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ESG Integration
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Wafra

Leveraging SASB guidance to frame ESG integration in private markets

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Introduction

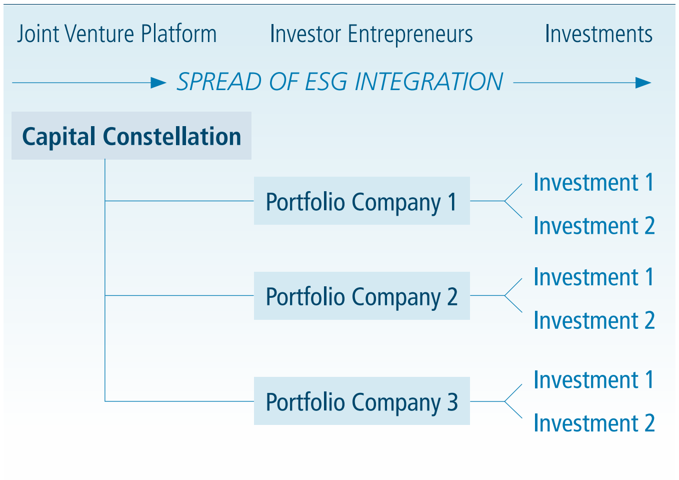
Founded in 1985, Wafra Inc. ("Wafra" or the "Firm") is an alternative investment manager with assets under management across a range of investment strategies, including private equity, strategic partnerships, venture capital, alternative finance, real assets, real estate and liquid markets. The Firm's approach to environmental, social and governance ("ESG") investing is embedded in its heritage, with over 30 years of experience in managing customized portfolios for clients in a way that aligns their investments with their values. Wafra believes ESG factors aid in long-term value creation and became a signatory to the United Nations Principles for Responsible Investment ("PRI") in 2016.

In 2018, Wafra helped launch Capital Constellation ("Constellation" or the "Platform"), an innovative joint venture investment platform owned by large global asset owners, including the Alaska Permanent Fund Corporation, the British Railway Pension System, AP3, Kuwait Investment Authority, and the Public Institution for Social Security of Kuwait (an indirect parent of Wafra). The Platform makes early-stage investments in next-generation alternative investment managers, enabling them to break through the challenges of initial fundraising by providing strategic support and creating an aligned, substantial, and long-term capital base. As such, the venture aims to help build sustainable asset management businesses that have the potential to shape the future of private capital markets.

Unique Opportunity

Constellation presents a unique opportunity to drive the adoption of strong, long-term ESG practices, not only among a new generation of alternative managers ("investor entrepreneurs" or "portfolio companies") but also across their underlying assets ("investments"). Wafra's Sustainable Investment team, responsible for the Firm's ESG efforts, seeks to facilitate the integration of ESG considerations into the investment decision-making processes of Constellation's investor entrepreneurs and provides ongoing guidance on best-in-class ESG practices. This approach aims to generate a multiplier effect, allowing ESG synergies to flow through across portfolio companies and their investments (*see Figure 1*).

Figure 1: Spread of ESG integration throughout the Constellation Platform



The Platform's ESG policy sets forth a robust process focused on integrating sustainability considerations into the investment process and providing ongoing guidance to each portfolio company. Constellation's ESG integration strategy has three main steps, which address ESG factors throughout the life cycle of its respective portfolio company relationships:

- **Pre-investment:** Due diligence of ESG risks and opportunities for each potential portfolio company.
- **At investment:** Initial engagement of a selected investor entrepreneur on integrating ESG factors into its investment process.
- **Post-Investment:** Consultation and collaboration with each portfolio company to share ESG best practices and support the implementation of strategic value creation projects.

Collaborative and Focused Approach

Wafra developed Constellation's ESG strategy in close consultation with the Platform's founders, resulting in a methodology that reflects their shared values and vision. Constellation takes a hands-on approach to ESG and views its portfolio company investments as partnerships in which it aims to educate, engage, and empower each investor entrepreneur to adopt best-in-class ESG practices and build long-term sustainable businesses.

No one portfolio company investment faces the same risks and opportunities, so Wafra has opted to customize Constellation's ESG methodology by industry, size, and geography. As an early adopter of the reporting standards issued by the Sustainability Accounting Standards Board ("SASB") in the private equity space, Wafra's approach to sustainable investing is grounded in the principles of financial materiality[1]. The Sustainable Investment team works closely with each investor entrepreneur to identify an actionable set of ESG best practices that can meaningfully complement and enhance its investment process.

Constellation's ESG Integration Process

Constellation's ESG integration process has three consecutive steps, which consider ESG factors before and after investing in each portfolio company:

1 As defined by SASB, "financially material" issues are topics that are reasonably likely to impact the financial condition or operating performance of a company.

