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Navigating challenges, seizing opportunities

Building ESG into private market portfolios

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Highlights

- Despite a palpable shift in attitudes about environmental, social and governance (ESG) investing, particularly in the United States, there is evidence that capital inflows are rising in certain sustainable investing categories, including private assets.
- Changing preferences, materiality, and opportunities - reinforced by regulation - propelled ESG growth in public markets and are increasingly incentivising similar dynamics in private markets. As a result, investor interest in applying ESG to the private sphere is rapidly rising.
- In establishing a framework for ESG investing in private markets, having a robust foundation in fundamental analysis expertise in public markets can help inform best practices and decision-making. At Fidelity, we combine our bottom-up research capabilities to apply an ESG lens across the investment cycle - sourcing, ownership, and exit.
- However, significant differences exist between ESG investing in private versus public markets. These arise from factors such as the time horizon of investments, information availability, ownership structure and channels of influence.
- ESG data in private markets are generally less consistent if they are available at all, making sustainability-aligned investments more challenging than in public markets. However, asset owners potentially have more time, control, and influence to enact change.
- We are putting this approach into practice through direct lending, collateralised loan obligations (CLOs) and direct real estate strategies, demonstrating how ESG investing in private assets has the potential to mitigate risk and add long-term value.

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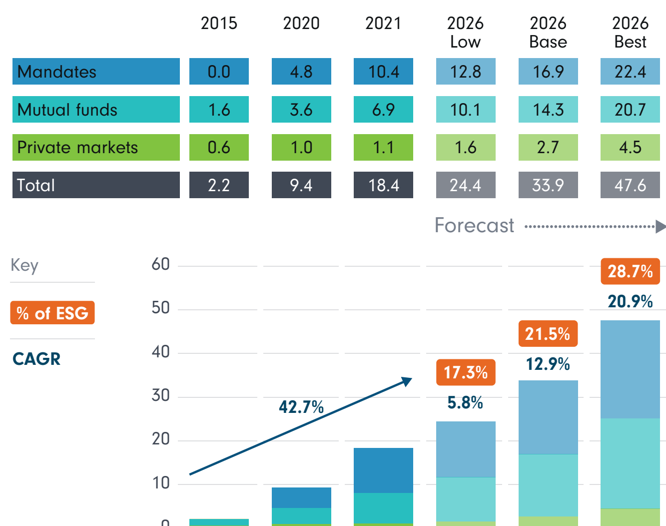
ESG: From 'nice to have' to 'must have' in private assets

Environmental, social and governance (ESG) trends present investors with one of the most meaningful sets of challenges and opportunities across the world today. According to PwC, in the base case scenario, sustainably managed assets are estimated to reach about US$34 trillion by 2026. Between 2015 and 2021, the compound annual growth rate was 42.7% (see Figure 1). Among investors, some - including insurers and reinsurers - are likely ahead of others in integrating ESG in private assets. Reinforced by regulation, the reasons for this remarkable shift are threefold:

1. **Changing preferences**. Consumer, investor, and societal attitudes are creating demand to incorporate a stronger focus on sustainability in capital allocation, influencing investment decisions at every level. This trend accelerated during the COVID-19 Crisis, highlighting the relationship between business resilience and sustainable business practices. There is increasing recognition that investors should consider ESG beyond the confines of individual portfolios towards a more outcomes-oriented view to drive real-world results, such as how asset allocation decisions align with the Paris Agreement.
2. **Changing materiality**. The magnitude and likelihood that sustainability issues affect financial performance have become more apparent, increasing data transparency and new technology that enables analysis at a more granular level. Furthermore, the ramifications of ESG issues such as climate change are becoming more salient, changing how asset owners integrate sustainability. Previously, the emphasis may have been on how ESG factors affect a particular company. While this remains relevant, a second dimension is being considered, looking at the business's environmental and social impact on society. We explore how ESG materiality is developing in the next section.

There is increasing recognition that investors should consider ESG beyond the confines of individual portfolios towards a more outcomes-oriented view to drive real-world results.

