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Private assets and ESG

The link is strengthening, but there's still work to do

June 2023

In cooperation with
PREQIN

Private assets and ESG

In conversation with:

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They are two of the hottest topics in the world of asset management – ESG and private assets. But historically, they have not always been seen as intertwined.

In this paper, two experts consider five of the most pressing questions about the link between private assets and ESG, and how it can be strengthened further.

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Global Head of Private and Alternative Investments, BNP Paribas Wealth Management

Many opportunities for further ESG integration

ESG factors have increasingly been integrated in the management of private assets over the past few years.

This is mainly due to growing demand from investors – not just institutions such as pension funds and insurance companies, but also private clients – for private assets strategies that integrate ESG or make a positive impact. Investors are also interested in giving meaning to their wealth – a trend that the pandemic seems to have accelerated.

Today, a large number of private assets managers – in the US as well as Europe – have signed the United Nations Principles for Responsible Investment. In fact, the number that have done so has risen sharply over the past decade. Regulation has had a big impact on this increased uptake of ESG.

Against this backdrop, in May 2023 we held the latest in our series of ESG talks, this time on the subject of private assets and ESG. During the discussion, three experts gave their views on five topics linked to private assets and ESG:

- **how ESG approaches vary by asset class**
- **how large the market is and what kind of investors dominate it**
- **the challenges in terms of methodology and data**
- **drivers of future growth**
- **the impact of regulation.**

In this paper we summarise the experts' views on each of these important subjects.

What ESG means for private assets...

... and how ESG approaches vary by asset class.

Private markets are around 10-15 years behind the public markets when it comes to ESG. There are also different levels of maturity between the different asset classes within private assets.

Infrastructure is probably the most advanced, as it often targets essential services that do good from an ESG perspective by their nature. Examples include renewable energy plants and hospitals.

According to Soojin Kim, there's strong demand from clients for infrastructure – they want to invest in the energy transition, and infrastructure funds are well placed to help in this regard.

Private equity's integration of ESG is maturing and is likely to become mainstream over time. But there's still work to do – some studies suggest that only 25% of private equity firms have a dedicated ESG team. This is often not because of a lack of conviction in ESG, but because of the costs involved.

Real estate has a big role to play in the battle against climate change in the form of green buildings, and there is more and more pressure from tenants to mitigate carbon emissions. Given the nature of the asset class, real estate funds are generally more focused on the E in ESG than private equity funds, but they also touch upon the S in terms of the accessibility of buildings to a wide range of tenants.

In private credit, some funds are beginning to focus on ESG, with covenants linked to a company's ESG achievements, which is quite innovative. But overall, ESG is at a less mature stage for this asset class.

Meanwhile, there is a general feeling that it is more difficult to integrate ESG in the management of hedge funds than it is for private equity, real estate and infrastructure. That's because it's easier to consider a building's carbon emissions or water use than it is for, say, a hedge fund investing in derivatives.

