

How critical is ESG and sustainable investing to scaling a private capital business?

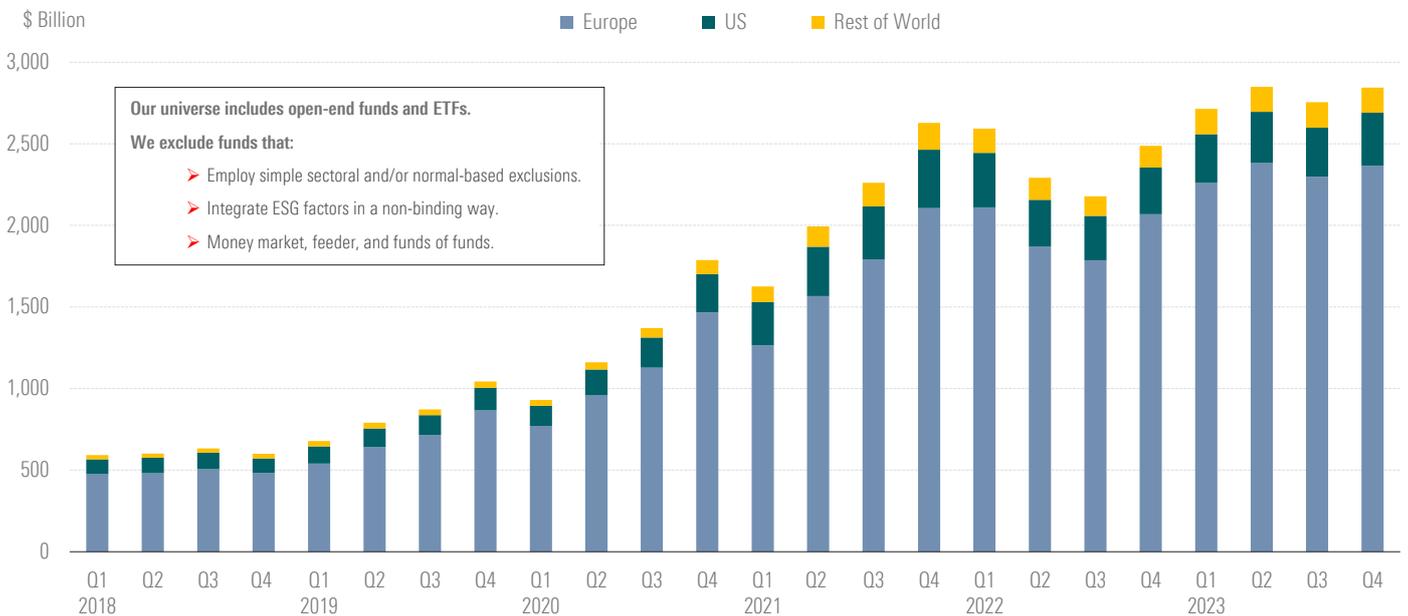
Private capital fund managers have seen investors demand more ESG aligned products over recent years. This has resulted in ESG fund assets increasing from around \$900bn at the beginning of 2020 to approximately \$2.8tn by the end of 2023.

Europe leads the way in terms of ESG funds, with continuous growth predominantly supported by net inflows from European investors. Funds Europe reported in May 2023 that 87.5% of LPs they surveyed intended to increase their ESG allocations by mid-2025 with over 70% of them willing to pay additional management fees for quality reporting.

The market has developed significantly, with product development occurring at a rapid rate, especially in European private markets, although there remains significant room for further scaling as the investment landscape in the United States has not been as quick to allocate to these funds given the backdrop of greenwashing concerns and what has been termed anti-ESG laws in some states with material allocations.

2023: Global ESG fund assets

Up 14% from a year ago to \$2.8tn



Source: Morningstar Direct. Data as of Dec. 2023; excluding money market funds, closed end funds, fund of funds and feeder funds. Morningstar's universe of ESG funds includes open-end funds and ETFs for which ESG factors are central to the investment process and excludes funds that employ only limited exclusions and integrate ESG factors in a non-binding way.

The Netherlands, in particular, has emerged as a global leader in impact investing, with an estimated market size of €150-180bn in 2021, representing 4-6% of AUM, compared to 1-2% globally. Since releasing this data the Netherlands Advisory Board on Impact Investing (NAB) have launched a campaign to encourage institutional investors to allocate at least 10% of their AUM to impact investments by 2025.

