

# ESG in Private Assets

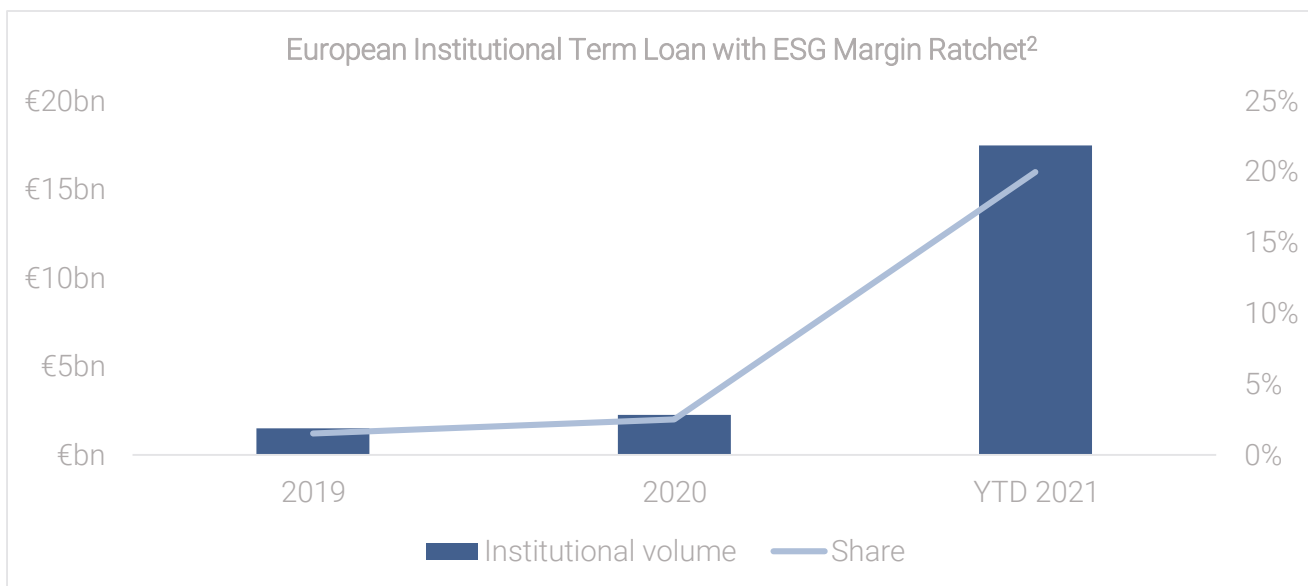
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## Introduction

Assets managed by the private capital industry have seen unprecedented growth over the last decade. With this trend set to continue, assets are expected to increase by 74% between 2021-26 according to S&P<sup>1</sup>. Managers across all private asset classes are expecting to benefit from this level of growth. This article will examine the role that ESG plays against this backdrop of vast capital allocations shifting towards private assets.

## To what extent have private capital managers shifted to address ESG concerns?

The prevalence of ESG-linked assets has grown across all corners of private markets. Within the Private Debt and Equity space for example, fund managers are financing an increasing number of new investments with ESG-linked debt instruments. The chart below shows how the volume and share of European ESG Term Loan debt has increased between 2019 and 2021. These ESG instruments feature mechanisms whereby the loan pricing steps up/down according to whether the Private Equity owner/sponsor manages the company to hit a set of KPIs. Such KPIs can include: carbon emissions; gender diversity; staff training; corruption etc.



## To what extent has the broader private capital industry shifted to address ESG concerns?

The industry architecture (e.g. banks, lawyers etc.) that supports the private capital industry has made significant advancements in providing new services that allow managers to address ESG concerns. Many lenders have dedicated ESG teams to help funds structure their facilities so that ESG goals of the lenders and borrowers are aligned. Law firms are channelling more and more resources to help managers align their ESG goals with investors when structuring new funds and financing facilities.

## What different mechanisms do private capital managers use to align their funds/businesses with ESG objectives?

Primarily, private capital managers align their funds towards ESG objectives via the investment process. Recent academic research<sup>3</sup> of the public fund market suggests that there is a return premium to be harvested from ESG assets. The rationale being that by screening out non-ESG aligned investments, the manager reduces downside risks inherent in companies that are over reliant on fossil fuels or outsourcing labour to developing countries, for example. Private capital managers implement ESG considerations within the investment process through:

<sup>1</sup> <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/global-alternatives-aum-forecast-to-double-by-2026-topping-23-trillion-68404362>

<sup>2</sup> Callan's "2021 ESG Survey" Data period: Jan 2019 – Oct 2021

<sup>3</sup> <https://adviserservices.fidelity.co.uk/sustainable-investing/do-sustainable-funds-outperform-wider-market/>

- o Negative Exclusion: excluding entire sectors, companies or countries based on ESG criteria, moral or ethical views (i.e. tobacco, weapons, nuclear energy, pornography, gambling, alcohol)
- o Positive Screening: investing in assets demonstrating positive ESG performance relative to peers.
- o ESG integration: the inclusion of ESG factors and non-credit considerations alongside financial analysis in the due diligence process.

Clearly, the ESG credentials of portfolio companies are important, however in addition, the manner in which deals are originated is also a key consideration. Within the Private Credit space, debt managers typically partner with Private Equity sponsors only when the Sponsor's values align with those of the lender. Many Private Credit lenders originate via deep, longstanding relationships with Sponsors. These relationships are built and solidified over the years not only through investment performance, but through shared ideals and values, with ESG being a key example.

## How have private capital managers innovated to meet the ESG requirements of institutional investors?

Over recent years, institutional investors have increased the use of ESG as a criterion used to evaluate managers, hence managers have innovated to focus ESG efforts. One such innovation is ESG linked performance fees. Innovative managers are calculating performance fees of new funds based on fund/corporate ESG performance (measured by predetermined KPIs) alongside fund performance. The KPIs used will vary by asset class, however examples include:

- o Diversity and Inclusion at the manager level / GP
- o ESG scoring of portfolio assets (typically measured and verified by an independent third party);
- o Portfolio concentration of "green assets" – more relevant in the infrastructure and real estate fund spaces;
- o The number of portfolio companies where ESG credentials have been strengthened by the manager's active participation in the business – more relevant in the Private Equity and Venture Capital fund spaces

## How do private capital managers communicate ESG performance transparently with investors?

Recently introduced Sustainable Finance Disclosure Regulation ("SFDR") requires fund managers to explicitly categorise the degree to which their funds target ESG objectives. Article 8 funds aim to "promote environmental or social characteristics", where article 9 funds are even more ambitious as the investment strategy must include a "sustainable objective". Examples of article 9 funds include funds investing in green bonds or renewable energy infrastructure. Article 6 funds do not integrate any kind of sustainability into the investment process.

Many proactive managers already use independent third parties to regularly assess the portfolio by scoring each asset through an ESG framework (typically co-constructed by the third party and the manager). Asset by asset ESG "performance" is tracked over time so that regular reporting can be provided directly to investors.

## Summary

- Private capital markets continue to evolve, building on dramatic industry wide changes, in order to address the ESG concerns of investors.
- Private capital managers have integrated ESG considerations into their investment processes and their fund terms/structure (performance fees, fund financing).
- Investors can rely on new regulation to increase market transparency regarding the extent to which ESG plays a role within fund objectives. Some managers provide their investors with independently calculated "ESG score" reports.

## Additional Notes

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