Insights+

ESG in Alternatives
2023

PREQIN

Contents

Acknowledgements

Research Insights Analysts
Alex Murray, PhD
Rachel Dabora

Preqin contributors
Tuva Bergan-Gulli
Megan Harris
Maya Jordan

Executive Editor
Danny McCance

Senior Manager, Editorial
Jasmin Naim

In-House Designers
James Flanagan
Tim Short

Key findings

1

Infrastructure ESG funds are closing in on private equity's fundraising lead

Despite private equity having dominated ESG fundraising since 2014, the strong growth in fundraising in 2021 and 2022 meant infrastructure funds secured nearly as much capital – $70.5bn was secured by infrastructure funds compared with $75.1bn secured in private equity. The average size of funds was larger in infrastructure in this period at $2.14bn, compared with $1.57bn in private equity. The success of these asset classes, which are at opposite ends of the risk spectrum, illustrates the breadth of opportunities for ESG strategies pursuing returns.

2

Impact strategies continue to gain traction in North America

Since 2014, Europe-based ESG funds have dominated in terms of aggregate capital raised, accounting for 79% of the total for these types of funds, while 14% was raised by North America-based funds, and 7% by those in APAC. However, in impact fundraising, 37% of total capital was raised by Europe-based funds, while North America-based funds accounted for 59%, and APAC just 2%.

3

Smaller European managers as transparent as North Americans

With size comes the ability to resource the development of organizational policies and integration of ESG into investment practices. However, a growing number of smaller, less experienced managers in Europe have achieved levels of transparency comparable with their larger, more established North America-based peers (see page 8). These managers have clearly embraced ESG and invested in integration. This suggests many proponents have adopted ESG as a form of tactical differentiation as part of their growth strategy.

4

ESG-related litigation increasingly relevant for more industries

Corporate ESG litigation has markedly increased in recent years, particularly toward companies involved in the extraction and sale of fossil fuels. This is not surprising: Preqin's ESG Risk Exposure Estimates ranks the oil & gas industry the second highest, after chemicals (see page 17). However, defendants are increasingly diverse. Of the corporate ESG claims in 2021, only 41% were brought against fossil fuel companies. Managers face significant reputational and asset-value risks if claims are filed against them.

ESG market update: moving to the middle market

By Alex Murray, PhD

Europe dominates ESG fundraising, with smaller, nascent managers in the region as transparent as their larger North American peers

As private markets grapple with the challenges facing the real and money economies into 2023, the integration of ESG across alternatives continues. Despite pushback from a vocal and ardent anti-ESG movement, particularly in the US, many managers continue to embrace ESG as a risk-management tool, to ensure long-term asset values amid a tightening regulatory backdrop. A turning point in ESG's adoption across private capital asset classes came in 2022, as fundraising soared to new heights. While attentions since may have re-focused on return generation and value protection in the face of macroeconomic pressure on valuations, in 2023 ESG adoption is broadening.

The new opponents to ESG

The Governor of Florida, Ron DeSantis, as well as state representatives from Kentucky, North Carolina, and Texas, have threatened to divest from fund managers that commit capital under ESG-risk-management standards. The representatives have opposed public pension plans that have been divesting from traditional energy assets and fund managers with ESG policies, contending that they should not be excluding these assets.

Texas was one of the first states to pass a prohibition against entering into any banking or fiscal contracts with financial companies that boycott firearms or traditional energy producers. The state also went as far as to publish a list of specific investment managers to avoid, with backlash from many over the politicization of the process.[1] States that have pledged to restrict all funds from ESG-related investments have yet to act on them. Fund managers with ESG policies and risk-management standards still play an active role in state public pension plans. As Marcie Frost, CEO of the California Public Employees' Retirement System (CalPERS)[2] says in reference to the ESG adoption by investors:

1 https://www.ft.com/content/8031aaad-efc6-4829-ac02-bd9c151974f4

2 https://pro.preqin.com/investor/2365

"Applying the lens of ESG is not a mandate for how to invest. Nor is it an endorsement of a political position or ideology. Those who say otherwise are actually advocating for investors like CalPERS to put on blinders, to ignore information and data that might otherwise help build on the retirement security of our two million members."[3]

Marcie Frost, CEO, CalPERS

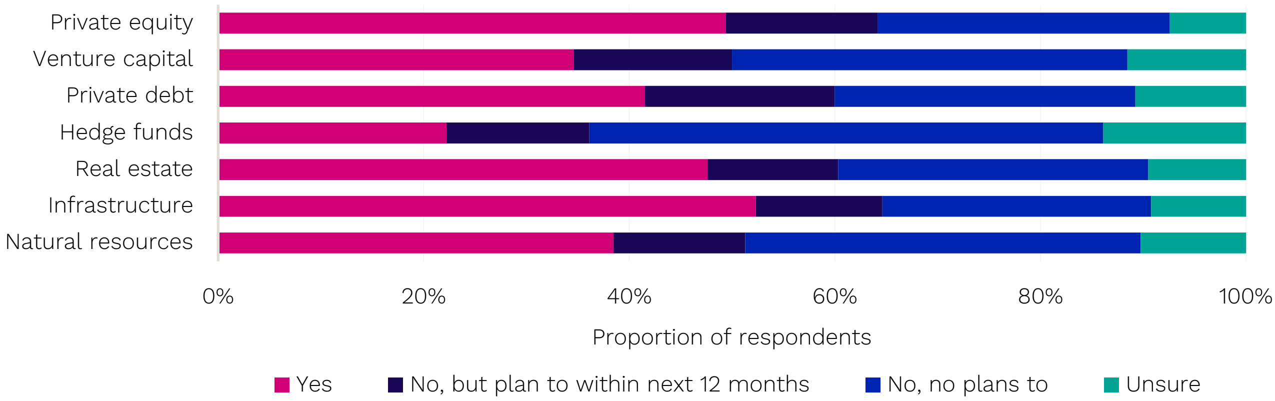
Dividing lines in ESG integration

Despite a few outspoken investors pushing back, most alternative investors across the asset classes either already have implemented, or intend to implement active ESG policies within the next 12 months (Fig. 1.1). Infrastructure investors are ahead, with 52% already having active policies in place, reflecting the need to engage with multiple stakeholders during primary development and ongoing operations. For hedge funds, 50% of investors have no plans to integrate ESG policies, with some keen to keep their options open regarding trading conventional energy stocks that may conflict with any stated ESG ambitions.

3 https://news.calpers.ca.gov/esg-myths-calpers/

Fig. 1.1: Majority of investors have adopted, or plan to adopt, an ESG policy

Investors with an active ESG policy by asset class



Source: Preqin Investor Survey, November 2022

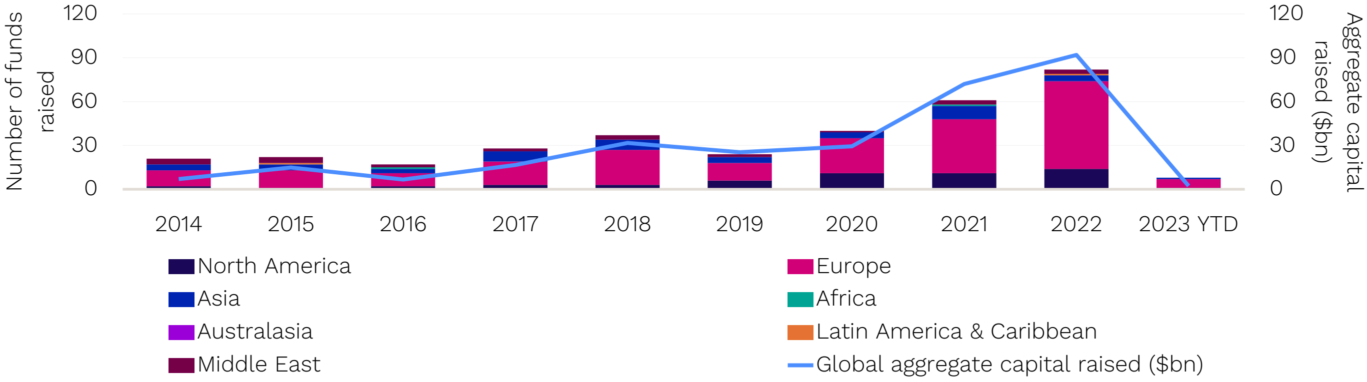
Fundraising and funds in market

The latest ESG fundraising data excluding impact investing shows strong growth in activity between 2020 and 2022. There was a threefold increase in aggregate capital raised, from $29.4bn in 2020 to $92.0bn in 2022 (Fig. 1.2). In 2022, the share of capital raised by Europe-based funds dropped to 68%, its lowest since 2016, below the 77% annual average between 2014 and 2023. So far in 2023, fundraising has been much slower, reflecting a broader trend across alternatives. Recent fundraising has seen average ESG fund size increase from $399.3mn in 2017 to $590.3mn in 2021 and $575.0mn in 2022.

Private equity ESG funds have generally dominated over the past decade, accounting for just under 50% of the $298bn raised since 2014 (Fig. 1.3), in line with its share of assets under management (AUM) across the asset classes. Infrastructure funds have recently come to the fore, particularly in 2021, when they

