ESG in the Secondary Market

Winner:
BVCA Responsible Investment Award 2018

Disclaimer

Table of contents

For further reading:

- Fiduciary duty in the 21st century (2017), UNEP. PRI, Generation Foundation http://www.unepfi.org/fileadmin/documents/fiduciary_duty_21st_century.pdf
- Private equity and responsible investment: an opportunity for value creation (WWF-UK) (2011) http://assets.wwf.org.uk/downloads/private_equity_aw_lores_2.pdf
- Adam Black (2011), Guide to Responsible Investment, chapter 11: Monitoring of ESG issues within portfolio companies, ISBN 978-1-904-696-87-2 (Private Equity International)

Executive summary

From the time of Coller Capital's founding, over 25 years ago, ESG considerations played an informal role in the firm's investment management processes.

The importance of this role was recognised more formally in 2011 with the adoption of our ESG policy and the establishment of our ESG Committee.

Since then, we have made significant progress in implementing an ESG framework across the life-cycle of our investments. This framework:

- protects and creates value for our investors
- reduces investment risk
- enhances our long-term returns

In August 2014, Coller Capital became a signatory to the United Nations-supported Principles for Responsible Investment (PRI).

In March 2016, we appointed a Head of ESG & Sustainability to lead and enhance our efforts in ESG, particularly with regard to our investment process.

We were delighted to achieve A+ for the two sections of our 2018 PRI report. We have worked with the PRI on a number of initiatives in recent years, including ones related to human rights, ESG and the supply chain, and ESG reporting and measurement.

Our ESG efforts have been recognised by the BVCA, which has awarded Coller Capital the Responsible Investment Award 2018 (for the category 'Firms with over £1bn AUM').

We remain active members of: the BVCA's Responsible Investment Advisory Committee; the Hong Kong Venture Capital Association's ESG Committee; and Invest Europe's Responsible Investment Roundtable.

Also via Invest Europe, we contributed to the private equity industry's response to the European Commission's Inception Impact Assessment on "institutional investors' and asset managers' duties regarding sustainability".

An enhanced understanding of ESG risks and opportunities

We believe that well-managed companies manage ESG well, and that poor ESG is a potential indicator of weak management and poor company performance.

Our Head of ESG & Sustainability, Adam Black, is part of the Risk function within our investment team. This ensures that ESG is integrated into our investment decision-making and management process, as part of our wider approach to risk management.

For each new investment opportunity, the investment team and ESG-lead consider ESG due diligence checklists and undertake bespoke analysis. We also make use of a third party reputation-risk database, 'RepRisk', and the Sustainability Accounting Standards Board (SASB) sector guides to enhance our due diligence on GPs and their portfolio companies.

A specific commentary on ESG risks has been provided in all recommendations to our Investment Committee since 2016. The Committee has now considered ESG analysis and commentary for over 500 investment opportunities, and there have been a number of occasions on which we have decided not to proceed with an investment because of ESG concerns.

Having a highly-qualified ESG expert within the investment team ensures a level of rigour in our ESG checklists, our bespoke analysis, and our ESG investment commentary. It also enables us to engage better with our portfolio managers on the policy and practice of ESG.

The development of ESG in private equity

The early days of the secondary market in the 1990s coincided with a rise in environmental and social regulation, and the growth of environmental services for financial clients (including large buyout funds).

In the 1990s and early 2000s ESG was largely seen as a short-term risk to be discussed as part of a firm's due diligence during price negotiation (though some banks and pension funds did also become concerned about reputational factors and exposure to longer-term risk).

Few, if any, managers at the time actively engaged with their portfolio companies on ESG, and it was rare to see ESG highlighted on exit as a lever of value creation.

By 2010, however, much more progress had been made: the United Nations had launched the Principles for Responsible Investment (PRI); the first GPs had signed up to the Principles; and many more had adopted formal ESG policies.

Critical to this progress was the role of asset owners – with LPs becoming increasingly interested in ESG. The integration of ESG into private equity had begun.

At the sponsor level, buyout managers led the charge, because of their greater ability to affect meaningful change at portfolio companies.

There was less focus on ESG by secondary managers, most of whom relied on portfolio company managers or undertook only high-level due diligence.