Figure 1: Global ESG assets under management (US$trillion)



	2015	2020	2021	2026 Low	2026 Base	2026 Best
Mandates	0.0	4.8	10.4	12.8	16.9	22.4
Mutual funds	1.6	3.6	6.9	10.1	14.3	20.7
Private markets	0.6	1.0	1.1	1.6	2.7	4.5
Total	2.2	9.4	18.4	24.4	33.9	47.6

Source: PwC, 2022. Data are based on analysis by the PwC Global ESG and AWM Market Centre, which conducted surveys involving about 250 asset manager respondents with global AUM of US$50 trillion and about 250 institutional investor respondents with global AUM of US$60 trillion. The analysis also includes data from Lipper, Preqin, and ESG Global. Figures include retrofitted funds.

3. **Changing opportunities**. Evolving preferences and the materiality of sustainability issues have helped foster the rapid development of ESG solutions, creating potentially attractive opportunities for investors. The decarbonisation transition, for example, has supported various pockets of the global economy, most notably the electric vehicle (EV) sector. This also applies to the commercial fleet as well as passenger vehicles. PwC estimated that by 2040, all new light and commercial vehicles sold in the EU will be zero-emission vehicles.[1] Additionally, raw materials to build vehicles and the charging infrastructure will be needed, along with cleaner fuels, especially in shipping and aviation. Transport decarbonisation has been a key pillar for government initiatives, including the US's Inflation Reduction Act, and will likely present investment opportunities for investors for years to come.

While rapid growth in sustainable investing has been concentrated in specific geographies and public markets, mainly listed equities, the drivers of change are spilling into private markets (see Figure 1). What was once a 'nice to have' component is now often considered a 'must have' in private asset solutions. More investors are demanding a more progressive, aspirational methodology to support sustainability investing strategies. While governance remains a critical element, environmental and increasingly social factors are coming to the fore.

The acceleration of ESG adoption in private assets is likely to meaningfully change risk-return characteristics, which may resemble the evolution in public markets but with significant differences. In this paper, we consider why ESG is playing a more central role in private assets, what public markets can teach us about private markets and set out a framework to help investors be stewards of change in private markets. Lastly, we also consider how to apply ESG to private asset solutions, including direct lending, collateralised loan obligations (CLOs), and real estate.

Materiality materialising

Evidence that ESG has a material impact on an issuer's risk-adjusted return is strengthening, with ESG return drivers transmitted through three key channels[2]:

- Cash flow (higher rated ESG companies may benefit from efficient use of resources, robust human capital development and innovation to support earnings growth).
- Systematic risk (companies with higher ESG profiles tend to have lower cost of capital, which can translate to higher relative valuations).
- Idiosyncratic risk (companies with stronger risk management practices and regulatory preparedness may have more downside protection).

However, it is important to note that the materiality of individual ESG issues is often dynamic and can change over time. This can be driven by ESG factors interacting with traditional return drivers or the risk associated with an issue shifting in response to varying external conditions. Russia's invasion of Ukraine, for example, could mark a recalibration of sovereign ESG risk.

Furthermore, the degree to which sustainability factors are material differs by sector. Beverage manufacturers, for example, may be far more affected by water efficiency than financial institutions. ESG-related materiality is also more complex relative to traditional financial factors. For example, some investors on a portfolio decarbonisation pathway also recognise that reducing climate risks may come at a price, whether it be climate-related regulatory costs, potential job losses, or lower energy security. The latter was particularly relevant in the aftermath of the war in Ukraine.

These trade-offs need to be carefully considered under the concept of 'double materiality', in which materiality is examined not only from an internal, corporate, or sovereign perspective but also externally to consider the impact on the environment, the community and broader society. As a result of increasing recognition of this double materiality concept in ESG, combined with rapid growth in capital flows towards sustainable assets, regulators are rapidly introducing a raft of policies, reporting guidelines and data frameworks. The purpose is to facilitate transparency and avoid misrepresentation of sustainability characteristics. Increasingly, private issuers are being scrutinised along with their publicly-listed counterparts for their ESG standards within these regulatory frameworks.

New regulations such as the EU Taxonomy, the EU's Corporate Sustainability Reporting Directive (CSRD) and Sustainable Finance Reporting Directive (SFDR) will act as catalysts for increased data and transparency in both public and private markets. More recently, the International Financial Reporting Standards (IFRS) Foundation introduced the International Sustainability Standards Board (ISSB) initiative, which targets a more consistent, high-quality ESG reporting framework.

Institutional investors under fiduciary, regulatory and client pressure to consider ESG in investment decisions are also demanding more relevant disclosures. The resulting higher transparency in ESG data should facilitate a more structured, quantitative analysis of sustainability issues and broader integration into investment decisions.