The Nordics have maintained their progressive and supportive stance on ESG and impact, seeing a steady increase in demand for impact products as a result with allocations to Venture Capital funds, in particular, having an almost three-fold increase in investments since 2020. The focus on social and environmental welfare, governance and innovation have ranked them among the top performers in the Sustainable Development Goals (SDG) Index. The Nordic governments have also implemented various policies and incentives to promote sustainable finance and impact investing, such as green bonds, social impact bonds and tax relief schemes for such ESG related instruments.

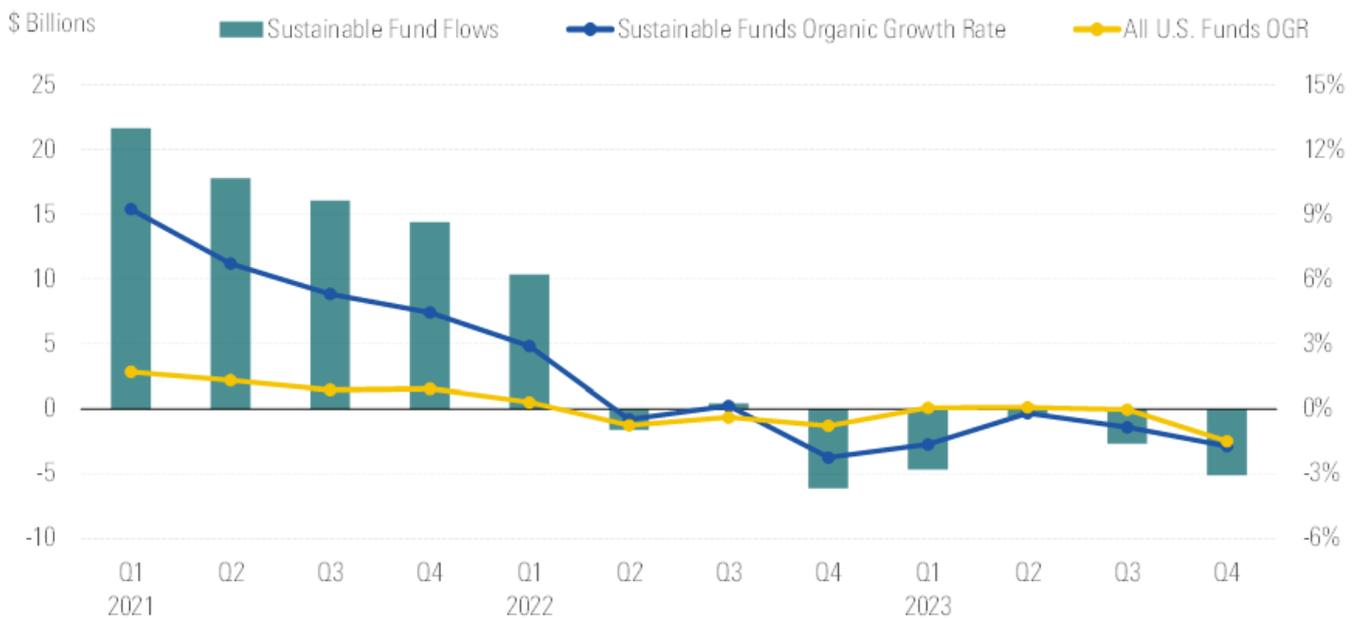
However, not all regions and countries are equally committed to advancing the impact agenda. The Impact Task Force (ITF), a group of experts and practitioners convened by the

World Economic Forum, has warned that the current state of impact investing is not sufficient to meet the SDGs and goals of the Paris Agreement. The ITF has called for more action and collaboration from governments, regulators, investors and intermediaries to create a more enabling environment for mobilising private capital for impact.

The United Kingdom (UK) has shown mixed signals and diverging paths on ESG and impact issues. The UK, which was once a pioneer in sustainability and innovation, has faced economic and social challenges due to the COVID-19 pandemic and Brexit, and has delayed some of its ESG regulatory initiatives and climate commitments.

However, UK regulators are now looking to reclaim their leadership in this market. With UK managers with over £5bn AUM required to comply with the Taskforce for Climate Related Financial Disclosures (TCFD) by 30 June 2024, the finalisation of the Sustainability Disclosure Requirements (SDR) and the UK's commitment to adopt the sustainability accounting standards issued by the International Sustainability Standards Board (ISSB), there will be far greater scrutiny and accountability for those producing ESG related information.