Fig. 1.2: More ESG funds in Europe, as global capital raised rises

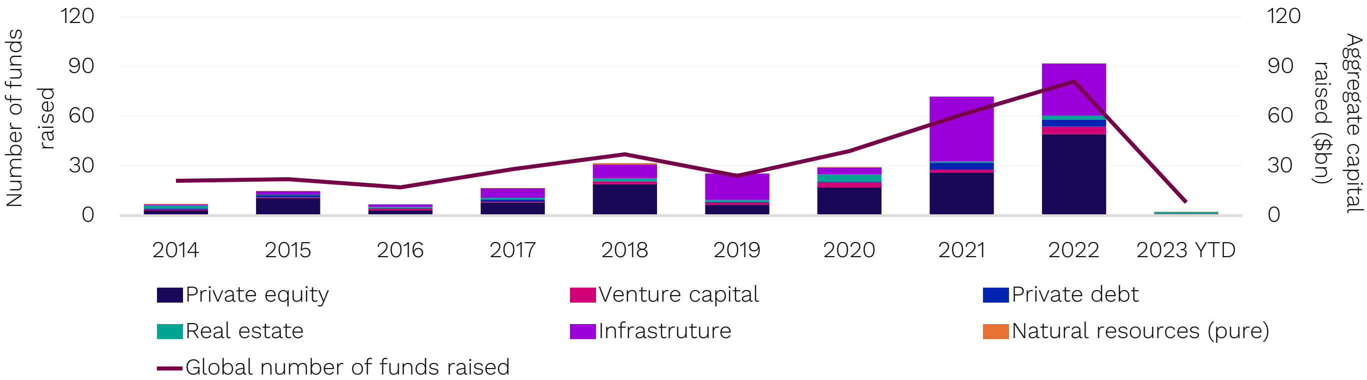
ESG fundraising by region



Source: Preqin Pro. Data as of May 2023

Fig. 1.3: Private equity fights with infrastructure for ESG capital

ESG fundraising by asset class



Source: Preqin Pro. Data as of May 2023

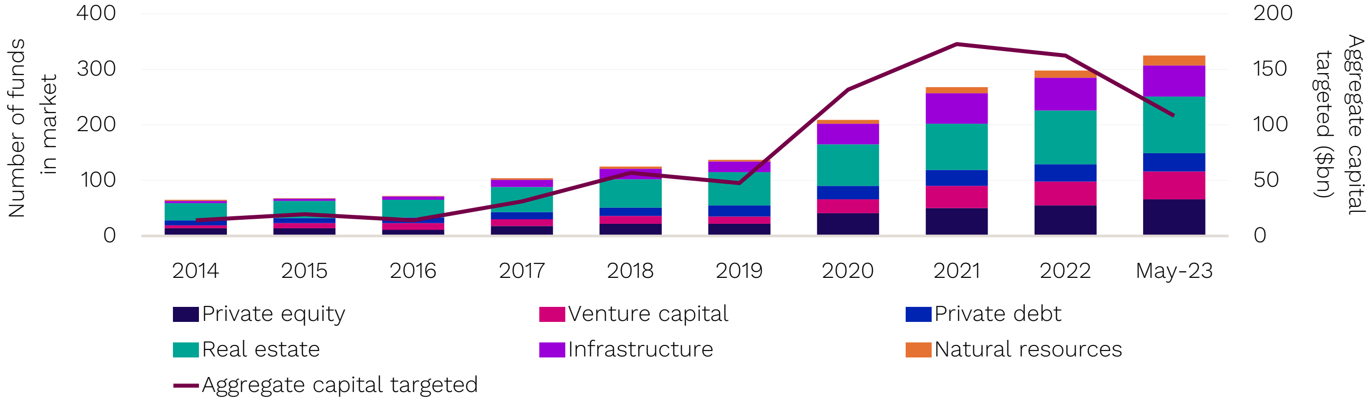
raised $38.9bn, eclipsing the $25.9bn private equity fundraising. Infrastructure is uniquely placed to deliver societal and environmental change given its capacity to support essential economic developments. Managers in this asset class maintain greater transparency, because they need to engage multiple stakeholders in the development of infrastructure projects.

Smaller funds carrying ESG fundraising

Average ESG fund target size is set to reverse its previous growth trend, with aggregate capital targeted falling from its 2021 peak of $172.7bn to $108.1bn as of May 2023. This is despite the number of ESG funds in market going up (Fig. 1.4). We can infer that ESG integration is increasingly adopted by smaller funds, as more middle managers adjust to growing demand from investors. In particular, infrastructure funds' share of the capital targeted for ESG funds in market has been declining since its peak of 56% in 2017.

Fig. 1.4: Average ESG fund target size falling

ESG funds in market by asset class



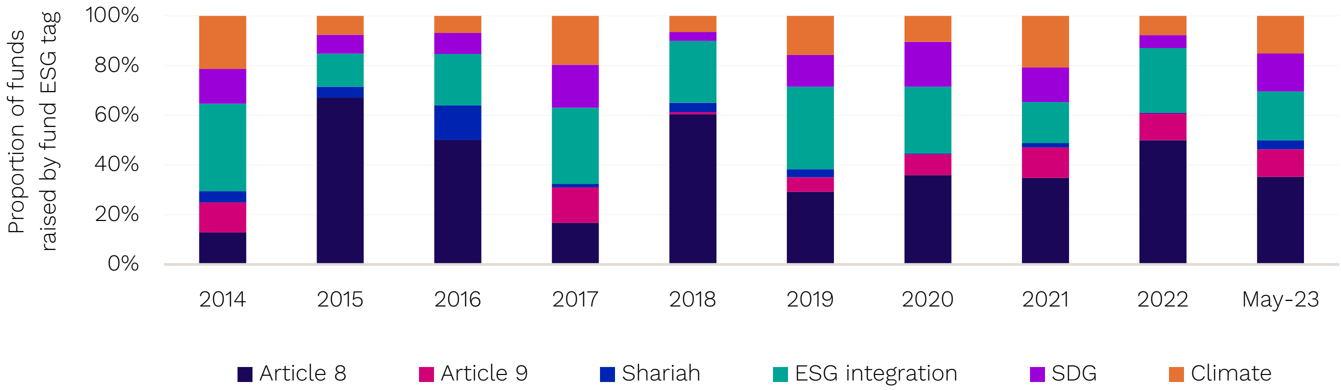
Source: Preqin Pro. Data as of May 2023

ESG tags – not just a marketing ploy

ESG funds have increasingly adopted labels to describe their ESG approach. To classify our ESG coverage, Preqin tags funds accordingly. The breakdown of aggregate capital raised by ESG funds suggests that Article 8 funds have dominated the fundraising landscape (Fig. 1.5), despite many having closed to fundraising before the Sustainable Finance Disclosure Regulation (SFDR) Article 8 designation was developed in 2021. This suggests that funds have adopted ESG designations during operations, with some older vintages doing so even after the investment period. Therefore ESG integration is more than a marketing tool to help raise capital, and investors are asking managers to improve ESG integration in funds they've already committed to. The investment horizons in private capital models demand that investors drive change not just in new funds, but also in current funds, to achieve their ESG portfolio ambitions in the short to medium term.

Fig. 1.5: Article 8 SFDR holds popularity as fund description

Proportion of aggregate capital raised by ESG fund tags, vintages 2014–2023 YTD



Source: Preqin Pro. Data as of May 2023

PREQIN

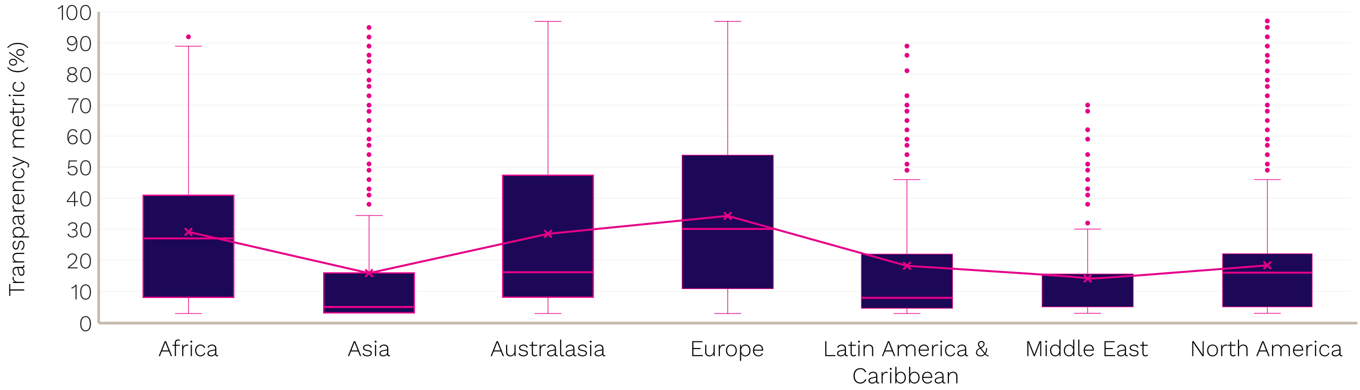
Transparent tactics for fledgling managers

Turning to manager transparency regarding their ESG policies and practices, we see Europe-based managers have the highest average and median transparency metrics (Fig. 1.6).[4] Australasia- and Africa-based managers also exhibit higher transparency than other regions, but the spread in the levels of transparency in these leading markets illustrates that many managers have yet to evidence their integration of ESG. Factors other than region also help to explain manager ESG transparency. The scale of the manager is an important driver, measured by historic funds raised. With size comes the ability to resource the overhead of developing organizational policies and integration of ESG into investment practices. However, there are a growing number of smaller, less experienced managers in Europe that have achieved comparable levels of transparency to their larger, more established North American peers (Fig. 1.7). These managers have clearly embraced ESG and invested in integration, despite growing demand for investment elsewhere as their organizations grow. This suggests many proponents have seen ESG as a form of tactical differentiation as part of their growth strategy.

4 Box: Interquartile range; Horizontal line in box: median; Cross: Average (mean) transparency metric; Spot: Outlier fund manager transparency metric.

Fig. 1.6: European manager ESG transparency highest globally

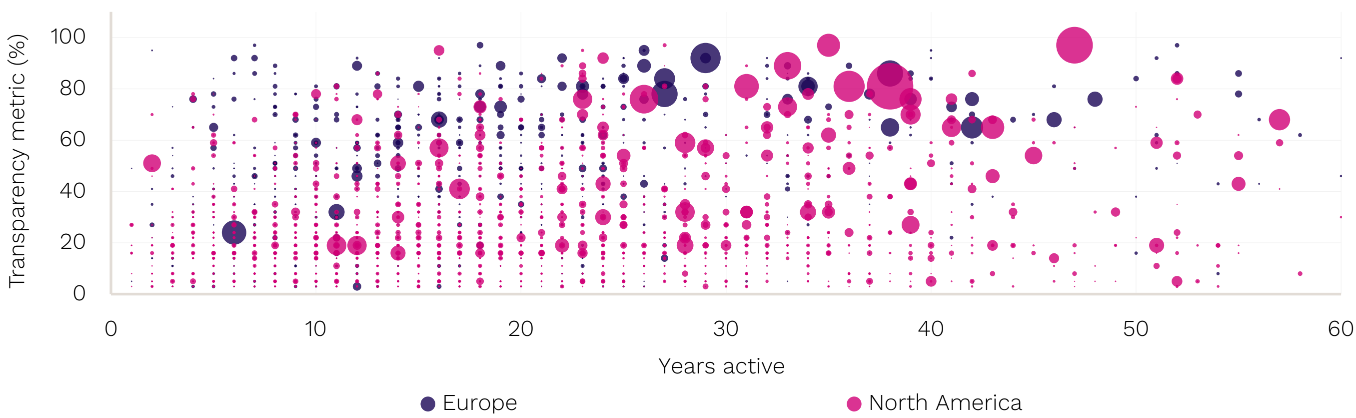
Manager transparency metrics by region



Source: Preqin Pro. Data as of May 2023

Fig. 1.7: European managers quicker to develop ESG transparency

North America- and Europe-based managers' ESG transparency metrics (%) by years active and funds raised (circle size)

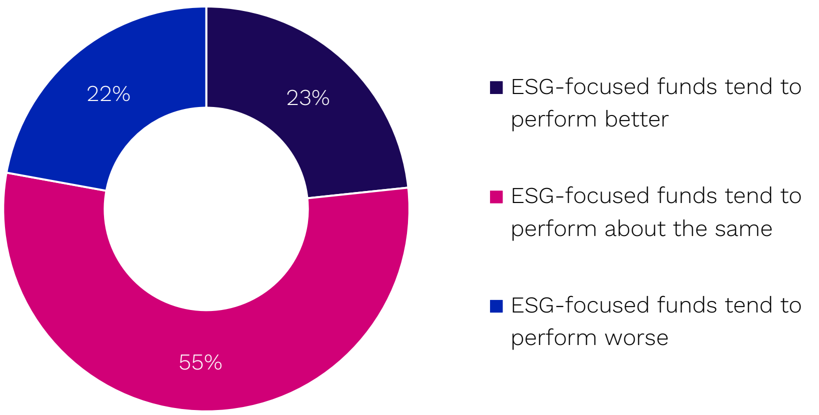


* Circle size represents funds raised in last 10 years

Source: Preqin Pro. Data as of May 2023

ESG and returns
Whether ESG helps drive longer-term returns remains a contentious issue. According to our investor survey, conducted in November 2022, investors' views suggest there is no strong consensus either way (Fig. 1.8). However, what is clear is that ESG does affect investors' willingness to do deals. The survey also showed that 29% of investors reported having turned down a deal over ESG concerns while another 43% reported they would do so. While the upside benefits of ESG investing may take time to materialize, it seems investors consider ESG as a means to manage downside risk. As regulatory regimes are set to tighten in the coming years, the role of ESG in protecting asset values from stranded-asset risks remains.