Differences between public and private market ESG implementation

ESG investing should be applied across public and private markets, though it is also vital to consider some crucial differences. First is the information environment. Private companies typically face fewer obligations to disclose information publicly, so direct engagement is often a critical source of data gathering. However, as previously noted, larger private companies increasingly are legally obligated to follow best practices set in public markets.

Second, investments in private assets may involve larger ownership stakes or effective control, which is less common for investors in public markets. Therefore, investors in private assets may have more potential to influence change. For an investor consortium with a direct stake in an office building, for example, the ability to demand ESG improvements will likely be far more consequential compared to an investor with a small minority stake in a listed real estate investment trust.

Third, private market investors are presented with a different set of risk-return characteristics, including more extended holding periods, additional liquidity constraints, and more complex exit strategies. Arguably, this makes ESG considerations even more relevant in the origination stage because ESG issues are typically more likely to impact business performance or valuations over longer time horizons. ESG considerations also can be significant during the exit process. There is a strong incentive to work with management and other stakeholders to demonstrate and report ESG characteristics and improvements at the end of the investment cycle. (See Figure 2)

What private markets can learn from public markets

Despite the differences, there are lessons from public markets that can be applied to private markets. A clear governance structure - grounded in qualitative and quantitative research backing ESG investment solutions and a consistent, active engagement strategy - has long supported our sustainability platform in public markets (see Figure 3). In this section, we demonstrate how this approach can advance sustainability processes in private markets.

A significant barrier preventing the application of public market ESG methodology to private markets is the availability of material data. While the reliability of ESG disclosures is improving in public markets, it is still in the early stages in the private sphere. Therefore, applying comparative analysis using available data from public companies can help enhance investment decisions in private assets. For example, Fidelity's proprietary sustainability ratings or MSCI ESG ratings can offer valuable information on how private companies are performing on the same or similar material ESG issues relative to their public counterparts.

First, by using both public and private market data, we can gain informational advantages relative to relying solely on private market data. Second, insights, knowledge, expertise and best practices in public markets can be applied to help private companies develop their ESG trajectory.

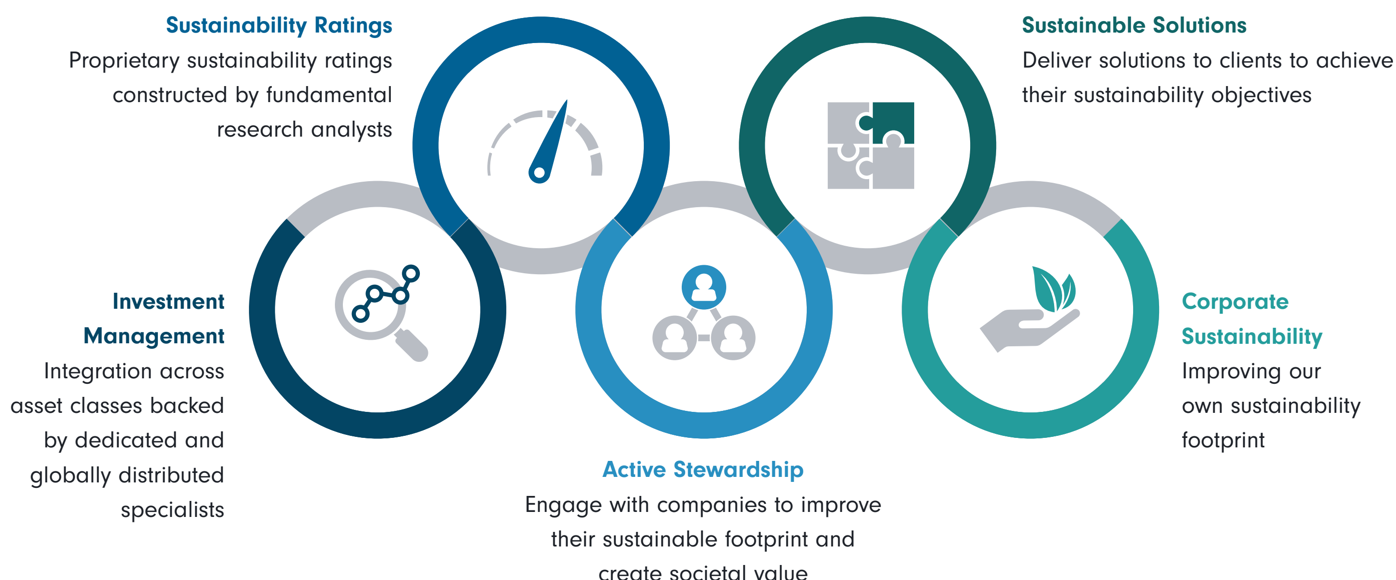
Whether a public or private transaction, investment decisions follow a similar methodology involving a combination of external and proprietary ESG ratings, on-the-ground research, and fundamental analysis. In this regard, ESG contributes rather than leads the conversation on risk and pricing.

