG does not happen in isolation; it is part of the entire investment process.

AL: Can you provide a recent example of an investment, detailing your approach in action?
SB: The following investment profile of Goldtree, a palm oil producer in Sierra Leone, demonstrates Phatisa’s approach to development impact and the way in which disciplined investment, inclusive business strategies and ESG best practices work hand in hand to generate compelling financial, social and environmental outcomes.


PRE-INVESTMENT GOLDTREE MILL

Palm oil is a key dietary input and is used extensively in the food industry. With 1 million tonnes ofedible oils imported into West Africa annually, Goldtree’s focus is to be an efficient and competitiveproducer of edible oils for consumption in local and regional markets. With funding from AAF, Pan-African Agribusiness Ltd (the founder) and the Finnish Fund for Industrial Cooperation (Finnfund), commercial operations have resumed at the plantation following the civil war, which ended in 2002 and was particularly fierce in the remote Kailahun district. The capital injection has funded a new mill, workshops, offices, housing, vehicles and equipment, and working capital for ongoing operations. Traditional low-yield palm oil extraction methods, which are dangerous as well as environmentally damaging, have been replaced with safer, more efficient processes. In 2013, a new modular processing mill, the first commercial mill to operate since the civil war ended, was built, capable of producing 20 tonnes per hour. It is equipped with a furnace and boiler, which allows waste fibre from processed fruit to be turned into energy. This waste-to-energy strategy enables Goldtree to operate without diesel generators, reducing both emissions and the need to draw power from the under-developed national grid. Demand for fertiliser has also fallen, as furnace ash and remainder empty bunches are used to replenish soil nutrients.

In addition to a small 600-hectare nucleus estate, the company draws thousands of poor Sierra Leoneans into its supply chain by sourcing raw materials from 6,400 independent outgrowers on 30,000 hectares within a 40-kilometre radius of the mill. Goldtree deliberately ensures fair prices for product, in order to benefit from reliable, consistent supply. With AAF Technical Assistance Facility (TAF) funding, Goldtree has provided outgrowers with training in harvesting techniques, fertilizer application and farm maintenance, resulting in record yields for farmers. The TAF is also helping to upgrade feeder roads from smallholder growing areas to the main trunk road to Daru, which will not only improve market efficiencies and access, but will also reduce the isolation of growing communities.

The robustness of Goldtree's ESG management system was tested during the Ebola outbreak. Regrettably, two employees contracted the disease at the onset of the epidemic; however, the full Goldtree team remained onsite and worked closely with Médecins sans Frontières to implement a risk management plan, immediately introducing rigorous protocols, which prevented further infections. This enabled AAF to increase its investment in Goldtree to support the company, when most other investors were mothballing their operations.

Goldtree is active in practising and promoting sustainable environmental and social operations and is pursuing ISO 14001 certification. The company is also working towards compliance with internationally accepted standards of the Roundtable on Sustainable Palm Oil (RSPO). Once achieved, it will be the first RSPO-certified palm oil producer in Sierra Leone.

More generally, Goldtree actively engages with outgrowers to raise awareness of the effects of deforestation and loss of biodiversity and wildlife.

AAF's investment in Goldtree has generated significant economic multipliers within and beyond the nearby town of Daru, which was poor with limited economic activity. Today, Daru is a bustling town with a vibrant local economy. Goldtree now has 463 permanent employees and Phatisa calculates that over 50,000 Sierra Leoneans have been positively impacted, directly and indirectly, by its operations to date.

AL: How do ESG factors affect the performance of a private equity portfolio?
SB: For PE investors to add

and preserve value and ultimately realise competitive returns, strong ESG management is a logical win-win. By addressing ESG issues in a thoughtful and deliberate manner, investors can avoid an array of potential business obstacles, while building shared value among critical stakeholders that can influence the financial success of any company.

AL: How do you manage a project to have both social impact and economic returns?
SB: Phatisa's approach to development impact reflects the professional background and personal orientation of its staff. At its core, the Group comprises like-minded individuals, many of whom have previously worked for development finance institutions, and are deeply persuaded that private-sector capital can be a driver of pro-poor growth and sustainable economic development. Moreover, given the structure of agriculture in much of sub-Saharan Africa, there is an opportunity to build robust value chains in ways that build lasting economic nexuses between the informal, semi-formal and formal economies, and allow for greater value capture and retention in Africa.

We have a strong and experienced portfolio team that works hand in hand with the ESG team and our TAF to guide portfolio companies. Our in-house skills transfer plays a pivotal part in ESG implementation and creating long-term sustainable impact.

AL: How to effectively monitor ESG risks in a private equity portfolio?
SB: The diverse ESG issues in any investment portfolio can often be seen as both risks and opportunities.Key issues for a given company will vary, depending on geography, scale of operations and industry segment. For a Greenfield investment, some of the greatest ESG risks may include land acquisition and conversion, labor practices and working conditions, and water and soil management. For expansion capital investments, top issues may include supply chain risks, labor relations, worker health and safety, and managing waste. Equally, there many opportunities throughout the value chain to utilize ESG good practices to generate value.

AL: And how to effectively measure and value ESG activities in the portfolio companies?
SB: Phatisa tracks various metrics at its portfolio companies, including capital invested, land size and outgrower land, number of employees (split by gender), number of smallholders or vendors impacted, technical assistance provided, output tonnes, sales revenue, profits, and taxes paid. More discursive analysis and case study reporting also helps to elucidate development impact of Phatisa investments for interested investors.

AL: Do you see wide adoption of ESG principles by private equity funds in Africa?
SB: Yes and African PE is leading the way globally.

AL: LPs increasingly expect private equity firms to apply ESG principles. Do you feel that private equity funds meet institutional investors' criteria of responsible investing?

SB: We cannot speak for other funds, but we continuously engage with our investors and conduct annual investor relations assessments to find ways to improve. From recent feedback, we believe we areleading the way in Africa.