Fig. 1.8: No consensus on ESG fund performance
Investor views on performance of ESG-focused funds vs. non-ESG-focused funds



Source: Preqin Investor Survey, November 2022

Impact investing – not just ESG+

By Rachel Dabora

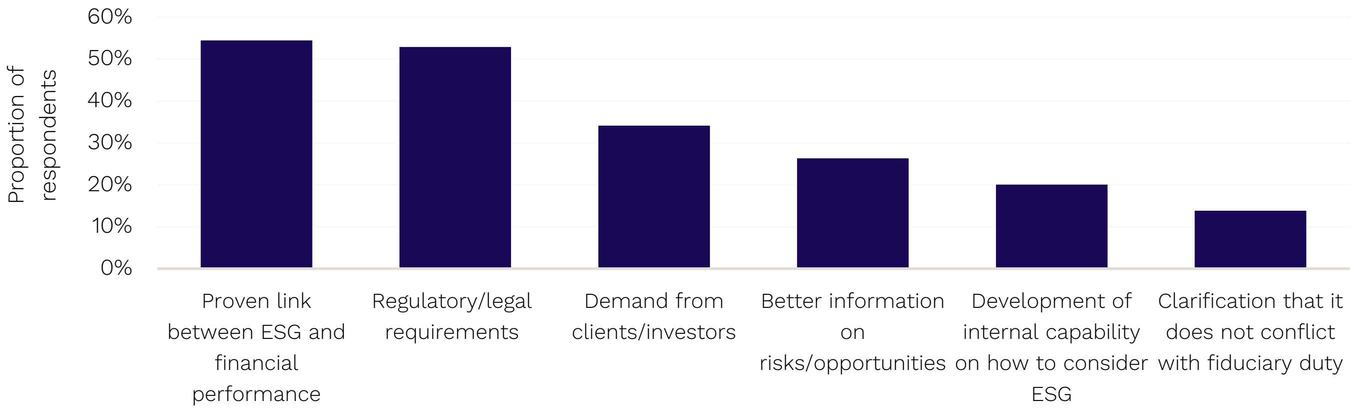
Despite its association with ESG integration and other ESG strategies, investors should consider impact investing separately

When it comes to the term ESG, some strategies don't sit easily within it. Impact funds are a pertinent example. ESG integration identifies environmental, social, and governance factors to maximize returns and minimize risks, evaluating investments based on individual characteristics and comparing respective performance.

Impact investing, on the other hand, takes these considerations, particularly environmental or social goals, to another level. These investments incorporate specific environmental or societal outcomes in their business model, putting them at the center of their strategy. Although some individuals argue that ESG investing does not deliver higher financial returns, Preqin's November 2022 investor survey found that, for 55% of respondents, the main driver of investor willingness to consider ESG issues in decision-making is a proven link between ESG and financial performance (Fig. 2.1).

Fig. 2.1: Financial performance is a key motivator for ESG investors

Investor views on what would make them consider ESG issues



Source: Preqin Investor Survey, November 2022

External rate of return

That said, some question whether it is even possible to reliably quantify positive social or environmental outcomes. This, alongside other concerns over greenwashing in the financial services sector, has encouraged regulators to re-evaluate vague definitions of impact investing. In November 2022, the European

Securities and Markets Authority (ESMA) published a consultation paper[5] proposing that funds using the term impact in their name would have to make clear how they will generate positive social or environmental outcomes alongside a financial return. Regulations reflecting this are expected to publish in the coming year.[6] The Securities and Exchange Commission (SEC) is working to address the same issue in the US, and under a 2022 proposal[7] is seeking to distinguish impact funds from ESG funds.

Niche to mainstream

Impact funds have grown significantly over the past 10 years, with the number of funds raised and aggregate capital raised increasing significantly in the aftermath of the pandemic. In 2021 the number of funds grew by 61% year over year and the final close amount by 26% (Fig. 2.2). However, the number of funds decreased by 35% year over year in 2022, while the aggregate capital raised more than doubled from $12.7bn in 2021 to $33.6bn. This capital concentration in 2022 suggests impact strategies have moved mainstream, rather than being the preserve of smaller, niche managers.

The Global Impact Investing Network (GIIN) estimates that the impact market, which encompasses asset types beyond private capital such as green bonds, includes over 3,000 organizations and nearly $1.2tn in AUM.[8] The GIIN identified clear tailwinds for the continued growth of the impact investing sector in the coming years, based on progress over the past decade and looming global climate goals.

5 https://www.esma.europa.eu/sites/default/files/library/esma34-472-373_guidelines_on_funds_names.pdf

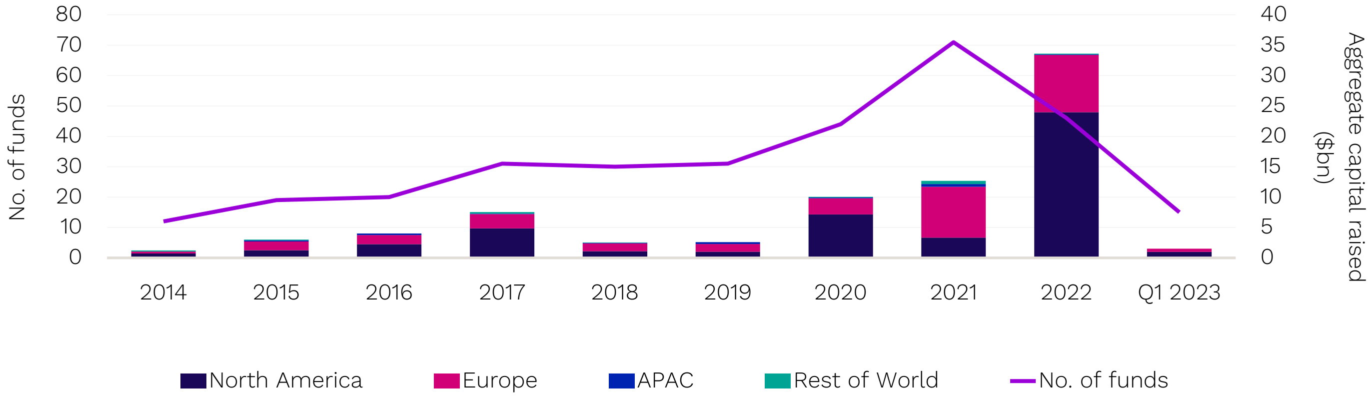
6 https://www.ft.com/content/d20ca1f1-ebb2-4ab1-a3ff-8b61191e0186

7 https://www.sec.gov/rules/proposed/2022/33-11068.pdf

8 https://thegiin.org/assets/2022-Market%20Sizing%20Report-Final.pdf

Fig. 2.2: Impact funds see capital concentration amid 2022 surge

Impact fundraising, aggregate capital raised by region, year, and number of funds



Source: Preqin Pro

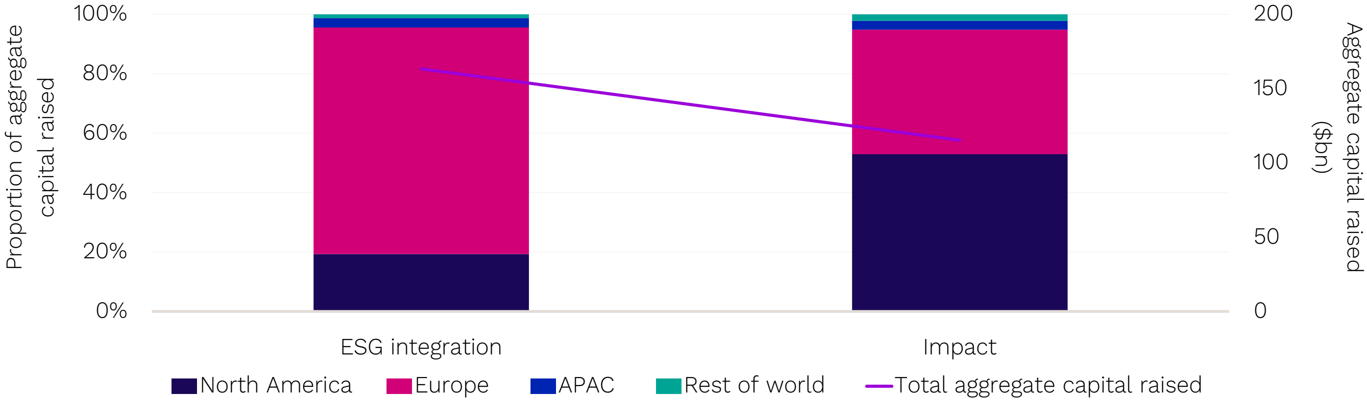
PREQIN

North America favors impact over Europe
ESG integration and regulations are more developed in Europe than other regions but impact investment strategies are more concentrated in North America.[9] Rather than looking at when capital was secured, examining fund vintages from 2013 shows that European funds have dominated ESG integration fundraising, securing 76% of the global aggregate (Fig 2.3). However, among impact funds, North America funds of comparable vintages lead, accounting for 53% of capital raised.

9 https://www.preqin.com/insights/research/reports/esg-in-alternatives-2022-the-transparency-tipping-point

Fig. 2.3: North America leads on impact fundraising, Europe on ESG

Impact vs. ESG aggregate capital raised by region, vintages 2013–2023



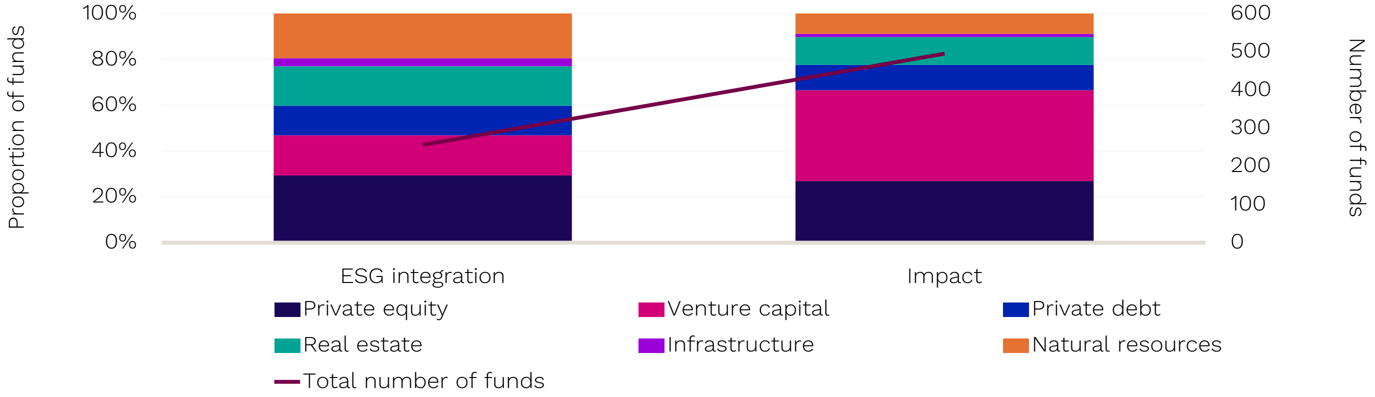
Source: Preqin Pro. Data as of May 2023

Historically the US has been the main market for impact investing, and the Inflation Reduction Act of 2022 should support this with its $369bn stimulus package for investment in energy security and climate change. This may increase the pool of capital for impact fundraising given the heightened environmental ambitions. One challenge for private capital investors, however, lies in capturing high returns for investors from impact projects, particularly in renewable energy projects such as wind and solar, which have shown lower returns with decreasing risk.[10] In these cases, it is not the fact that these are impact investments that is reducing returns, but the infrastructure characteristics of such projects. Impact funds span the asset classes and as such, reflect their underlying features, including risk and return, as much as their impact status. The higher weight of VC funds in impact fundraising (Fig. 2.4) suggests they might achieve a higher average IRR than a representative sample of ESG funds. However, impact funds may accept below-market-rate returns as part of the financial trade-off in pursuit of external social and environmental outcomes.