Figure 2: Fidelity's view of ESG in public markets vs. private markets

	In practice – public markets	In practice – private markets
Sourcing	Forward-looking, materiality-driven analysis supported by proprietary ESG ratings and company meetings.	Limited publicly available ESG data. Longer investment horizon requires more rigorous ESG due diligence.
Ownership	Voting and engagement are the primary channels to improve ESG standards and trajectory.	Direct ownership and a larger stake can increase the potential to drive positive changes.
Exit	ESG improvements can result in potential for higher valuation. Holdings are typically very liquid.	ESG improvements may result in higher valuation and appeal to a wider buyer base. Responsible exit strategies and lower liquidity add complexity.

Source: Fidelity International, March 2024.

Figure 3: Five pillars of ESG



Source: Fidelity International, March 2024.

One example of how public markets expertise can help inform investment decisions in private assets involves an investment in a senior-secured, direct lending transaction to a dental services group in the Netherlands. In this instance, materiality characteristics deciphered from public healthcare companies with similar attributes can be applied to private issuers in the same sector to conduct due diligence, negotiate agreements, engage, and monitor progress.

There are also some advantages relative to public markets. For example, private credit transactions allow for more potential to customise when setting the terms of the loan, including ESG priorities. Introducing features such as a two-way margin ratchet helps align goals. These pricing ratchets reward the borrower through a pricing discount if they meet key performance indicators (KPIs), such as increasing the use of electric vehicles in operational activities and reducing the use of electricity generated from fossil fuels. In contrast, failing to reach KPIs would result in a higher cost of borrowing.

Engagement is key, and a as a sole private lender, influence can be enhanced through a higher level of control and access to management teams. For example, a rigorous engagement strategy can help bridge the lack of data transparency among private borrowers, allowing lenders to set and monitor progress at a more granular level. This is aligned with the same goals. From an owner's perspective, improving ESG standards can potentially deliver higher valuation and a larger pool of potential buyers upon exit. In our view ESG management is both a risk mitigation and value enhancement tool.

Applying ESG to loans and CLOs

Another attractive opportunity in private markets is leveraged loans and, more specifically, collateralised loan obligations (CLOs). The structure of CLOs typically offers higher potential for returns, diversification, and inflation protection due to an embedded floating rate component. However, manager expertise is also more relevant relative to public market equivalents due to the higher complexity, illiquidity, and other idiosyncratic risks, such as the potential for collateral deterioration.

CLOs also are appealing from an ESG perspective. Compared to US and public market counterparts,

European CLOs traditionally have relatively lower ESG risk, with negligible exposure to oil and gas, weaponry, and tobacco. For this reason, the adoption of values-based exclusion criteria is manageable within existing CLO investment frameworks.

However, as private markets take a page from public markets, investors increasingly opt for an outcomes-based approach, applying a consistent ESG methodology across public and private assets to help gauge progress towards their sustainability goals. There are several steps in which Fidelity applies a consistent process of assessing borrowers - whether public or private - through an ESG lens as follows:

- **Determine eligibility**. A sustainable investing framework guides the qualitative and quantitative standards required for an investment to be considered sustainable. In general, the aim is to build a portfolio in which

the majority of assets are as good or better than the weighted average ESG score of the investment universe, considering forward-looking 'E', 'S' and 'G' risks and incorporating these factors into their operations, decision-making and risk mitigation approach. For all borrowers, but particularly those who do not yet meet our sustainability framework standards, engaging with management teams and sponsors to integrate ESG thinking can help improve performance potential in the long term.