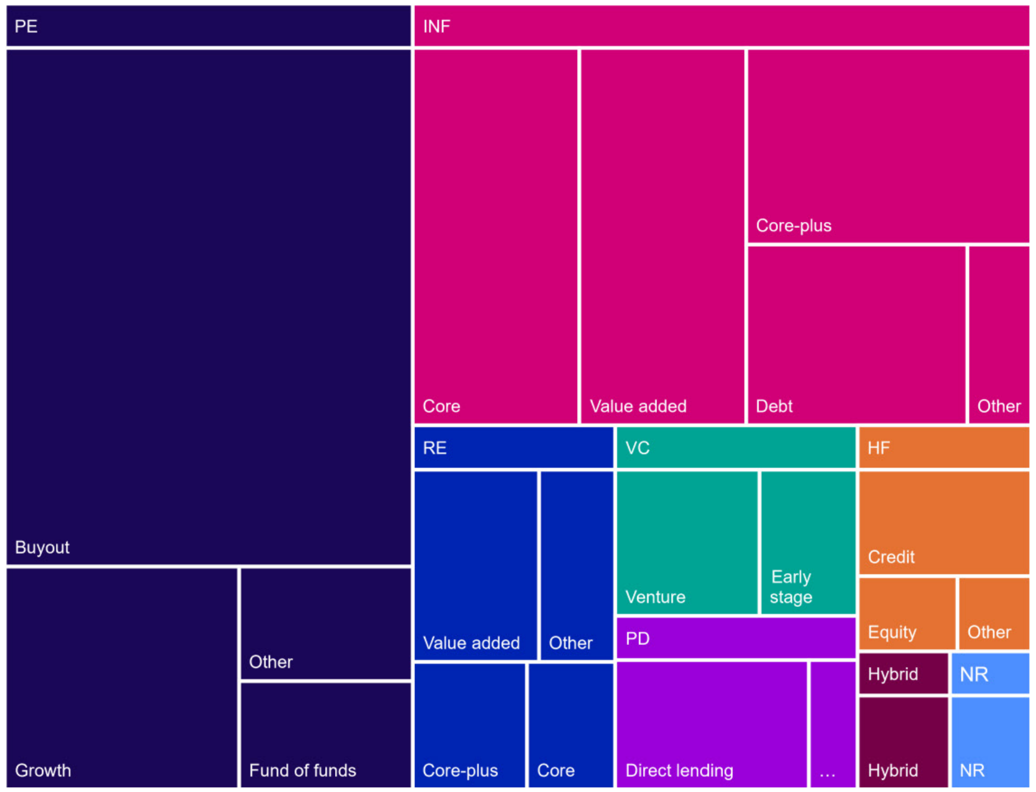
2.

How large is the market and what kind of investors dominate it?

The chart below shows that private equity and infrastructure are the leading private asset classes in terms of number of ESG-labelled funds, accounting for around three-quarters of the total. Real estate, venture capital, private debt and hedge funds make up roughly similar amounts of the remainder.

The blue bars in the graph (top of next page) show that the number of private assets funds with an ESG policy being launched and the aggregate fund size increased steadily over the past decade before slowing down in 2022 due to the uncertain macroeconomic backdrop. The number of launches has picked up again so far in 2023.