Coller Capital led the way in integrating ESG into secondaries – developing an ESG policy in 2011; signing the PRI in 2014; and appointing a Head of ESG & Sustainability, and creating its own ESG report in 2016.

We soon recognised that our platform had the potential to engage a large number of managers – thereby amplifying the impact of ESG in our industry.

ESG timeline

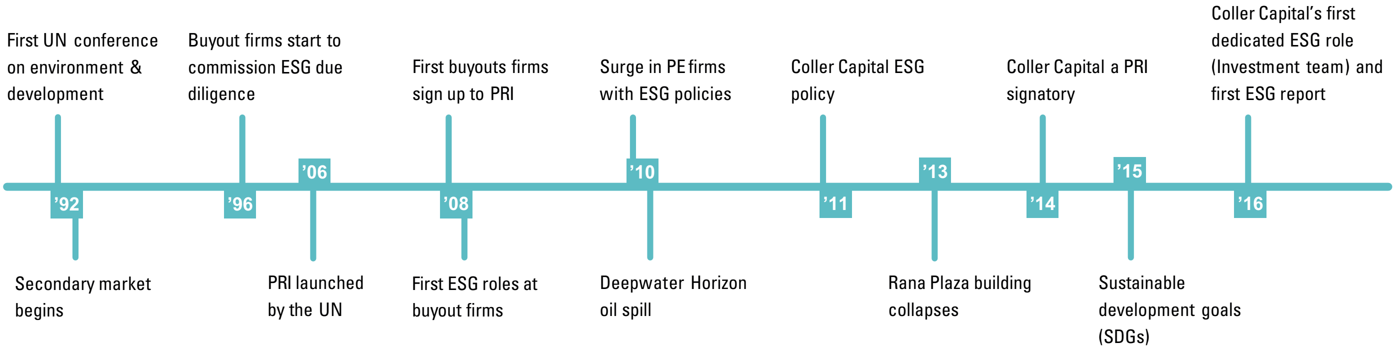


Figure 1

ESG at Coller Capital – a snapshot

At Coller Capital, we view responsible investment as fundamental to our business, and as key to delivering a strong long-term performance for our investors.

We have invested with over 400 GPs – with responsibility for over 8,000 companies (including fund position exposures) – and we have built a powerful platform to influence them. Thus, by integrating ESG into our investment management process, we have been able to amplify the impact not only of our own ESG policy but also those of our investors (Figure 2).

For traditional secondary investments, where we have a minority stake, we analyse the ESG policies and performance record of underlying managers and their large investee companies.

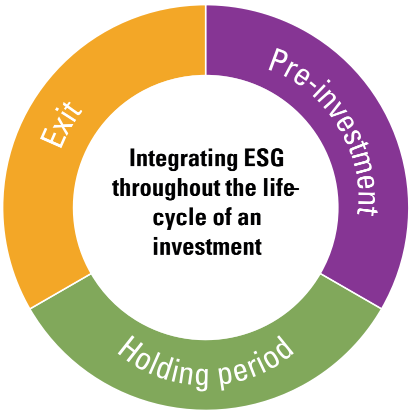
We have more influence in 'direct'[1] secondaries, where we seek to ensure that ESG is a formal component of the GP/portfolio company relationship throughout the lifecycle of an investment.

Coller Capital's ESG policy

In developing our ESG policy, we gave consideration to: the PRI; the UN Global Compact; the recommendations of the Taskforce for Climate-related Financial Disclosures (TFCD); and applicable management standards, such as ISO 14001 (on the environment), SA 8000 (on social responsibility) and OHSAS 18001 (on occupational health and safety).