10 https://www.ft.com/content/d20ca1f1-ebb2-4ab1-a3ff-8b61191e0186

Fig. 2.4: Impact funds skew to VC, while ESG funds are more diverse

Impact vs. ESG funds closed by asset class, vintages 2013–2023



Source: Preqin Pro. Data as of May 2023

Impact on its own

Impact investing has commonly been grouped with ESG, but it follows its own trends. Historically it has been prevalent in North America, which will likely continue despite the current backlash against ESG investment strategies in the US. Impact investing also differs from ESG integration in the way that it interacts with environmental or social factors, and its goals in directly linking environmental and social benefits with returns. Impact managers still have a responsibility to maximize returns for their investors, however, the central focus of the fund remains to accomplish environmental and social goals. This may lead to compromises not suited to all investor types, as some prioritize alpha generation over value-aligned investments. It's crucial that investors understand the differences and potential challenges of impact investing, compared with ESG integration.

Meeting climate targets requires decarbonizing infrastructure

Many more infrastructure assets need to set zero-emissions targets to reach climate goals

Marie Lam-Frendo
CEO
Global Infrastructure Hub
(GI Hub)

Joss Blamire
Director of Infrastructure
GRESB

With infrastructure responsible for 79% of global GHG emissions,[1] we can't reach climate targets without decarbonizing infrastructure. Yet, too few infrastructure assets have zero-emissions targets – especially outside of renewables.

There is growing momentum on setting zero-emissions targets in the renewable sector

The number of renewable assets setting zero-emissions targets has been trending up since 2019. GRESB[2] data show 39% of renewable assets now have zero-emissions targets. Other infrastructure sectors have made progress toward climate targets but have been less able than renewables to commit to zero-emissions targets. Only 9% of transport assets, 7% of social infrastructure assets, and 7% of water infrastructure assets currently have zero-emissions targets.

The long-term infrastructure plans and investment priorities of governments similarly focus on renewables as a key first step on the path to net zero. In a 2022 review[3] of G20 countries' long-term national infrastructure plans. other transition pathways, like technological carbon removal and reducing the carbon intensity of material production, were found to be less developed.

The implication is that for outside renewables, the path to net zero and the assets that will bring us there are less clear – for governments as well as asset owners and operators.

Private investment is critical to decarbonize other infrastructure sectors

G20 countries have signaled their intention to further develop robust and comprehensive plans to meet climate targets. Private investment will be essential to execute these plans, 'green' all infrastructure sectors, fill gaps in critical infrastructure, and build resilience. At the same time, asset owners and operators have been put under increased regulatory pressure to set zero-emissions targets.

But even as private investment in infrastructure reached a record high in 2021, driven mostly by renewables, overall private investment in infrastructure has been stagnant for nearly a decade.[4] Furthermore, the infrastructure investment gap has grown to $3 trillion annually. To fill that gap, not only does private investment need to increase, but decarbonization frameworks also need to enable capital to flow to all infrastructure assets, even those that haven't been or will be difficult to decarbonize.

Stronger consensus on portfolio-level targets will be crucial for driving investment across sectors

Reaching consensus on portfolio-level targets for infrastructure is complex, due to the diverse range of asset classes in infrastructure investments. However, this consensus is urgently needed, because alignment on these targets will significantly help direct investment flows towards a more sustainable and resilient future.

1 https://content.unops.org/publications/Infrastructure-for-climate-action_EN.pdf?mtime=20211008124956&focal=none
2 https://www.gresb.com/nl-en/
3 https://infrastructure-transition.gihub.org/
4 https://www.gihub.org/infrastructure-monitor

Marie Lam-Frendo leads the G20's Global Infrastructure Hub, which collaborates across the public and private sectors to produce data, knowledge tools, and programs that advance sustainable infrastructure development. Previously, she was the Head of Asia-Pacific for Acuity and Head of the Infrastructure Initiatives department of the World Economic Forum.

Joss Blamire is an expert advisor on ESG and infrastructure development with a focus on real assets and renewable and low carbon energy. He has extensive experience advising fund managers and asset owners in understanding their ESG needs, developing sustainability strategies, and assessing investments against international benchmarks and standards.

ESG litigation – raising the bar

By Tuva Bergan-Gulli

A growing body of ESG-related litigation can help guide private market actors, as well as seed new fund strategies, engagement methods, and reporting

Alongside the growth of the ESG investment industry, the number of ESG-related legal claims has been rising too. With an expanding body of ESG regulation globally, enhanced disclosure requirements, maturing legal precedents, and crackdowns by watchdogs, this is only expected to grow.[11] Further, the rise of anti-ESG sentiment in the US is also predicted to increase litigation in that country, testing ESG's legal standing from both its supporters' and opponents' points of view.[12] While ESG litigation is not new, it's an increasingly important way to ensure accountability, enforce government and corporate commitments, and drive the global ESG agenda. For private markets specifically, ESG litigation constitutes both an engagement tool, and for financial institutions, an increasingly material risk, as reputational damage and expensive payouts can significantly affect valuations.[13]

In Preqin's November 2022 Investor Survey, investors cited their own demands, industry standards and best practices, as well as regulatory requirements as key reasons why fund managers establish ESG policies, at 73%, 62%, and 50%, respectively (Fig. 3.1). This illustrates the reputational risks managers face if they are subject to ESG-related litigation. Moreover, when asked what would cause investors to begin considering ESG issues in investment decisions, the top responses included legal requirements (53%, Fig. 3.2), just behind financial performance (55%).

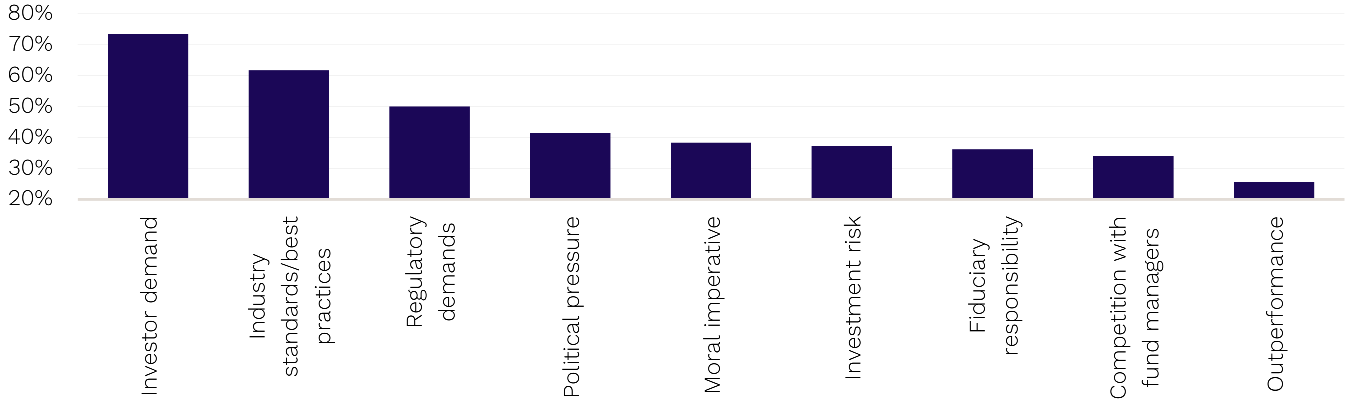
11 https://www.kingsleynapley.co.uk/insights/blogs/dispute-resolution-law-blog/litigation-trends-for-2023-esg-claims

12 https://www.responsible-investor.com/esg-backlash-will-spark-rush-of-litigation-says-leading-lawyer/?utm_source=newsletter-daily&utm_medium=email&utm_campaign=ri-daily-subscriber&utm_content=20-03-2023

13 https://www.theguardian.com/environment/2023/may/22/big-polluters-share-prices-fall-climate-lawsuits-fossil-fuels-study

Fig. 3.1: Investor demand puts pressure on GPs

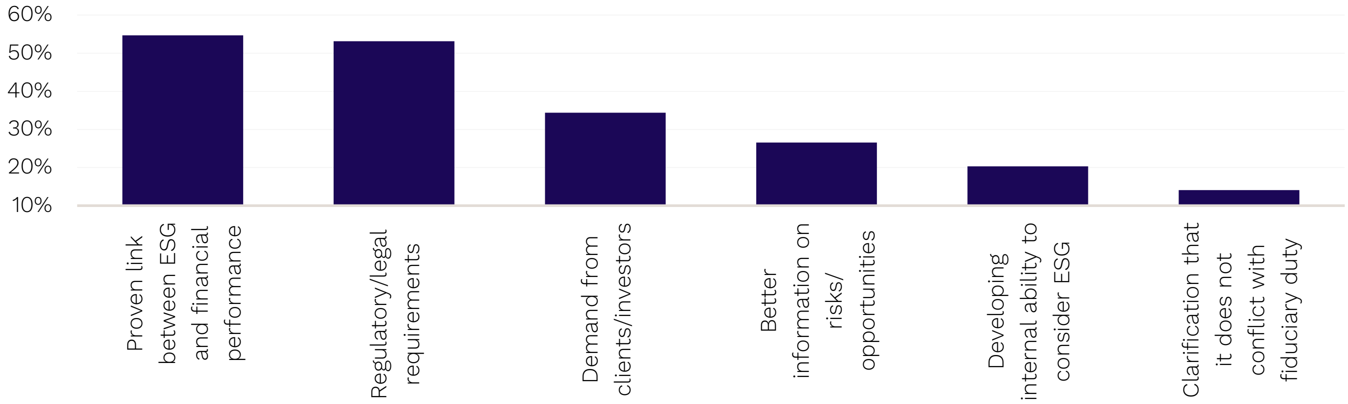
Investor views on why fund managers establish an ESG policy



Source: Preqin Investor Survey, November 2022

Fig. 3.2: ESG adoption depends on financial performance and regulation

Investor views on what would make them consider ESG



Source: Preqin Investor Survey, November 2022

ESG litigation – who claims what?