ESG labeled funds by asset class and investment strategy

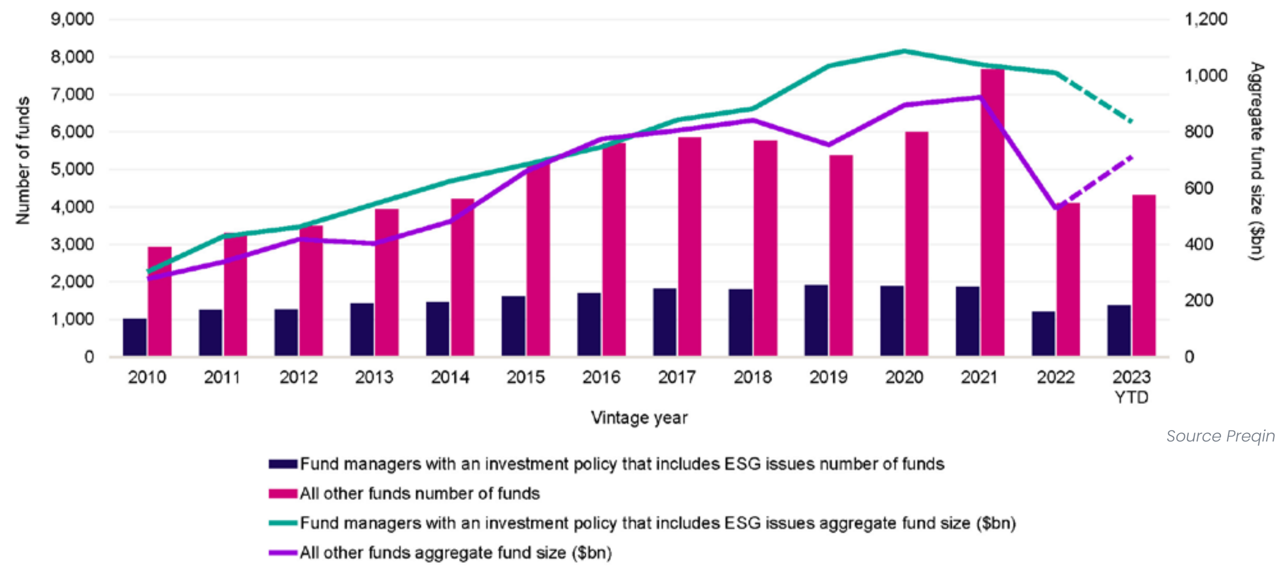


Source Preqin

> **While the younger generation really feels the threat of climate change, the older generations seem more concerned about human rights, social issues and poverty.**
>
> **Renato Guerriero**

While ESG received a lot of attention during the pandemic, the below chart makes it clear that it has in fact been growing for many years. That said, since the pandemic there has been a lot more ESG activity from first-time fund managers and those that are new to the sustainable investment space.

Proportion of total private capital fundraising under ESG commitment



Source Preqin

The following chart shows the number of investors that have told Preqin that they intend to allocate to ESG private assets mandates over the coming 12 months. We can see that insurance companies, asset managers and family offices are at the top of the list.

55 insurance companies have an ESG LP mandate

Source Preqin

Private and ultra-high-net-worth clients are increasingly taking ESG considerations into account in their investment decisions, and there is also growing interest among the youngest generations in making ESG-compliant and impactful investments. Private assets managers are likely to adapt their offerings as a result.

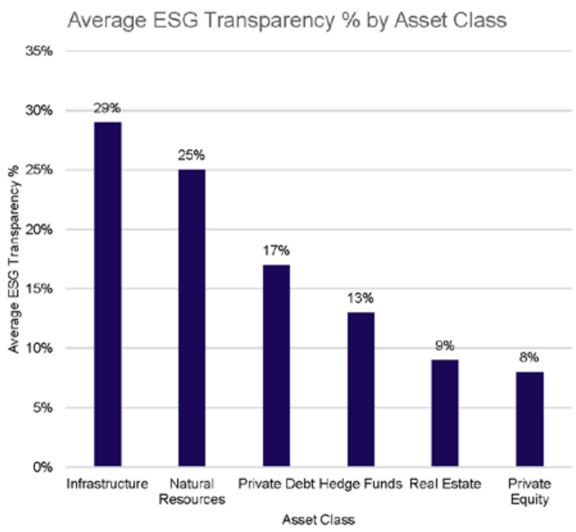
When it comes to impact funds, there is something of a binary position among investors. For some, making an impact is their top priority. Some others, however, prefer to invest in traditional private assets funds and use the profits they generate to allocate to charities or philanthropic projects of their choice.

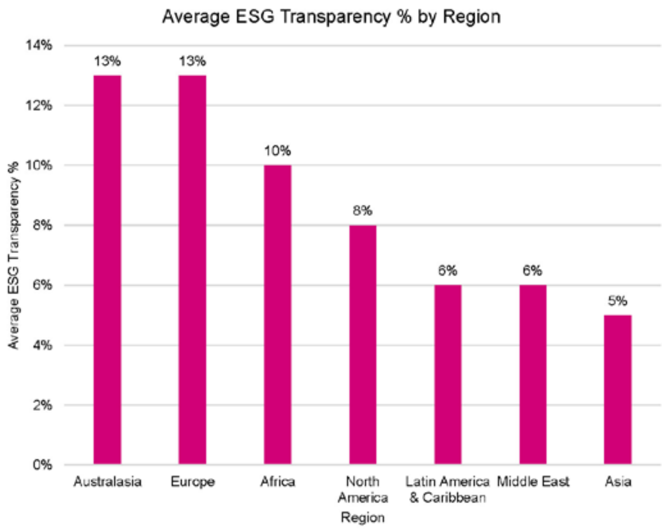
3. The challenges in terms of methodology and data

Incorporating ESG criteria in the management of private assets is easier said than done.