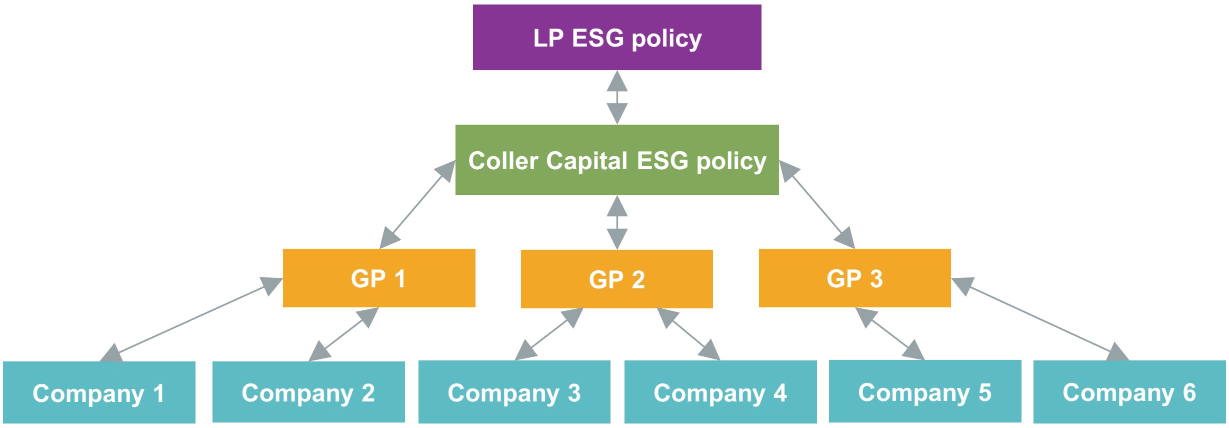
We also take into account applicable private equity-specific ESG frameworks and documents – including the ESG Disclosure Framework, and the PRI LP ESG DDQ.

We seek continual improvement in our management of ESG factors throughout the year (in line with our own ESG policy), and Coller's ESG committee reviews the continued suitability and effectiveness of our policy on an annual basis.



[1] Coller Capital defines a direct secondary as any investment where we can expect to have a holding in the underlying funds of a manager that allows us to have significant influence in their underlying funds and assets.

Amplifying ESG impact



Source: Coller Capital.

Figure 2

Coller Capital's corporate values

Our corporate values (Delivering for investors; Innovation; Empowerment; Fairness & respect; and One firm, one team) are underpinned by our focus on a core central value: Integrity. For Coller Capital, integrity means:

- Never compromising our investors
- Never crossing the line between competitiveness and wrong-doing
- Always keeping our word
- Never saying anything that isn't true
- Always acting in a way that safeguards the firm's reputation

We believe that our pursuit of responsible investment as a business is perfectly aligned with the strong sense of responsibility – to our investors and to each other – expressed in our corporate values.

Coller Capital's ESG policy

- Consider applicable ESG issues in all investments, business strategies and initiatives, at both firm and fund level
- Provide our investment professionals and other relevant personnel with an appropriate level of support, assistance and ESG training
- Operate an ESG Committee, chaired by our Head of ESG and Sustainability, comprising Coller's leadership and representatives from across the business, to monitor implementation of our ESG policy and to approve any enhancing initiatives
- Ensure ESG risks and opportunities are considered as part of our evaluation of any prospective investment
- Where appropriate, encourage the GPs of portfolio funds to enhance their approach to ESG. Assist them in own ESG or similar policies
- Work constructively with LPs in our funds that express an interest in ESG matters
- Encourage continual improvement in ESG policies and practices by the GPs of our portfolio funds
- Review ESG information (on performance and incidents) provided to us by the GPs of our portfolio funds (both as a result of our formal monitoring requirements and by seeking informal updates)
- Report progress and recommendations to our ESG Committee and relevant governing bodies

The firm also has thematic ESG addenda to the Policy covering modern slavery and human trafficking, and farm animal welfare (FAW).

The ESG committee and its mission

Oversight of our ESG policy is the responsibility of Adam Black, Head of ESG & Sustainability, with the support of our ESG Committee. The policy is implemented by our investment team through our formal ESG processes.

Adam Black is part of the Risk function within the Investment team, which ensures full consideration of ESG within our investment management process.

The ESG committee's core members are:

- Adam Black (Chair) – Head of ESG & Sustainability
- Jeremy Coller – CIO
- Paige Brotherton – Partner, Investment Team
- Iyobosa Adeghe – Principal, Investment Team
- Frank Ochsenfeld – Partner, Head of Legal & Compliance
- Stephen Marquardt – Partner, Co-Head of Investor Relations
- Ian Flavill – Head of Cybersecurity & Facilities
- Alan Briefel (FAIRR) – Observer

Coller Capital has access to a wide range of ESG experts (global and local consultancies, NGOs, and academics). This virtual network is available to support the Investment team and is also made available to portfolio GPs to assist with ESG implementation.