In a 2020 report,[14] law firm Latham & Watkins with the World Business Council for Sustainable Development identified five key categories of ESG-related litigation:

1. **Government** – claims directed at national governments or governmental organizations, which have indirect effects on companies
2. **Infrastructure** – claims directed at significant infrastructure development projects, involving companies, governmental bodies, or both
3. **Company** – claims concerning the companies themselves, including their operations, their governance arrangements, and their disclosures and corporate reporting
4. **Fiduciary duty** – claims concerning alleged breach of duty of care under national laws
5. **Informal disputes** – claims that are addressed through informal dispute resolution mechanisms, typically targeting sectors, individual companies, or groups of companies

14 Latham & Watkins LLP, WBCSD, “ESG Litigation Roadmap” (2020); https://www.wbcsd.org/Programs/Redefining-Value/Making-stakeholder-capitalism-actionable/Enterprise-Risk-Management/Resources/ESG-Litigation-Roadmap

Although most ESG-related claims are made against governments, there has been a marked increase in corporate ESG litigation in recent years.[15] Many of these cases are brought against companies involved in the extraction and sale of fossil fuels. This is perhaps not surprising; according to Preqin's ESG Risk Exposure Estimates, oil & gas is the industry with the second highest ESG risk exposure, following chemicals (Fig. 3.3).

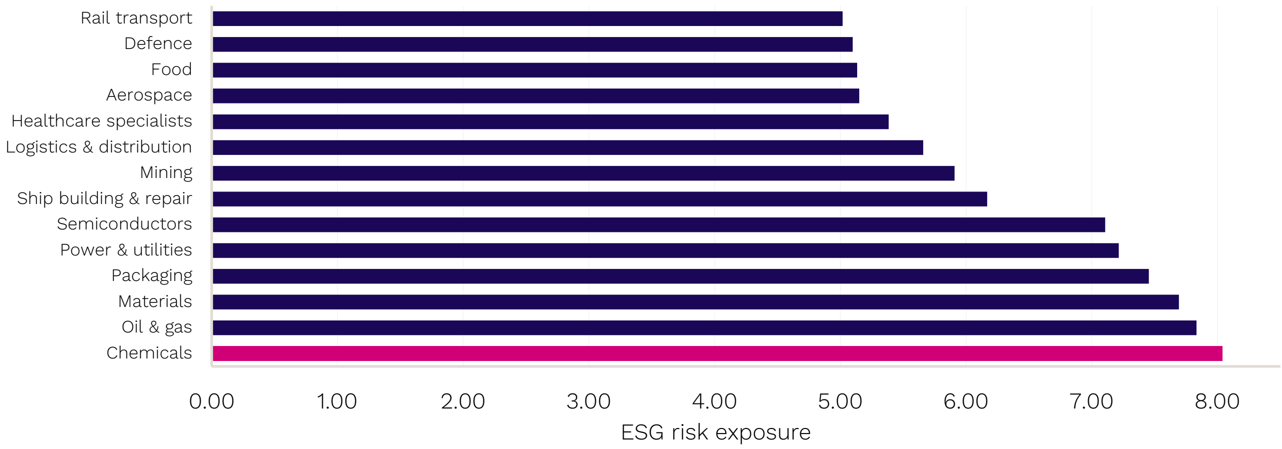
However, the defendants are increasingly diverse. Of the corporate ESG claims in 2021, only 41% were brought against fossil fuel companies, while the majority were filed against companies in other industries, including food and agriculture, transport, plastics, finance, mining, and media.[16]

15 Setzer & Higham, *Global trends in climate change litiation 2022 snapshot* (2022)

16 ibid

Fig. 3.3: Chemicals and oil & gas industries most exposed to ESG risks

ESG risk exposure estimates by industry



Source: Preqin Pro

Relevance for financial institutions

Investors are increasingly seeing ESG litigation as a way to drive change on ESG issues. Unlike more traditional engagement mechanisms, such as voting and consultations, ESG litigation provides a means to hold portfolio companies accountable and compel them to confront issues immediately.[17] And it can create long-term, beneficial effects on shareholder value. For example, last year the Swedish pension fund AP7 brought legal action against Activision and Microsoft over their planned merger, as the bid and terms breached governance standards and caused shareholders to lose money.[18] Using ESG litigation to actively engage with companies, the fund successfully achieves outcomes that would otherwise be difficult.

Another way private market actors have been using ESG litigation to drive the ESG agenda is through dedicated ESG litigation funds. In 2018 Aristata Capital was founded, the first litigation fund dedicated to driving positive social and environmental change while offering attractive financial returns. The fund provides finance for claimant groups that are unable to afford litigation, and in return, they receive a multiple of its investment or a percentage of the settlement where claims are successful. The fund raised nearly £40mn for the first close of its impact litigation fund.[19]

17 https://www.theguardian.com/environment/2023/may/22/big-polluters-share-prices-fall-climate-lawsuits-fossil-fuels-study

18 https://www.ipe.com/news/ap7-sues-us-gaming-firm-and-microsoft-over-planned-merger/10063723.article

19 https://www.responsible-investor.com/investment-firm-raises-40m-for-first-ever-esg-litigation-investment-fund/

Practice what you preach
Conversely, financial institutions are among those being sued. To broaden understanding of climate-related financial risks, several claims aim to clarify the legal obligations surrounding financial institutions' portfolio emissions.[20] For example, in the US 13 universities have had proceedings issued against them for failing to divest from fossil fuels, on the basis that this breaches state law and fund managers' fiduciary duties to prudently manage charitable funds.[21] Similarly, in the UK a complaint was filed against the Directors of the Universities Superannuation Scheme, alleging mismanagement of the fund, including by over-investing in fossil fuel assets.[22] The case was initially dismissed, but the claimants received permission for a hearing at the Court of Appeal in 2023. Despite the initial dismissal, the case has been hailed as evidence of the increasing momentum by activists, shareholders, and other stakeholders to hold institutions accountable for climate change. Moreover, research suggests that even unsuccessful cases or cases that do not make it to a full hearing still impact decision-making.[23] In other words, the mere fact that claims are being brought can change behaviors.

Reducing opacity in private markets
Several ESG-related controversies have recently made waves in private markets, including high-profile allegations of greenwashing and enforcement action by regulatory bodies.[24] Regulators such as the FCA in the UK and the SEC in the US have proposed new rules around greenwashing, clarifying financial institutions' responsibility to make substantiated and credible ESG-related claims.

In 2020 we launched Preqin's ESG Transparency KPIs, tracking fund managers' and investors' level of ESG transparency around core disclosures at the firm, portfolio, and asset level. As of 2023, the global average ESG transparency metric is 9%. Drilling into what type of information is being disclosed, there is a clear prevalence of firms providing overarching statements about future targets and long-term plans, rather than granular breakdowns of actions taken. To illustrate, of the nearly 5,000 fund managers who claim to have 'statements, policies or initiatives related to climate change' in place, 44% disclose their own greenhouse gas (GHG) emissions, and only 28% disclose that they track their portfolio companies GHG emissions (Fig. 3.4). In Preqin's November 2022 investor survey, 43% of respondents said they would turn down investment opportunities due to concerns over ESG standards, and 29% said they already had done so (Fig. 3.5). In other words, providing clear, transparent, and credible ESG information is increasingly essential, both to avoid enforcement action and to secure and help maintain investor interest.

20 https://www.responsible-investor.com/investment-firm-raises-40m-for-first-ever-esg-litigation-investment-fund/

21 Setzer & Higham (2022)

22 McGaughey and Davies v Universities Superannuation Scheme Ltd (2022)

23 Setzer & Higham (2022), 29

24 Source: Scrutiny of ESG claims for private investments grows | Financial Times (ft.com) 'Greenwashing' warnings accelerate drive for business sustainability standards | Financial Times (ft.com)

Fig. 3.4: ESG disclosure is multi-layered with less detail at asset level

Number of fund managers with climate and emissions disclosures

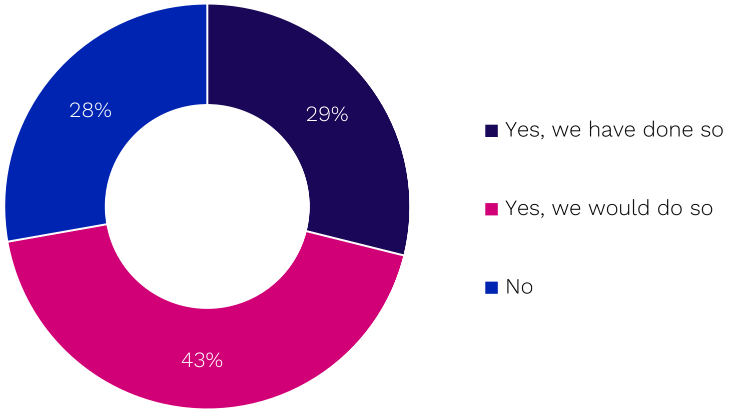
Number of fund managers who disclose	
Statements, policies, or initiatives related to climate change	4,949

Proportion of fund managers who also disclose	
GP carbon or GHG emissions	44%
Tracking of GHG emissions at portfolio companies	28%

Source: Preqin Pro

Fig. 3.5: Majority of investors say ESG factors could undermine a deal

Investor views on turning down investment opportunities due to concerns over ESG standards



Source: Preqin Investor Survey, November 2022

Looking ahead

The rise of portfolio emissions-related claims, combined with the expansion of mandatory ESG-related disclosures and ESG litigation's potential consequences on valuations, contributes to growing pressure from both investors and regulators for managers to incorporate ESG into investment decisions. As more claims are filed and processed, a better understanding will emerge of what ESG means in a legal context, both as a risk and an engagement mechanism. This will increase transparency among private market fund managers for investors navigating the ESG landscape.

Thematic investing with SDGs and climate

By Maya Jordan

Thematic investing offers new strategies and captures investors' ambitions for their portfolio ESG outcomes

According to our November 2022 Investor Survey, 60% of investors see ESG as being of average or higher importance in investment decision-making (Fig. 4.1). Further, 72% of investors stated they have turned down, or would turn down an otherwise attractive investment over ESG concerns (Fig. 4.2). Recent events like the Black Lives Matter movement and COVID-19 have highlighted investment themes related to social impact and health inequality, aligning them with environmental priorities such as climate resilience, decarbonization, and reducing plastic waste.

Since 2007, 241 UN Sustainable Development Goal (SDG) aligned funds and climate funds have been raised (Fig. 4.3). This coincides with two major developments for alternatives: the shift from the UN Millennium Development Goals to the SDGs, and the Paris Climate Agreement. As 193[25] UN member states signed the UN SDGs, and 195 countries pledged to keep temperature rises below 2°C this century,[26] fund managers have pursued opportunities to create products supporting these ambitions and investors have shown interest. These initiatives emphasize climate and sustainability issues as material risks, to allow investment decision-making to avoid potential losses in the future. According to the International Financial Reporting Standards – International Sustainability Standards Board (IFRS-ISSB), financial materiality ensures that information (such as climate impacts or other ESG factors) that could influence investor decision-making is disclosed and not omitted or obscured.[27] These considerations arguably provide a competitive advantage to leaders in ESG, while hitting laggards the hardest. In his 2022 Letter to CEOs, Larry Fink, CEO of BlackRock, stated: 'Few things will impact capital allocation decisions—and thereby the long-term value of your company—more than how effectively you navigate the global energy transition in the years ahead.'[28] Severe weather events, supply chain distribution, and greater inequality have made sustainability and ESG issues impossible to ignore, and inseparable from financial performance. Thematic funds are unlike impact funds in that they do not accept a trade-off in financial return in pursuit of social and environmental outcomes. They harness the opportunity from clearly identified themes and trends as a means to pursue competitive, market-rate returns.