One of the biggest challenges for investors is the relatively limited disclosure of ESG performance by private assets managers. As we can see in the chart below, disclosure is highest for infrastructure at the asset class level, while at the regional level it is highest in Australasia and Europe. However, it's striking how low the overall percentages are.

Infrastructure and Europe/Australasia highest disclosure classes, but overall percentage remains low





Source Preqin

"Methodology and data is one of the hardest ESG challenges facing private assets investors.

Soojin Kim, Preqin

Europe and Australasia are probably in the lead in terms of disclosure due to the impact of regulation. Europe is broadly recognised as a front-runner in ESG thanks to regulation such as Sustainable Finance Disclosure Regulation (SFDR) and the EU taxonomy, while in Australia the regulator recently took away several funds' ESG labels due to concerns about greenwashing. The regions where regulation is most stringent is where ESG is best placed to thrive.

But one of the reasons for poor transparency is that many private assets funds struggle to get accurate data from the companies they invest in. For example, they may provide limited data about their Scope 3 greenhouse gas emissions or about diversity within their firm.

Emissions are difficult enough to deal with even in terms of Scopes 1 and 2, as there are several methodologies that companies can use to calculate them. But Scope 3 is far more complicated as firms need to consider emissions from the whole of their supply chains – a hugely difficult task. This makes comparing the emissions of private asset funds, which may be investing in large numbers of companies, extremely difficult.

For these reasons, some private asset managers are choosing to leave organisations such as Glasgow Financial Alliance for Net Zero and Climate Action 100+. And in some cases, the steering committees and boards of some of these organisations have asked certain firms to leave if they can't fulfill their criteria.

4. Drivers of future growth

As the chart below shows, a proven link between ESG and investment performance is the main driver for investors to adopt ESG strategies. The second is regulation, which we discuss in the next section.

Reasons to begin considering ESG issues in investment analysis/decisions

Source Preqin

Some clients are still sceptical about the performance potential of ESG funds or impact funds from an investment perspective, but many others strongly believe that ESG has a positive impact on value creation and helps maximise the price of the company at exit. In fact, given the increased expectations of companies, it's quite possible that firms with poor ESG credentials will struggle to find buyers in the coming years.

The challenge for the ESG community is to persuade investors that investing in ESG funds and even impact strategies will lead to better long-term returns and outperformance of their non-ESG peers. This is likely to become easier when the funds launched in recent years have a longer-term track record.

> **While financial returns clearly matter, the way these returns are generated is mattering to investors more and more.**
>
> **Claire Roborel de Climens**

5. The impact of regulation

Regulation has a big role to play in furthering the cause of ESG in the private assets universe. For example, the US Securities and Exchange Commission (SEC) has been working on two primary new rulings recently, one about the naming of funds and the second about climate-related disclosures. Gary Gensler, the current SEC chair, is a forceful proponent of ESG.