Adam Black, Head of ESG & Sustainability

Adam has been an ESG specialist for over 25 years. He is a Fellow of the Institute of Environmental Management & Assessment (FIEMA), a Chartered Environmentalist (CEnv), and a Chartered Member of IOSH (the Institution of Occupational Safety & Health). He holds a BSc (Honours) in Environmental Science, an MA in Environmental Law, and a postgraduate diploma in Occupational Health and Safety.

Adam has experience in most aspects of ESG implementation and management, including: training and coaching; organisational behaviour; ESG incident investigation; and crisis management. He has delivered ESG risk mitigation and value creation programmes across a wide range of industries, in over 50 countries around the world.

Adam has responsibility for integrating ESG into all Coller's investment decision-making and management processes both within the firm and with portfolio funds and managers.

Before joining Coller, he worked for buyout firm Doughty Hanson as an ESG Operating Partner and Head of Sustainability (which was one of the first dedicated roles of its type for private equity).

Adam is active with: the Sustainable Finance Working Group at IEMA; Invest Europe; the BVCA; the Hong Kong Venture Capital Association; and the UN-supported Principles for Responsible Investment.

Integrating ESG into the investment process

It is possible to integrate ESG considerations into all stages of the investment process – across the spectrum of transaction types and asset classes.

At Coller Capital, some level of ESG analysis is conducted for every investment we look at. We aim to influence the behaviour of fund GPs with whom we invest; and, for our direct secondary GPs, we seek to ensure that ESG is a formal component of the GP-portfolio company relationship throughout the investment lifecycle.

We also have the requisite processes in place to be able to notify investors of material ESG-related incidents or events, should they arise.

Our investment professionals have received training on ESG factors in investment decision-making and management. This has included in-house ESG training, on-the-job training, and an ESG e-learning course offered by the BVCA (which Coller Capital helped to develop).

We view ESG as an important tool that can be used to protect and create value, mitigate risk, and enhance the overall investment management process. We therefore advocate a commercial approach to ESG adoption (Figure 3) and promote a positive culture in the management of ESG factors (Figure 4).

Given the large number of managers and portfolio companies we deal with, we focus on material ESG factors. We ask our portfolio GPs themselves to define materiality, but, in deciding on definitions, thresholds and criteria, we suggest taking the following into consideration: the impact on funds; potential harm to reputation; financial loss/loss of value.

Material issues include incidents or management flaws that might result in significant harm or a threat to a company's 'licence to operate':

- Health and safety incidents resulting in multiple injuries/fatalities
- Product safety incidents resulting in harm to consumers or product recalls
- Environmental pollution resulting in harm to human health or the environment
- Employee relations breakdown or trade union action resulting in a severe impact on production/trading
- Fraud, bribery, or corruption resulting in a product boycott
- A cyber/IT incident leading to significant loss of personal data or IP