- **Select or exclude debt securities**. Our exclusion criteria remain a crucial part of ESG investing. For example, we apply an exclusion policy to issuers with material exposure to products or activities that are inherently harmful (tobacco), carry significant negative externalities (oil sands and coal mining), or breach international norms such as the UN Global Compact.
- **Integrate ESG as part of the investment process**. ESG integration in private markets differs from that in public markets. Nevertheless, we can learn from our methodology underpinning SFDR Article 8 requirements and Sustainable Family range of funds to help frame our approach for loan and CLO strategies. We follow the same Article 8 approach to managing loan and CLO strategies, which involve strict criteria and exclusion requirements, embedding ESG into the investment process and assessing every borrower's ESG trajectory.
- **CLO portfolio reporting**. Basing the reporting methodology on the SFDR Article 8 framework can help increase visibility regarding ESG characteristics, even if the strategy itself is not labelled as such. For example, independent verification can add credibility. Reporting should be transparent enough so that investors can track the sustainability progression and allow them to compare it with other parts of their investment portfolios.

Real estate: The path to net zero

Within ESG, climate change is perhaps the most urgent challenge facing the financial system, and this is particularly relevant for real estate investors. Building operational and construction emissions account for 38% of the world's energy-related emissions,[3] making it crucial for investors to address decarbonisation in their real estate portfolios.

Assets with higher ESG ratings may add return potential and portfolio resilience. According to research by global property services provider JLL using sector BREEAM ratings or EPC certificates,[4] greener buildings commanded higher rental rates, stronger capital valuations, and lower vacancy. Fidelity's proprietary research confirmed that sustainably renovated commercial properties have some critical performance advantages over non-sustainable property renovations.

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A clear decarbonisation plan is critical for asset owners, though the path taken to reach net zero is just as important. Applying a hierarchy to decarbonise offers a structure to help investors deliver real-world impact. Based on best practices established in the Net Zero Carbon Pathway Framework by the Better Buildings Partnership, Fidelity's real estate GHG hierarchy (see Figure 4) begins by influencing business decisions to eliminate GHG emissions across the building lifecycle.

Renovating rather than rebuilding an office building would cut the carbon footprint of delivering modern workspaces. For instance, an extensive refurbishment focused on modernisation and decarbonisation at our commercial property in Issy-les-Moulineaux, a suburb of Paris, led to a 60% reduction in energy consumption.

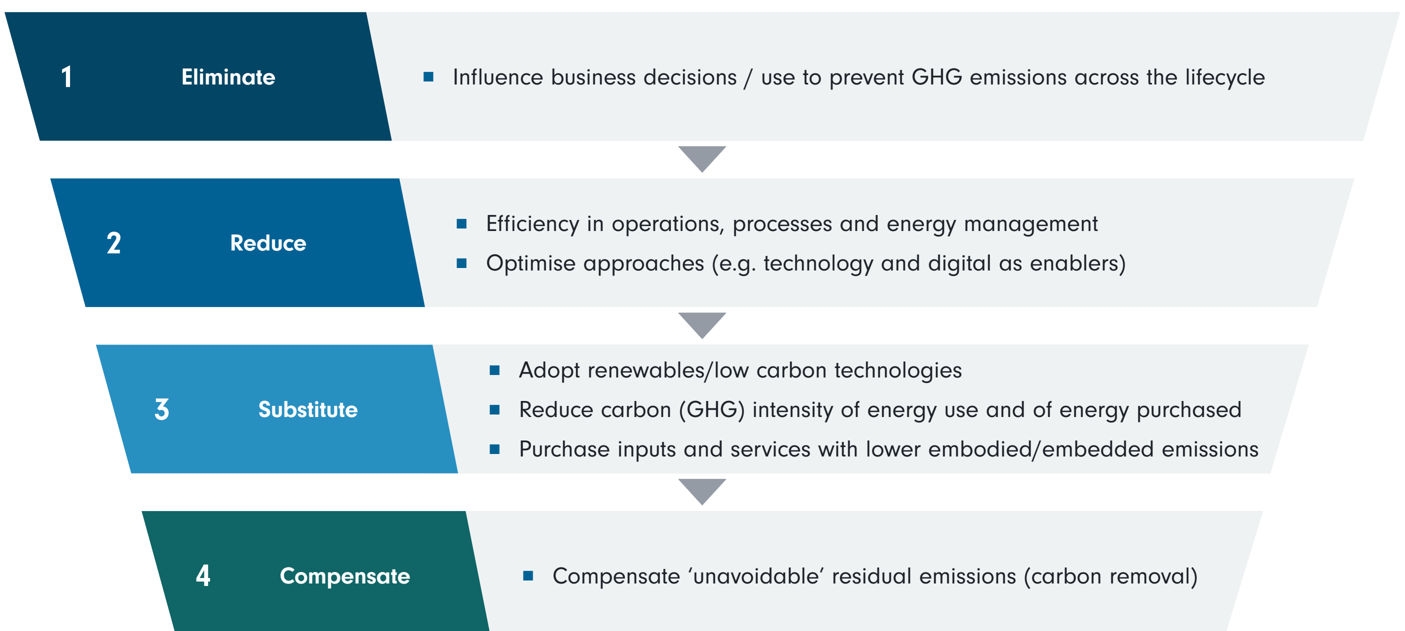
Reducing existing emissions by improving operational efficiency, such as lowering energy usage, can have a long-term impact on a property's carbon footprint. Technology has an important role in this step, including efficiency improvements and intelligent building management systems that save energy and cost. In the Paris renovation, this was accomplished by a series of upgrades, including the following:

- Substituting the use of natural gas with a lower carbon energy,
- Installing more efficient appliances, including heating and cooling systems,
- Introducing intelligent electricity and building management systems to monitor and reduce carbon emissions while maintaining or improving comfort levels.

Another important consideration is the embodied carbon, generally defined as the emissions during the construction or renovation phases, including the production, transportation, and installation of materials (In comparison, the operational carbon footprint is the total emissions when the building is in use). Again, in the case of our Paris renovation, the embodied carbon was estimated to be about 55% less than its benchmark for embodied carbon for Western European office building refurbishments. To reduce emissions during this phase, we reused the building's flooring, simplified the design to optimise the materials procurement strategy, and recycled more than 90% of the construction waste.

Lastly, the aim should be to substitute energy sources with those which have a smaller carbon footprint. For example, adopting on-site renewable energy generation or procuring 'green energy' will reduce the environmental impact of the consumption that is needed. That is why

Figure 4: Greenhouse Gas hierarchy in real estate



Source: Fidelity International, March 2024.

tenant engagement is key to decarbonise commercial real estate. Some measures to collaborate with tenants include lease negotiations with green clauses, renewable energy procurement, and data gathering and monitoring.

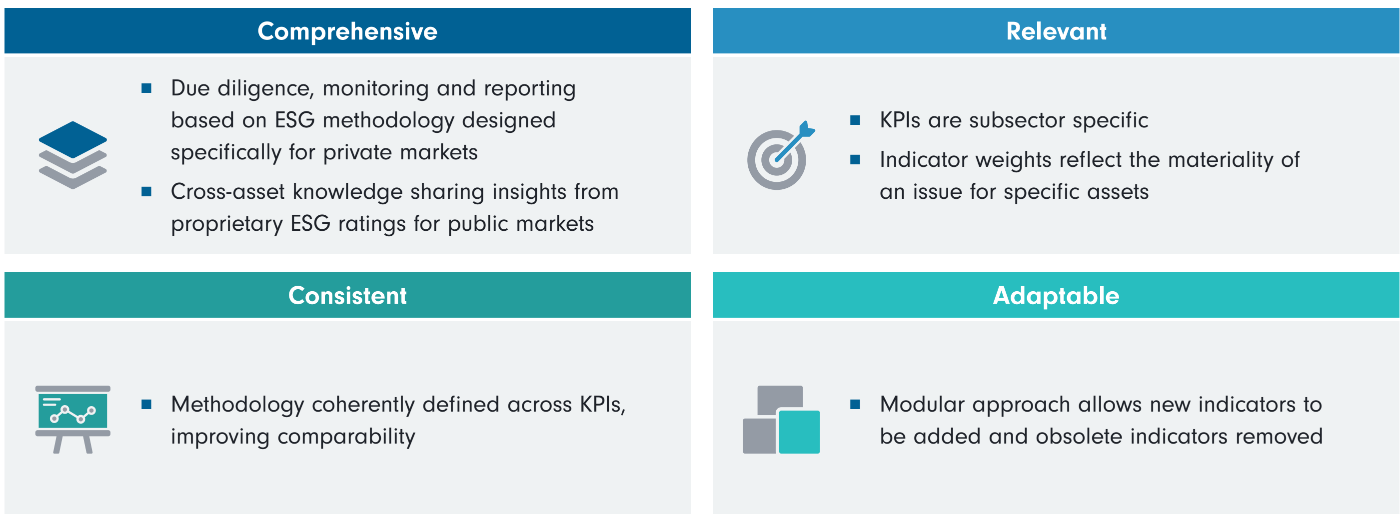
However, some unavoidable emissions will remain after the previous methods have been exhausted. The residual, unavoidable emissions should be removed via nature-based carbon removal strategies that can be independently verified.