1) Pre-Investment: Wafra incorporates ESG considerations in the due diligence of an investor entrepreneur to identify material risks and opportunities and assess the potential impact on future value.

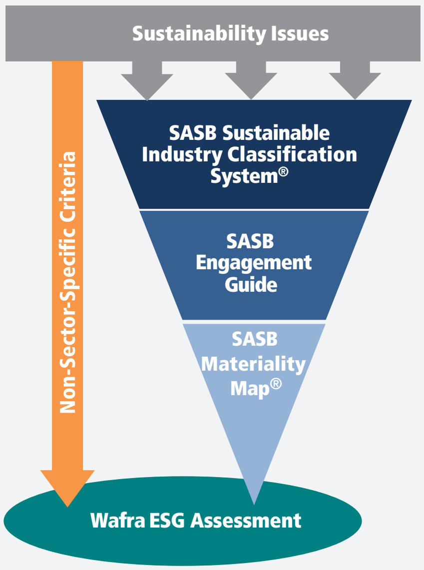
In the initial due diligence phase, the Sustainable Investment team focuses on a select group of ESG factors that relate to key financial and reputational risk indicators. Governance plays a key role during this phase. The team reviews each investor entrepreneur's existing procedures to address governance and related issues such as conflicts of interest, litigation, fines, and settlements, among others. Diligence also identifies non-sector-specific issues including potential reputational risks, which may be related to geographical areas of operation and adherence to UN Global Compact Principles (i.e. fundamental responsibilities in the areas of human rights, labor rights, and environmental standards, as well as bribery and corruption).

Additionally, the Sustainable Investment team uses SASB's guidance to develop a set of sector-specific ESG diligence parameters that emphasize financially material risks and opportunities for each potential portfolio company. The team assesses relevant sustainability issues through the lens of SASB's Sustainable Industry Classification System® (SICS®), Materiality Map®, and Engagement Guide to arrive at a set of material diligence issues.

For example, for an investor entrepreneur focused on the financial technology sector as illustrated in *Figure 2*, Wafra's ESG diligence will follow a two-tiered approach assessing ESG issues both at the portfolio company level (Tier 1) and at the investment level (Tier 2). Applying SICS®, the Sustainable Investment team will focus diligence at the portfolio company level on the Asset Management & Custody Activities sector and at the investment-level on the Software & IT Services sector. Based on the guidance that SASB's Materiality Map® and *Engagement Guide* provides for each sector, the team will evaluate issues such as the processes that the investor entrepreneur has in place to protect against security breaches internally and how it evaluates whether its investments adequately address data security risks across their respective product lines.

Wafra's Sustainable Investment team uses a quantitative flag system to highlight material ESG considerations to the investment team during the diligence and decision-making process. Diligence topics are allocated a green flag if there are no material ESG risks, a yellow flag if there are at least two ESG risks or a potential engagement opportunity, and a red flag if there is a financially material risk. These findings are included in the investment committee memos and risks are discussed with the deal team and portfolio company to determine the severity of the risk and whether the Sustainable Investment team can engage on remediation strategies post-investment.

Figure 2: Application of a two-tiered ESG diligence framework based on SASB's guidance



	TIER 1: Portfolio Company	TIER 2: Investment
Sustainability Issues	Rapid innovation exposes both finance and financial technology companies to growing data security threats	
SICS	Asset Management & Custody Activities	Software & IT Services
Sample Diligence Topics	Has there been unauthorized access to company networks, data and/or applications in the past 5 years? If so, please provide details of the breach and steps taken for remediation.	How does the investor entrepreneur diligence the identification of data security risks across their portfolio companies' product lines? What internal processes do the portfolio companies employ to protect and defend against cyberattacks?
Contextual Considerations	Approach to identifying and addressing data security risks, including the use of third-party cybersecurity standards	(1) Number of data breaches (2) % involving personally identifiable information (PII) (3) Number of users affected
Wafra ESG Assessment*	No material risks	Engagement opportunity

* Diligence topics are allocated a green flag if there are no material risks, a yellow flag if there are at least two ESG risks or a potential engagement opportunity, and a red flag if there is a financially material risk.

If the latter, the team will include this as a key performance indicator during ownership and may include remediation-related language in the relevant legal documentation with the portfolio company.

> *2) At Investment: Wafra integrates ESG commitments and protections into contractual agreements with each investor entrepreneur and conducts an initial engagement generally focused on integrating ESG considerations into its investment process.*

During negotiations with each new portfolio company, Wafra ensures that the company formally acknowledges Capital Constellation's ESG Policy. The policy includes specific provisions that all portfolio companies agree to be mindful of, including screening their investments for certain business involvements, disclosing material ESG risks and opportunities, and engaging with Wafra at least on an annual basis. Depending on the findings from the due diligence process, a custom set of ESG terms and protections may be integrated into the relevant contractual agreements with each investor entrepreneur to ensure a formal commitment.