Commercial approach to ESG

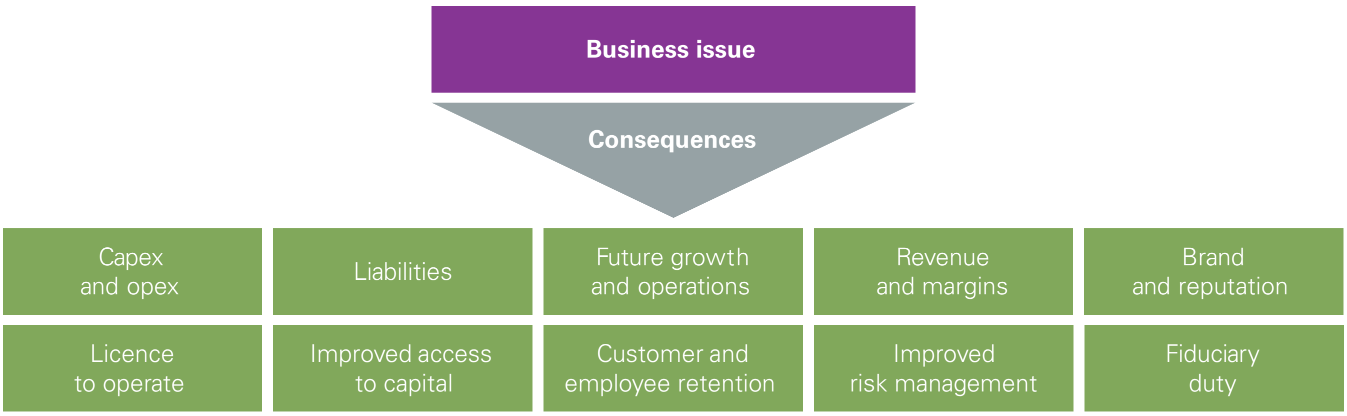


Figure 3

ESG initiatives at portfolio companies

Each GP adopts its own ESG style and approach, and managers differ significantly in how they engage with their portfolio companies.

We encourage our GPs to back ESG initiatives that fall into one or more of the following categories:

- **Revenues:** top-line growth and competitive advantage derived from new, ESG-related products or services (eg, on-site renewable energy generation; or the sale of greener or more socially responsible products).
- **Savings:** financial cost savings and/or reduced ESG impact (eg, production or supply chain operating efficiencies resulting in fewer incidents or accidents; improved energy efficiency; reduced waste generation or water consumption).
- **Brand protection:** cost avoidance and value enhancement from de-risking a business and reducing the likelihood of reputational damage (eg, measures to reduce the likely severity of an incident or to de-risk a supply chain).

We seek a meaningful consideration of ESG issues by our portfolio GPs at all stages of the investment: during initial due-diligence; within the holding period; and through to exit.

Organisational ESG culture

Figure 4

Evolving ESG initiatives

ESG at Coller Capital continues to evolve. We have a number of initiatives under development.

Fund positions and big data

We are exploring how to make better use of 'big ESG data', machine learning, and artificial intelligence alongside our own quantitative analysis skills. We believe our analysis of fund position opportunities in particular could benefit.

Sustainable development goals (SDGs)

The SDGs (Figure 6) are a collection of 17 global goals set by the United Nations. They cover a broad range of social and economic development issues, including: poverty; hunger; health; education; climate change; gender equality; water; sanitation; energy; environment; and social justice.

It is acknowledged that they cannot be achieved without the finance sector's involvement, and many asset owners and managers are seeking to align themselves with the SDGs.

Through our portfolio GPs, we know that many of their companies are involved in addressing these goals.

As a secondaries investor, we cannot contribute to each GP's SDG performance in a meaningful way. Instead, we focus on, and highlight, those where we can make a genuine difference. This applies especially to our direct secondary GPs, with whom we have more influence.

FAIRR

The Farm Animal Investment Risk and Return (FAIRR) investor initiative, founded by Jeremy Coller, aims to put factory farming on the ESG agenda.

FAIRR and its founding members believe that a worrying knowledge gap has emerged among investors in relation to the material investment risks and opportunities connected with intensive livestock farming and poor ESG standards (including animal welfare).

The FAIRR initiative aims to close that knowledge gap, ensuring that investors understand the true risks and opportunities, and supporting them in assessing these issues as part of their investment processes.
www.fairr.org

The goals where we are making most impact

Coller Capital supports the UN Sustainable Development Goals	End hunger, achieve food security and improved nutrition and promote sustainable agriculture	Ensure healthy lives and promote well-being for all at all ages	Ensure availability and sustainable management of water and sanitation for all	Ensure sustainable consumption and production patterns	Take urgent action to combat climate change and its impacts	Conserve and sustainably use the oceans, seas and marine resources for sustainable development	Protect, restore and promote sustainable use of terrestrial ecosystems, sustainably manage forests, combat desertification, and halt and reverse land degradation and halt biodiversity loss

Figure 6

Climate change and the task force for climate-related financial disclosures (TCFD)

The Financial Stability Board established the TCFD – an industry-led task force made up of 32 members, and chaired by Michael Bloomberg – to develop consistent and voluntary, climate-related financial risk disclosures for investors and stakeholders (Figure 7).

The TCFD's intention is to help companies understand what financial markets need from disclosure in order to measure and respond to climate change risks, and to encourage companies to align their disclosures with these needs.