25 https://www.un.org/sustainabledevelopment/blog/tag/193-member-states/

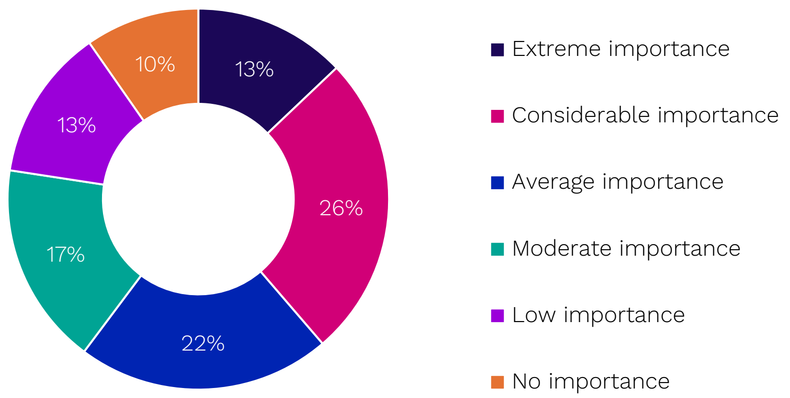
26 https://www.un.org/en/climatechange/paris-agreement

27 https://www.ifrs.org/groups/international-sustainability-standards-board/issb-frequently-asked-questions/#:~:text=The%20IFRS%20Foundation%27s%20focus%20is,expected%20to%20influence%20investor%20decisions.

28 https://www.ft.com/content/26de745d-9b98-4ca3-98c6-cb54db2bc095

Fig. 4.1: ESG of 'considerable importance' to investors

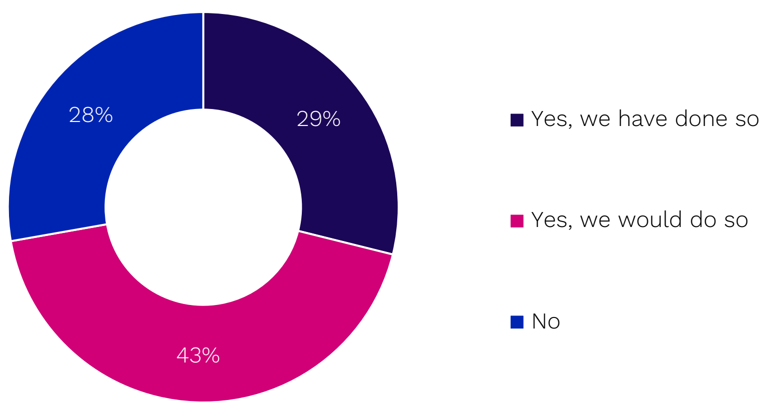
Investor views on the importance of ESG in investment decisions



Source: Preqin Investor Survey, November 2022

Fig. 4.2: Majority of investors say ESG factors could undermine a deal

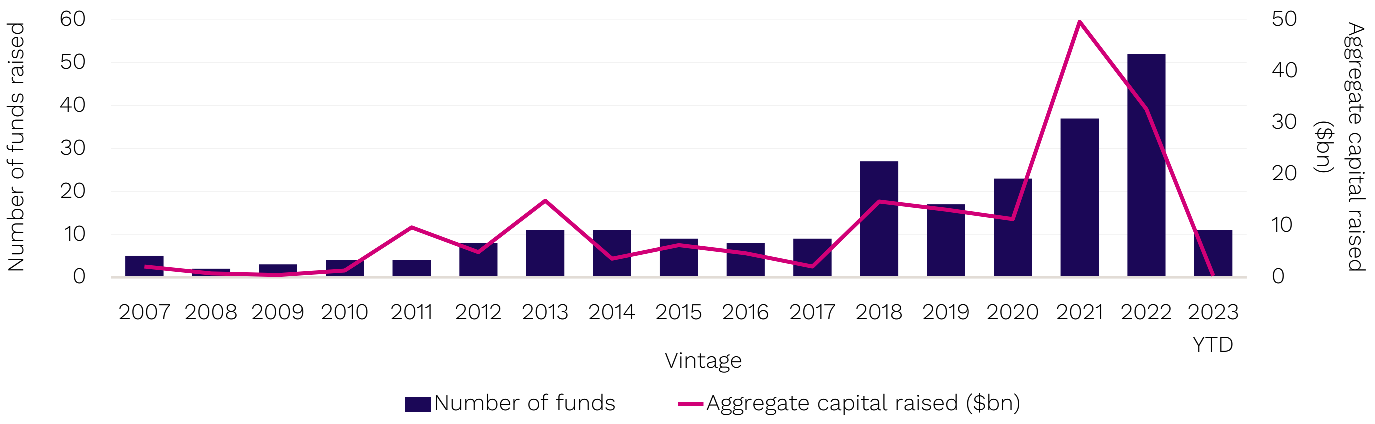
Investor views on turning down investment opportunities due to concerns over ESG standards



Source: Preqin Investor Survey, November 2022

Fig. 4.3: Thematic funds have fallen in size since 2020

SDG-aligned and climate funds by number and capital raised



Source: Preqin Pro

PREQIN

Themes in focus – biodiversity and water

Thematic funds aimed at limiting biodiversity loss and water scarcity, and mitigating their effects align with the UN Water Conference and the recent launch of the Taskforce on Nature-related Financial Disclosures (TNFD). The TNFD emphasizes 'nature-positive investments' and provides a framework around which financial institutions and companies can make decisions relating to risks and opportunities. The UN Water Conference, the first conference to place water action center stage since 1977, pushes beyond water being a universal human right and highlights water scarcity, access, affordability, and management. Alignment with these initiatives can be seen with the launch of funds and investment products such as blue and green bonds, biodiversity funds, or even ocean thematic funds.

Climate and SDG funds

Climate funds typically focus on supporting the mitigation of climate issues and SDG-aligned funds seek investments in portfolio companies aligned with the UN Sustainable Development Goals. SDG-aligned funds tracked by Preqin include those with strategies aimed at addressing SDG 3 – Ensure healthy lives and promote well-being for all at all ages, 7 – Ensure access to affordable, reliable, sustainable, and modern energy, 12 – Ensure sustainable consumption and production patterns, and 13 – Take urgent action to combat climate change and its impacts.

An increasing number of SDG and climate funds raised between 2007-2023 saw a marked increase in fundraising from 2015, the year of the Paris Climate Agreement and the launch of the UN SDGs. This affirms that many funds raised before 2015 that have retrospectively sought to align themselves with SDGs have not done so for the benefits of aiding initial fundraising from investors. From 2015 to 2021 there was a fourfold increase in the number of SDG and climate funds, reflecting the increased attention on ESG investing (Fig 4.3). A 34% decrease in the aggregate capital secured by such funds in 2022 may reflect a temporary de-prioritization of ESG factors as investors focus reverting to fundamental returns – 60/40 portfolios lost 17% in 2022.[29]

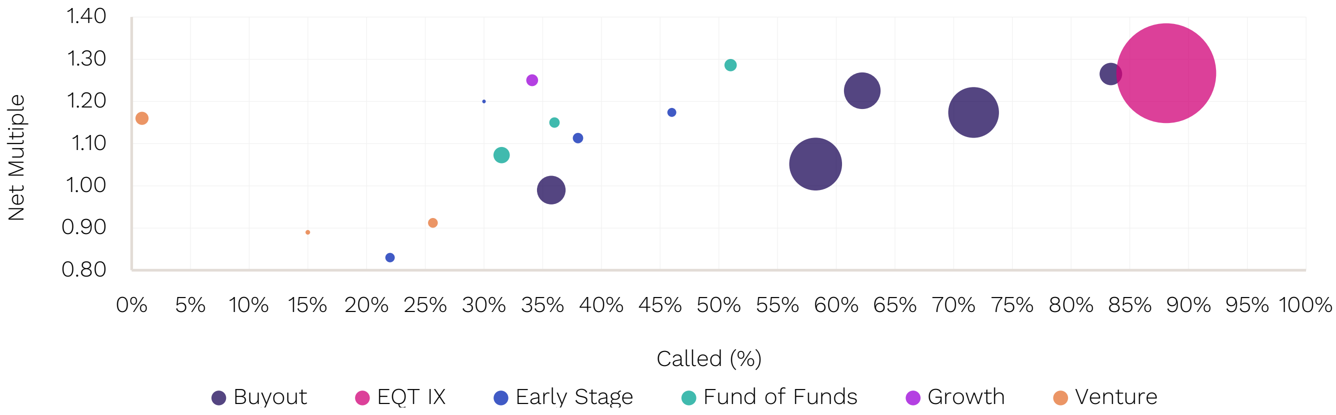
Performance drivers for SDG funds

Looking at a recent vintage of SDG funds can help understand the drivers of performance and deployment in this still nascent market. ESG-labeled (including SDG, climate, impact, Sharia law, Sustainable Finance Disclosure Regulation (SFDR) Article 8, ESG integration) private equity and venture capital (VC) funds of 2020 vintage are presented. Most of these funds are diversified or list 'diversified' as the core industry. The main industries of these funds are IT, software, and healthcare. Net multiples were chosen rather than net internal rate of return (IRR) due to the limited time these funds have been operating. More than three quarters (76%) of the funds reported net multiples greater than one, with a clear positive correlation between deployment and performance. The considerable spread over the percentage of capital called is driven by the relative immaturity of these funds – 11 of the 17 funds have called less than 50% of their committed capital (Fig. 4.4). Investors keen to see their allocation in pursuit of social and environmental outcomes should consider the risk that commitment to smaller funds may not be drawn as quickly.

29 https://www.ft.com/content/26de745d-9b98-4ca3-98c6-cb54db2bc095

Fig. 4.4: Larger ESG and impact funds deploy quicker

Impact and ESG 2020 vintage funds mulitples and capital called (%) by strategy and final close value*



Source: Preqin Pro

*Circle size represents final close value of the fund

The impact of technology and software exposure

ESG integration funds often have exposure to technology and software industries and verticals due to their alignment with SDG 9 – Build resilient infrastructure, promote sustainable industrialization, and foster innovation. While on the surface these sectors may appear less exposed to ESG risks considering scope 1 & 2 emissions, they may be more exposed to other material ESG risks such as diversity, equity, and inclusion (DEI), manufacturing labor, materials sourcing, supply chain, and scope 3 emissions risks[30]. One of the funds included here, EQT IX[31] (pink circle), is an SDG and SFDR Article 8 buyout fund with exposure to Europe and the US. It is diversified with exposures to healthcare, industrials, IT, media, and telecoms. In this sample it is by far the largest fund, closing at $15.6bn, and reports the highest net multiple (1.27) as well as the highest call percentage (88%). The experience of the manager in ESG is strongly linked with their ability to raise such a large fund, as well as supporting quicker deployment and achieving high performance. The fund's largest tracked investment was Recipharm AB for SEK 17.9bn, a public-to-private deal in December 2020.