US Fund Flows: Sustainable vs All US Funds (US\$bn)



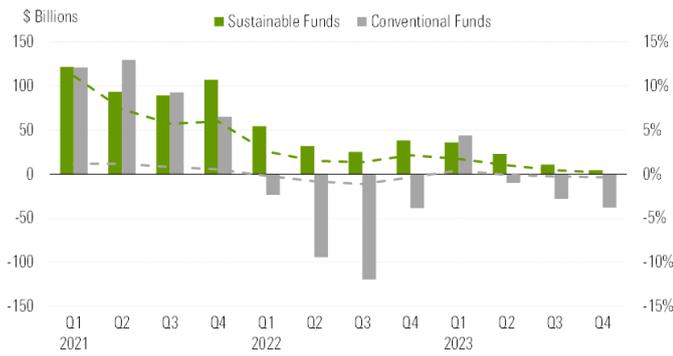
Source: Morningstar Direct. Manager Research Data as of December 2023

The US has reversed some of the previous administration's policies and re-joined the global efforts to tackle climate change but has also faced political and legal opposition to some of its ESG proposals.

This uncertainty has seen the US ESG funds suffer outflows over the past two years. Investors continue to pull funds with ESG funds suffering a \$13bn on net outflow in 2023 while conventional funds experienced positive inflows of \$92bn.

However, the data from Morningstar seems to support the desired regulatory trajectory in Europe. Sustainable funds have fared better than conventional funds in these uncertain times. ESG funds saw net new inflows of \$74bn while traditional funds saw net outflows of \$30bn. Interestingly, however, passive ESG funds saw a net inflow of \$84bn while active ESG funds saw a net outflow of \$10bn in 2023.

European sustainable fund flows compared with conventional fund flows (US\$bn)



Source: Morningstar Direct. Manager Research Data as of December 2023

European sustainable fund flows (US\$bn)



Source: Morningstar Direct. Manager Research Data as of December 2023

Underpinning fund growth with a stable operating model

The private capital industry in Europe faces a complex and dynamic landscape of ESG regulation and impact investing trends. Those in the market looking to appeal to institutional investors and progressive family offices need to adapt and respond to the changing expectations and preferences of their investors, regulators and stakeholders, and to demonstrate their value proposition and competitive edge in terms of sustainability and impact. Many funds are choosing to locate their ESG team within their value creation team, perhaps a sign of the perception that ESG is value accretive. In 2024, firms that can move beyond high-risk labelling to integrate ESG and impact into their strategies, processes and culture will be better positioned to grow successfully, both within the fast maturing European market as well as the fast developing rest of the world.

Grappling with the various ESG regulations to determine which are applicable and which ones investors are expecting them to consider has been the starting point for most. However, going beyond these to critically assess the business model and how much it needs to pivot to retain investors is going to be crucial, especially given the speed of change.

As more investors in Europe seek funds that evidence delivery of positive social and environmental impacts, fund managers and alternative investment firms face a complex challenge of complying with various ESG regulations. They need to identify which of their entities are subject to mandatory rules, what kind of reporting they have to provide to the public, investors and regulators, and whether they have the data to back up their ESG claims or explain any gaps. Moreover, they cannot assume that meeting one ESG standard automatically satisfies another, as different regulations may have different criteria and expectations.

A final word

It is undeniable that ESG is here to stay, and the demand for higher calibre sustainable products will continue to increase. Therefore, firms looking to grow, attract assets and enhance their brand will need to identify which products to offer. As they do so, it would be wise to look at the demand and risk in equal measure to ensure that fund flows are not offset by reputational damage or undue regulatory scrutiny.

Contacts



Shailen Patel
 Head of Corporate Advisory
 DD +44 (0)20 7849 2138
 shailen.patel@macfarlanes.com



Siobhan Holroyd
 Manager, Corporate Advisory
 DD +44 (0)20 7791 4315
 siobhan.holroyd@macfarlanes.com



Rachel Richardson
 Head of ESG
 DD +44 (0)20 7849 2480
 rachel.richardson@macfarlanes.com

Macfarlanes LLP | 20 Cursitor Street London EC4A 1LT

T +44 (0)20 7831 9222 | F +44 (0)20 7831 9607 | DX 138 Chancery Lane | macfarlanes.com

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