The TCFD has developed four recommendations on climate-related financial disclosures, which are intended to be suitably ambitious while also being practical enough for near-term adoption.

The recommendations are split across four 'thematic areas' representing core elements of how organisations operate: governance; strategy; risk management; and metrics and targets.

We are supportive of the recommendations and have encouraged our portfolio GPs to adopt the approach set out by the TCFD. Our climate-related risk note, issued to GPs in 2017, was developed using the TCFD as a framework.

We are also developing a formal response to the TCFD commensurate with our investment mandate as a secondaries firm. We expect the work we are doing at firm level to become a carbon neutral c

Core elements of recommended climate-related financial disclosures

Governance
An organisation's governance around climate-related risks and opportunities

Strategy
The actual and potential impacts of climate-related risks and opportunities on an organisation's businesses, strategy and financial planning

Risk management
The process used by an organisation to identify, assess and manage climate-related risks

Metrics and targets
The metrics and targets used to assess and manage relevant climate-related risks and opportunities

Source: The Task Force on Climate-related Financial Disclosures

Figure 7

ESG monitoring and reporting

Monitoring

We focus our monitoring efforts on the investments over which we have most influence (especially direct secondaries).

We ask for material information on both risks and opportunities, by exception and on a quarterly basis, and we are building a data management platform to formalise this process.

We also engage periodically with GPs who have been identified by us to be 'higher priority' from an ESG perspective because of their investments or ESG programmes. For many of these managers we have set up formal ESG 'watch lists' via 'RepRisk' – as we have for certain portfolio companies.

Reporting

Annual ESG questionnaire and report

We ask all portfolio GPs to complete an annual ESG questionnaire, in order to track their progress on ESG.

This enables us to report portfolio-level progress back to our own investors, as well as track our progress in implementing our own ESG policy.

Annual GP ratings

Our annual ESG ratings for our GPs (Figure 8) are largely subjective, but we consider hard data wherever possible (on the GP, its portfolio, and its ESG track record).

We consider that an excellent rating should be viewed as being an aspirational goal, designed to encourage continual improvement.

We work closely with underlying direct GPs when we believe the ESG issues presented are material to improving their competence across relevant ESG factors and ratings.

Our ESG ratings draw on the following sources:

- Our own knowledge of the GP, gained from discussions over time
- Feedback from peers, investors and other ESG-engaged stakeholders
- Our annual ESG Questionnaire
- Our annual ESG desk-based audit.
- Evidence from published sources such as RepRisk