Thematic funds targets underpin credibility

Thematic funds allow investors to align their portfolios with specific social and environmental ambitions. This is a growing alternative to generic ESG integration funds, which can lack focus and pose greater risk of greenwashing. ESG integration or broader sustainability strategies tend to have exposure to a variety of companies without clear criteria linking them to sustainability. There are no set criteria for ESG integration funds and so they can range from 'dark green' (strictly aligned to the aims of the Paris Agreement) to index tracking funds with exposure to oil and gas.[32]

With more defined and transparent strategies, these funds invest in companies operating in relevant industries. Initiatives and policies such as the Paris Agreement and TNFD will continue to underpin new products, giving both committed ESG investors and ESG skeptics options, and demonstrating tangible results to combat accusations of greenwashing. The Securities and Exchange Commission (SEC) Rule Proposal on climate is set to launch this fall, supporting the move to a climate neutral economy.

30 https://www.forbes.com/sites/forbestechcouncil/2022/08/04/how-the-tech-industry-can-shape-esg-20/?sh=35c6c1405af9

31 https://pro.preqin.com/funds/102554

32 https://www.ft.com/content/79772342-d260-4dd5-b943-5e75bc27878c

DREAM.
LIVE.
PROSPER.

DOUBLE-DIGIT RETURNS WITH NO LOSSES AND ABOVE-TARGET PERFORMANCE THAT'S DLP CAPITAL.

DLP Capital offers investors strong and consistent returns on their investment. Our funds have delivered double-digit returns year after year, with above-target performance, demonstrating our commitment to excellence as your trusted investment partner.

We take pride in our fund performance and track record, delivering these high returns without having a loss in our funds since inception. Our expertise allows us to make informed investment decisions to preserve investor capital while maximizing returns.

So why wait? Join us and experience the benefits of investing with a trusted partner who continuously delivers double-digit returns, provides unrivaled investment guidance, and most importantly, never compromises on quality.

Visit our website today to learn more about our proven investment strategies and how we can help you meet your financial goals.

dlpcapital.com/investnow | 800.350.8061

THE DLP CAPITAL DIFFERENCE

All of our funds have hit above-market returns since inception:

12.79%
DLP Lending Fund
**Inception to date as of 3/31/23*

11.49%
DLP Income & Growth Fund
**Inception to date as of 3/31/23*

10.31%
DLP Preferred Credit Fund
**Inception to date as of 3/31/23*

12.81%
DLP Building Communities Fund
**Inception to date as of 12/31/22*

27.76%
DLP Housing Fund
**Inception to date as of 3/31/23*

12.28%
DLP Fixed Fund
**Inception to date as of 3/31/23*

5-~~7.5~~ 9%
DLP Positive Note Fund

Disclaimer: Investing involves risk. Past performance is not a guarantee of future return, nor is it necessarily indicative of future performance. You should not make any investment unless you fully understand all risks associated with the same and have independently determined that such an investment is appropriate for you.

A new way to look at ESG risks

By Rachel Dabora

Analyzing industry exposure can help investors understand potential ESG risks

ESG risk estimates and ratings often rely on voluntary disclosures of carbon emissions, policies and procedures, and sustainability strategies and targets. However, transparency at scale remains a challenge in private markets. Investors looking for ESG-aligned deployment cannot rely on disclosures alone. ESG funds in public markets are increasingly scrutinized as regulators work to stop greenwashing in financial services,[33] and investors should consider further requirements for ESG products in private markets.

Funds aiming to meet growing demand for ESG-aligned assets will be required to understand which industry specific risks are being interrogated by regulatory bodies. The Sustainability Accounting Standards Board (SASB) has developed a framework over the past decade to identify and classify sustainability information material to a company's industry of operation. This is a good starting point for assessing the potential risks of different investments. Preqin uses these SASB pillars and factors as a base for classifying industry risks in private markets.[34]

Diversified funds make ESG risk analysis by industry challenging

Breaking down ESG funds by industry exposures can shed light on the risks on which managers should focus. Across all regions, diversified funds – that operate in more than one industry – tend to dominate (Fig. 5.1), but there are also a lot of ESG funds focused on utilities, raw materials, natural resources, and real estate. In North America and Europe, which have the most private market ESG funds, energy & utilities are the primary industry for 14% and 19% of ESG funds, respectively (Fig. 5.2). Conversely, IT is the primary industry of 13% of North America-based ESG funds compared with 8% for Europe-based funds. These findings provide a starting point for comparison on how the most relevant industry risks differ between regions. However, the diversified industrial exposure of funds creates a challenge in evaluating fund-level industry risks.

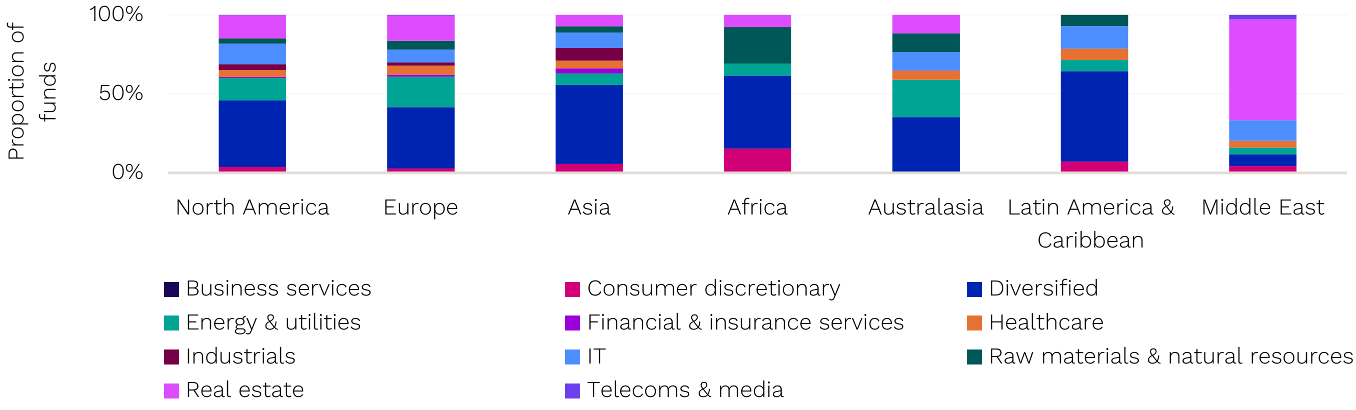
US renewables vs. French software

Comparing a renewable energy firm in the US and a software company in France highlights the difference in assessing relevant risk factors. For renewable energy in the US the highest risk exposure, according to SASB, is in 'product design & lifecycle management' at 10 (Fig. 5.3), energy management (8.5), and employee health & safety (8.1), whereas for software firms in France the highest exposures are in competitive behavior (10, Fig. 5.4), data security (10), and employee engagement, diversity & inclusion (10).

33 https://www.ft.com/content/79772342-d260-4dd5-b943-5e75bc27878c
34 https://docs.preqin.com/pro/Preqin-ESG-Solutions-Methodology.pdf

Fig. 5.1: ESG funds tend to be diversified by industry

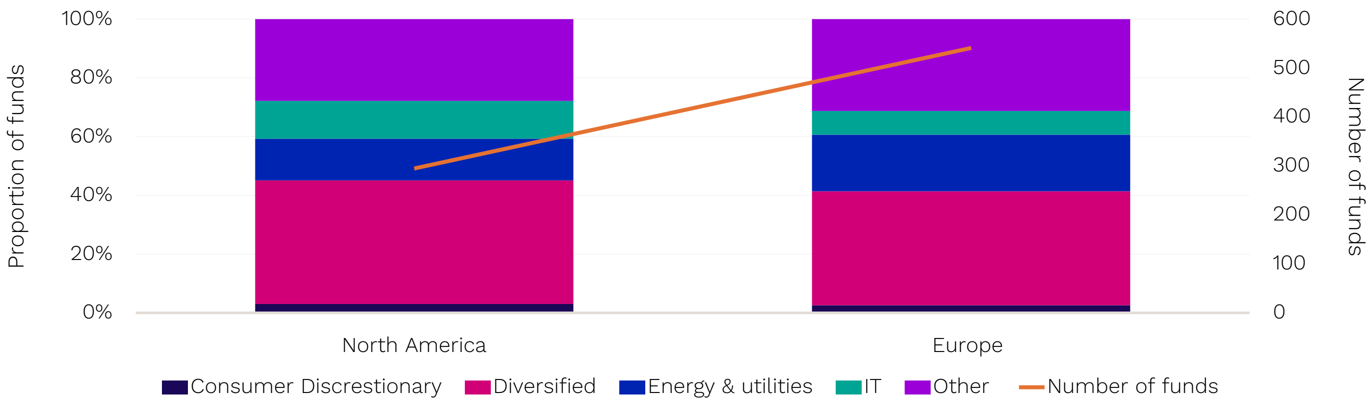
Proportion of ESG funds raised by region and primary industry, vintages 2013–2023



Source: Preqin Pro. Data as of May 2023

Fig. 5.2: ESG funds tend to focus on energy and tech

North America- and Europe-based ESG funds by primary industry



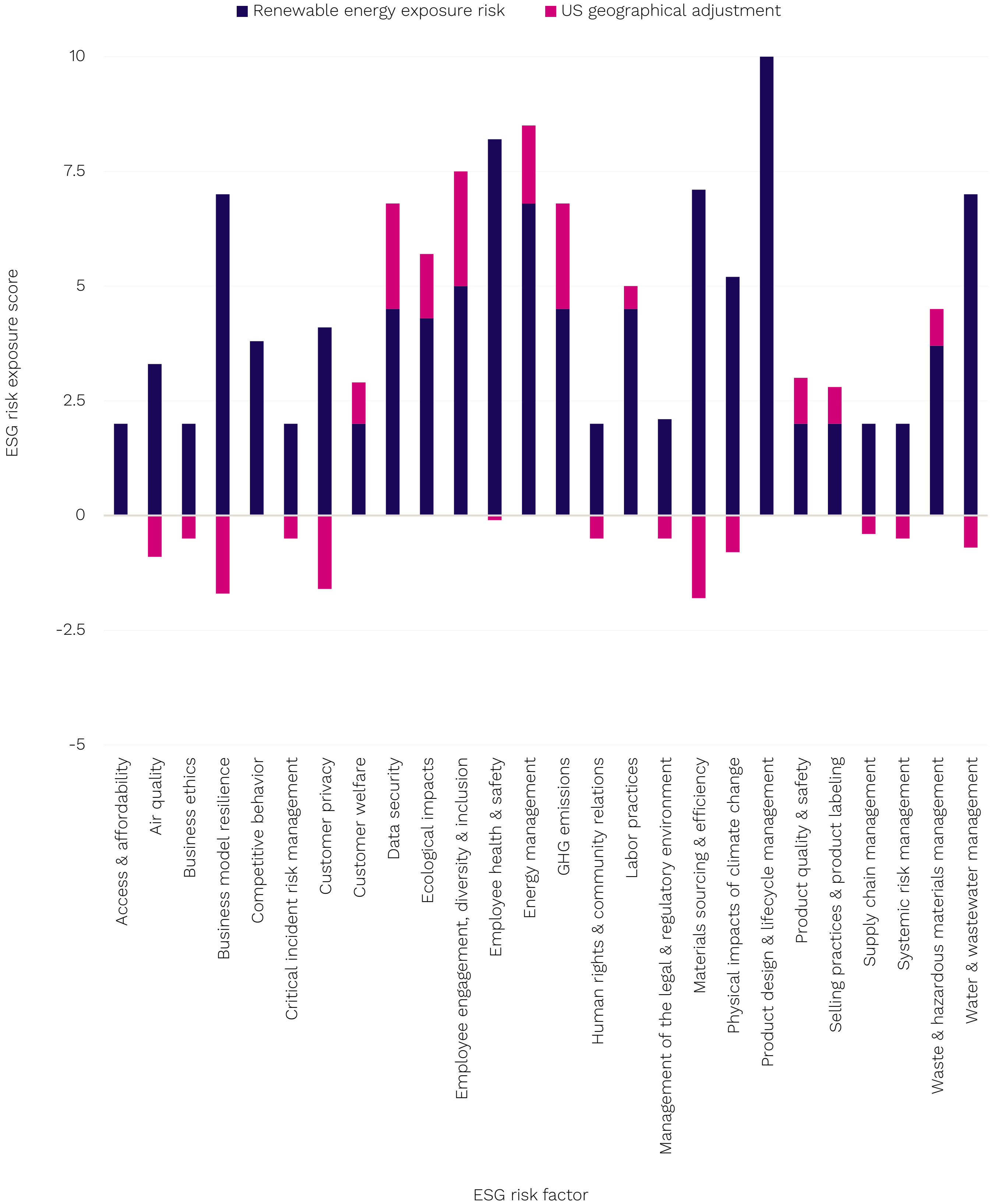
Source: Preqin. Data as of May 2023

As product design & lifestyle management poses the largest risk, it should be prioritized as part of whole-life-cost asset management for efficient operations, while decommissioning needs to be considered. An example of this is solar energy companies that rely on the production and deployment of photovoltaic panels with a lifespan of 25 to 30 years. These require proper disposal to minimize environmental impacts at the end of their useful life. The concern of proper disposal increases in countries that have poor waste management systems and will be reflected in the country modifier if the country has a below or above average waste management system.