Upon acquisition, the Sustainable Investment team engages with each investor entrepreneur to address any material ESG-related risks identified during diligence and assist in the development of customized, sector-specific ESG frameworks that highlight financially material factors. For example, for a portfolio company focused on financial technology investments, the team may recommend a focus on ESG factors such as security systems to protect and store personal information, measures to prevent and address data breaches, and processes to verify the quality of third-party service providers.

As such, Wafra seeks to help Constellation's portfolio companies customize a methodology that is meaningful to their investment approach, so that ESG becomes an integrated component of their investment process. Addressing material ESG issues not only helps hedge against reputational risk, but can also contribute to the long-term business success of Constellation's portfolio companies and to the overall strength of the Platform.

> *3) Post-Investment: Wafra's Sustainable Investment team consults and collaborates with each investor entrepreneur by sharing ESG best practices and supporting the implementation of strategic value creation projects.*

On an ongoing basis, the Sustainable Investment team provides Constellation's investor entrepreneurs with guidance on material ESG risks and opportunities, which have been highlighted during the initial due diligence and engagement. As the investor entrepreneurs are at an early stage of development, it is important to hone the focus of ESG engagement so that they can adequately address a limited set of key issues. The team therefore engages each portfolio company on only two to three material ESG factors per year. For those portfolio companies that are unfamiliar with ESG integration, the team can conduct educational seminars to advise on material risks, opportunities, and best practices.

Typical engagements focus on opportunities such as deepening the integration of ESG factors into a portfolio company's

Figure 3: ESG integration throughout the life cycle of a Constellation portfolio company

Pre-Investment		At Investment	Post-Investment
» Screening for industry agnostic factors such as UN Global Compact violations and geographical areas of operation » Evaluation of ESG risks that are material for each investor entrepreneur » Evaluation of ESG risks relevant for the portfolio company's underlying investments	*INVESTMENT*	» Integration of ESG commitments and protections into contractual agreements » Guidance on ESG integration into the portfolio company's investment process » ESG education	» Ongoing consultation and collaboration to implement best practices and value creation projects » Tracking of key performance indicators for monitoring and reporting purposes

investment process leveraging SASB's guidance, supporting the development of an ESG reporting framework, and advising on the process for becoming a signatory to the PRI. For example, in 2019, the Sustainable Investment team engaged with an investor entrepreneur focused on industrial decarbonization investments to develop an ESG framework for their flagship fund. This year-long engagement had multiple milestones, including developing a sector-specific ESG policy and framework, conducting a comparative analysis on impact measurement consultants, advising on material ESG diligence to be conducted in-house and impact diligence to be conducted externally, and finally providing guidance on best practices for ESG reporting.

Results are measured through key performance indicators and tracked using the same quantitative flag system introduced in the first step. Concerns or areas of opportunity are communicated to portfolio companies twice a year during engagement sessions and an overall assessment is shared annually with Constellation's Board of Directors (*see Figure 3*).

Potential for Alignment with the Sustainable Development Goals

In 2015, the UN adopted the Sustainable Development Goals ("SDGs"), a universal call to action to end poverty, protect the planet, and ensure that all people enjoy peace and prosperity. Since then, investors have increasingly been looking to quantify the impact of their investments on these goals. While Constellation is not focused on impact investing as a strategy, its partners believe the Platform can have a positive social and environmental impact. With respect to the SDGs in particular, Constellation's contributions may range from reduced carbon emissions due to investments in low-carbon power distribution to improved diversity standards in the technology sector.

For example, one of the Platform's investor entrepreneurs is invested in a company that recycles used industrial lubricants and motor oils leveraging a process that yields considerably lower carbon emissions compared to legacy practices. The company's products also improve fuel efficiency in terms of mileage per gallon relative to conventional oils, resulting in a measurable reduction of carbon emissions. As such, the investment contributes to SDG 7, which promotes universal access to affordable, reliable, sustainable, and modern energy services.[2]

Conclusion

Wafra has relied on SASB's guidance to develop an ESG framework for Capital Constellation that seeks to be specific to each sector in which the Platform invests, yet flexible enough to adapt to fast-changing standards and expectations in the responsible investing space. Its unique structure is intended to enable the Platform to drive the adoption of best practices for ESG integration among the next generation of alternative asset managers and their underlying investments. By working with each investor entrepreneur to customize an ESG methodology, Wafra's Sustainable Investment team seeks to ensure that ESG becomes not just a check-the-box exercise but an integral component of each portfolio company's investment process. Harnessing SASB's emphasis on financial materiality allows the Platform to empower its investor entrepreneurs to focus on an actionable set of best practices to integrate ESG in a way that meaningfully complements and enhances their respective investment processes.

2 This investment is provided generally for illustrative purposes; it may not be representative of the investments made by the Platform's investor entrepreneurs.