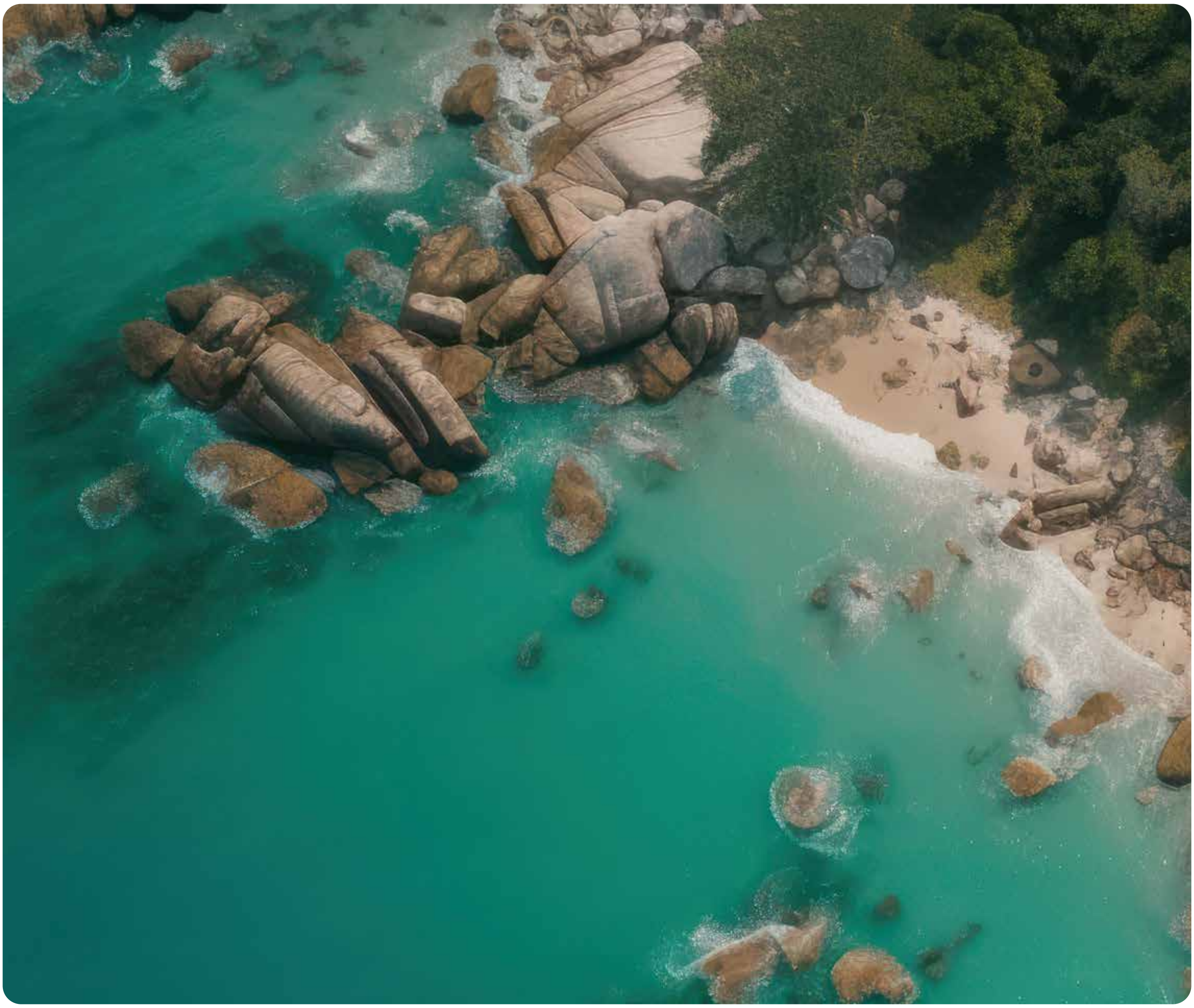
In Europe, meanwhile, SFDR is well known.

Encouragingly, recently there has been greater clarity about what Article 9 reporting means.

New regulation is beneficial in terms of driving ESG forward as it forces asset managers to adapt. This is good news, as it compels them to adopt more stringent KPIs and improves the level of communication that managers can send to their clients on, for example, carbon emissions and diversity metrics.

But there's still huge scope for improvement. It would be great if one day there was a clear framework setting out the KPIs that all companies need to achieve, although this may depend on a company's size and sector of activity. A major problem is that today there are no clear universal market metrics enabling investors to compare the private assets funds they are considering investing in.

> **Standardisation is essential, and it's crucial to have robust data and to be able to process it in a rigorous way. This remains a big challenge, and regulators have a big role to play in overcoming it.**
>
> **Claire Roborel de Climens**



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