Data security, on the other hand, includes issues related to exposure to cyber threats, and regulatory risks regarding data protection. Software companies therefore require strong data security and privacy measures, adequate employee training, and robust incident response plans to help mitigate operational risk. The country modifier, in the case of data security, is higher for countries with a greater percentage of the population with internet access and mobile banking. Assessing relevant ESG exposure risks for diversified funds is more difficult. However, looking at operational funds and their deals in each industry can provide insight. For example, Citi Impact Fund's venture capital (VC) deals broken

Fig. 5.3: Renewables are most exposed to design & lifecycle management

ESG risk exposure in US renewable energy investments

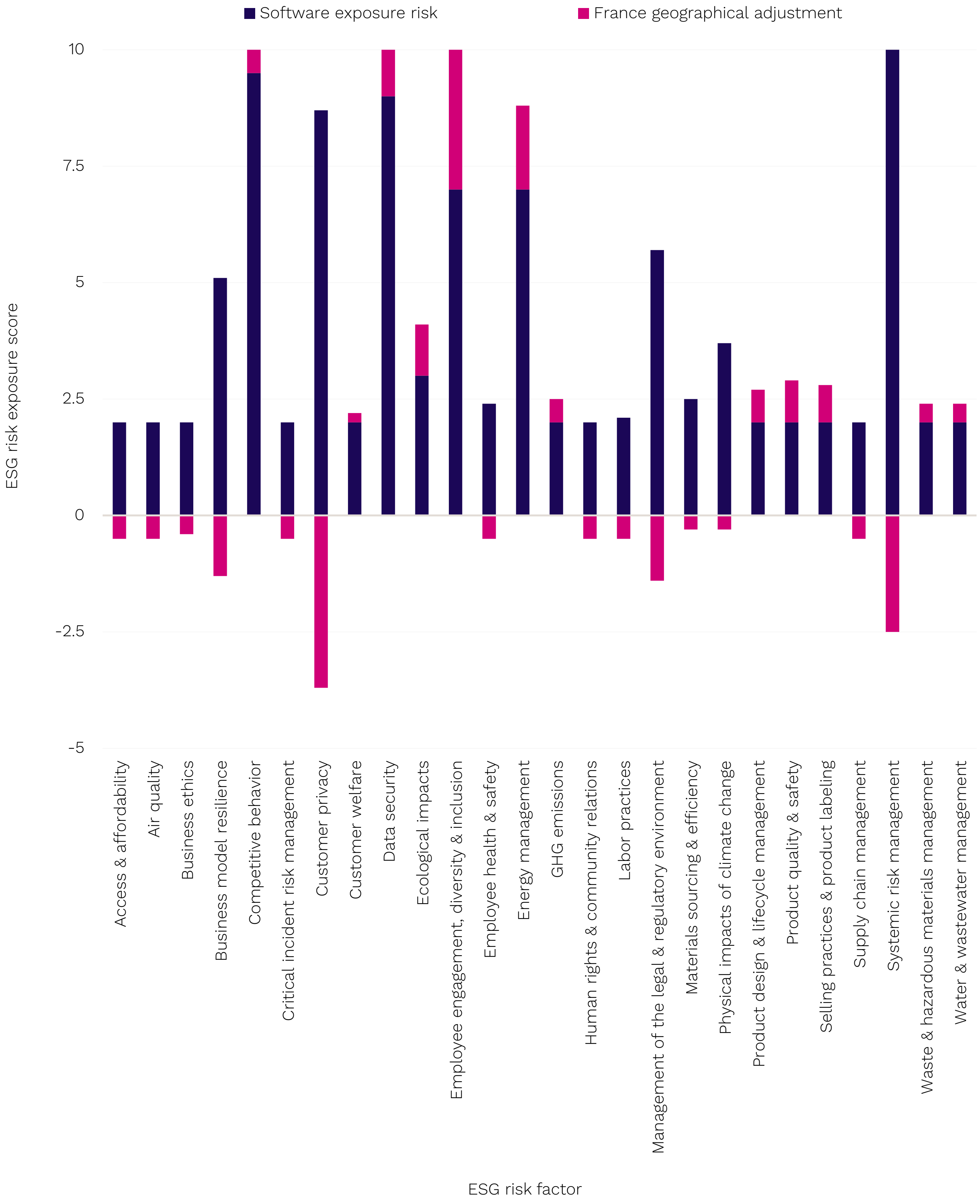


Source: Preqin Pro. Data as of May 2023

PREQIN

Fig. 5.4: French software has more high risk exposures

ESG risk exposure in French software investments



Source: Preqin Pro. Data as of May 2023

down by industry align with general 'ESG fund' label industry trends.[35] Software deals account for 46% of the funds total (Fig. 5.5). The potential ESG risks, for these deals, fall in line with the software risks above in France, although each deal's market would have to be evaluated separately. That said, the industry risk bases, without the country modifiers, have high exposures in competitive behavior, customer privacy, and systematic risk management, acting as a base for further evaluation.

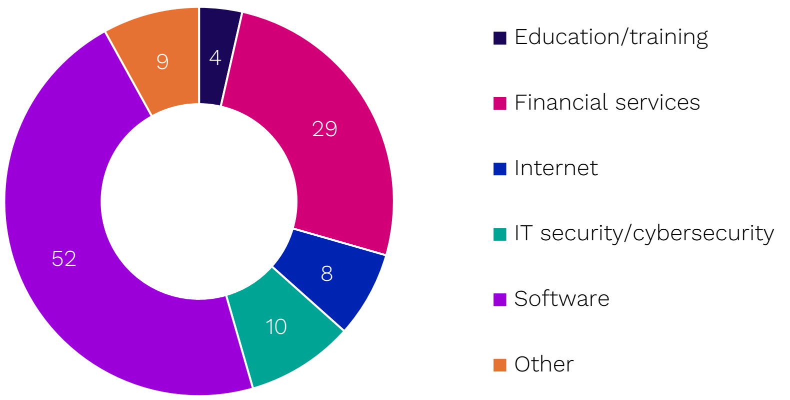
The long-term evolution of ESG risk

The significance of ESG risk exposure continues to increase in line with greater attention being paid to company's claimed ESG outcomes. As scrutiny of ESG integration in private markets continues, the identified risks form a framework around which managers can assess their portfolio companies' oversight of key risks and focus efforts on improving asset performance. Many such risks may be long-standing management issues and pre-date the emergence of ESG. As such, managers and investors alike should not see ESG integration as a new set of requirements, but embrace it as a contemporary lens through which to optimize management and business value.

35 https://pro.preqin.com/funds/108400

Fig. 5.5: Software is a popular industry among ESG diversfied funds

Citi Impact Fund's industries by number of deals



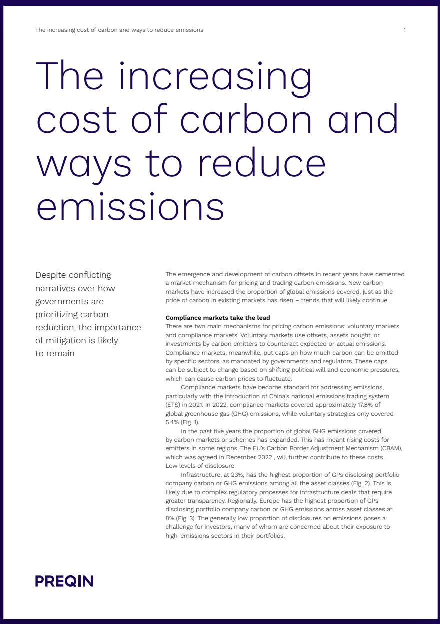
Source: Preqin Pro. Data as of May 2023

Empowering the global alternatives **community** with essential **data** and **insights**.

preqin.com

info@preqin.com

Related content



The increasing cost of carbon and ways to reduce emissions   1

The increasing cost of carbon and ways to reduce emissions

Despite conflicting narratives over how governments are prioritizing carbon reduction, the importance of mitigation is likely to remain

The emergence and development of carbon offsets in recent years have cemented a market mechanism for pricing and trading carbon emissions. New carbon markets have increased the proportion of global emissions covered, just as the price of carbon in existing markets has risen – trends that will likely continue.

Compliance markets take the lead

There are two main mechanisms for pricing carbon emissions: voluntary markets and compliance markets. Voluntary markets use offsets, assets bought, or investments by carbon emitters to counteract expected or actual emissions. Compliance markets, meanwhile, put caps on how much carbon can be emitted by specific sectors, as mandated by governments and regulators. These caps can be subject to change based on shifting political will and economic pressures, which can cause carbon prices to fluctuate.

Compliance markets have become standard for addressing emissions, particularly with the introduction of China's national emissions trading system (ETS) in 2021. In 2022, compliance markets covered approximately 17.8% of global greenhouse gas (GHG) emissions, while voluntary strategies only covered 5.4% (Fig. 1).

In the past five years the proportion of global GHG emissions covered by carbon markets or schemes has expanded. This has meant rising costs for emitters in some regions. The EU's Carbon Border Adjustment Mechanism (CBAM), which was agreed in December 2022 , will further contribute to these costs.

Low levels of disclosure

Infrastructure, at 23%, has the highest proportion of GPs disclosing portfolio company carbon or GHG emissions among all the asset classes (Fig. 2). This is likely due to complex regulatory processes for infrastructure deals that require greater transparency. Regionally, Europe has the highest proportion of GPs disclosing portfolio company carbon or GHG emissions across asset classes at 8% (Fig. 3). The generally low proportion of disclosures on emissions poses a challenge for investors, many of whom are concerned about their exposure to high-emissions sectors in their portfolios.

PREQIN

Q1 ESG research note market update

Read now

The increasing cost of carbon and ways to reduce emissions

Read now

Impact Report 2022

Read now

PREQIN