GP ESG ratings

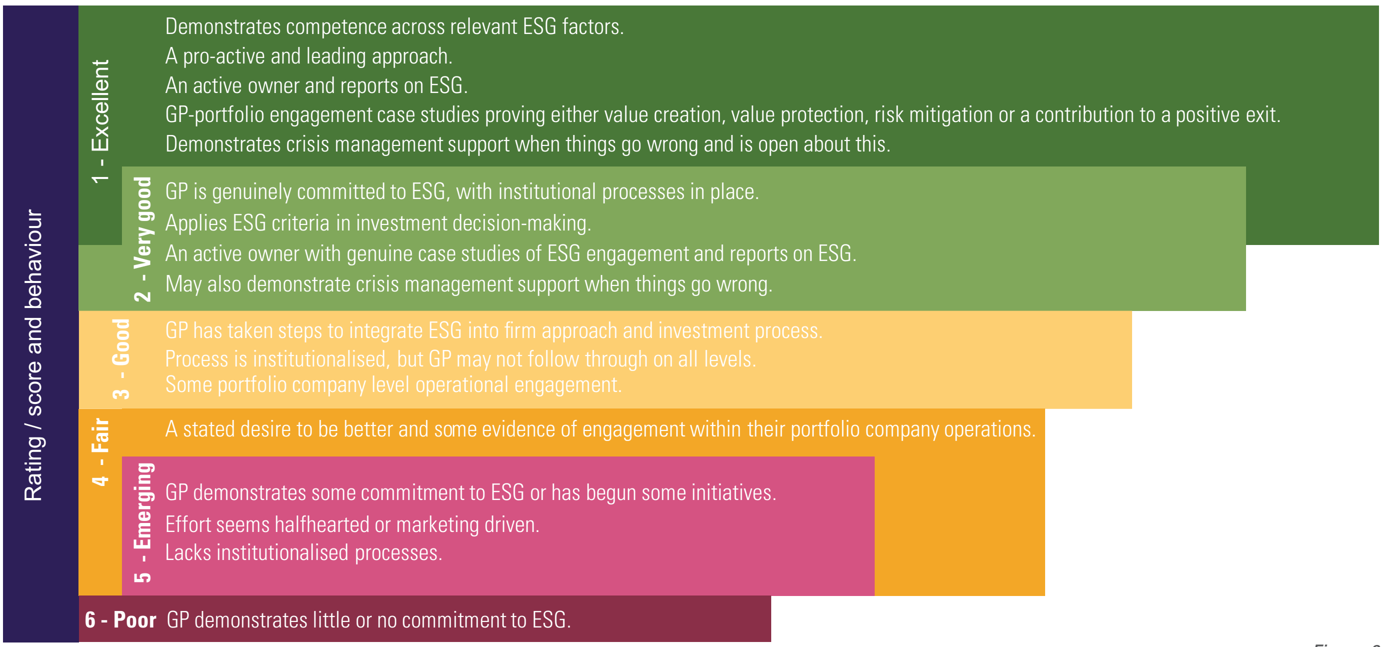


Figure 8

Appendix 1: ESG – selected research findings

There is a wide array of research demonstrating the organisational benefits of ESG in terms of: reputation/ brand; access to capital and fundraising; cost savings; revenue opportunities; employee retention; and so on.

As a consequence, we view ESG as part of our fiduciary responsibility and as adding value to Coller Capital as a business; we seek to integrate it into all aspects of our investment decision-making and business management processes.

According to a 2017 report from Harvard Business School (Why and How Investors Use ESG Information: Evidence from a Global Survey, by Amir Amel-Zadeh and George Serafeim) ESG disclosures are associated with fewer capital constraints and a lower cost of capital. 82% of respondents to the HBS study engaged with ESG because they considered it financially material to their investment performance.

On thematic ESG factors – such as diversity – we also find evidence of financial benefit. According to a McKinsey study (published in a 2015 article, Why diversity matters, by Vivian Hunt, Dennis Layton and Sara Prince) companies are 15% more likely to outperform financially where there is a focus on gender diversity, and 35% more likely to outperform where there is a focus on ethnic diversity.

Coller Capital's Global Private Equity Barometer

Coller Barometers in 2016, 2017 and 2018 have shown similar investor views on ESG:

- On climate related risks: two thirds of Europe's and Asia-Pacific's LPs were either taking climate change into account in their private equity decision-making or said they would be doing so within 2-3 years (though only a third of North America's LPs were doing so, or planning to do so, in that timeframe).
- Half of LPs have social impact investments or expect to make them within the next two years.
- On cyber security: LPs expect the cybersecurity threat to increase dramatically, with over half of LPs foreseeing serious cybersecurity attacks on their institutions within the next five years.
- Only one in five investors today requires its GPs to undertake cybersecurity risk assessments at the management company level, but over half say they will do so within 3-5 years.
- And barely one in ten LPs currently requires GPs to undertake cybersecurity risk assessments for their portfolio companies, but 45% of LPs say they will do so within 3-5 years.
- A significant minority of North American investors continues to regard ESG-related investment criteria as irrelevant or inappropriate for their private equity funds. By contrast, two in five European investors now regard a positive ESG report as an essential component of a decision to commit capital.
- Two thirds of LP's believe that the three ESG elements are of equal importance – although a quarter of investors see the governance element as the most important for private equity.
- A mojority of investors believe that appropriate progress is being made on staff diversity in private equity – at both GP management companies and in their own origanisations. However, sigificant minorities of investors say that an increase in focus is still needed at both types of organisations.

London

Coller Capital Limited
Park House, 116 Park Street
London
W1K 6AF

Tel: +44 20 7631 8500

New York

Coller Capital, Inc
950 Third Avenue
New York
NY 10022

Tel: +1 212 644 8500

Hong Kong

Coller Capital Limited
Level 14, Two Exchange Square
8 Connaught Place, Central
Hong Kong

Tel: +852 3619 1300

www.collercapital.com