Fidelity's proprietary ESG ratings

As the COVID-19 Crisis has demonstrated, ESG materiality is constantly evolving; just because a risk factor has not posed a material threat in the past does not mean it will not impact financial results in the future. Our sustainability ratings framework addresses this by capturing a forward-looking assessment of an issuer's management of crucial sustainability risks. The ratings enable comparability across sectors and geographies, as well as public and private markets (See Figure 5) with more than 4,000 companies covered.

This rating approach is designed to review and update specific indicators to reflect their materiality. As climate change has become more urgent within ESG, a separate set of proprietary Climate Ratings helps assess the ambition and alignment of portfolio companies to a net-zero future.

Figure 5: Key attributes of an ESG assessment framework



Source: Fidelity International, March 2024.

Figure 6: Elements of an engagement strategy

Source: Fidelity International, March 2024.

ESG engagement in private markets

Our active engagement process is another distinctive element of building Fidelity's ESG platform. We conduct more than 19,000 meetings annually to contribute to more granular and forward-looking issuer assessments. In 2022, we engaged with 1,548 companies on issues including just transition pathways, decarbonising the supply chain, and deforestation.

We believe engagement is preferable to divestment, and our experience in public markets has helped us engage more effectively in private markets. (See Figure 6) First, establishing a dialogue with portfolio companies enhances investment insights to inform investment decisions. Second, it fosters constructive change aligned with best practices to protect and enhance long-term value for shareholders.

Whether public or private, engagement should be tailored to the individual issuer, region, and asset class. Investors in CLO securities, for example, face different challenges relative to public equity owners. The former has no voting power, so success in engagement will rely more heavily on the strength of relationships with issuers and borrowers. For the most part, the terms of the loans are fixed before they are offered to investors. Therefore, ESG due diligence is an especially crucial step.

In other private asset categories, however, asset managers may have more sway over the terms of the loans, offering opportunities to design ESG into the transaction.

In direct lending, asset managers have an active role as a capital provider and therefore control a larger percentage - if not the entirety - of the debt structure, which usually involves smaller companies relative to CLOs. Differences in the structure of the debt, the controlling stake and the degree of direct access to management allow for more opportunities to add long-term ESG value to the company before exit.

Again, the ability to influence is different for direct real estate investors, who are essential owners of the asset. Their level of influence is often a product of the interrelationship between owner and asset occupier. Engagement centres on identifying personnel at occupier companies with similar values and ESG priorities while having a clear idea about the investment objectives, the ESG priorities, and the investment period. A critical advantage of direct real estate is the potential to have an intentional, incremental, and attributable impact by improving ESG standards on specific projects that align with investors' values.

Our heritage of bottom-up fundamental research, proprietary ESG ratings, and extensive ability to engage with portfolio companies to bridge data gaps and influence change put us on a solid footing to manage the ESG transition in private assets.

The high road in private markets

ESG investing in private markets is expected to accelerate in the coming years. Some aspects of this evolution may appear similar to how ESG has developed in public markets, such as the mainstream adoption of ESG analysis for risk management and enhanced disclosure requirements. We know the pace of change will be swift and uncertain. However, being early in building a robust foundation will help enhance the ability to respond quickly to changes, based on our public market experience and its practical application to private markets.

We also understand that effective implementation of ESG analysis in private markets will likely require a more tailored approach to deliver genuinely sustainable outcomes. Additionally, increased scrutiny in sustainable investing will require investors to incorporate ESG considerations at every step of the investment cycle (see Figure 7).

The 'E', 'S' and 'G' must be balanced carefully towards a more just transition. Lastly, ESG standards must be applied just as rigorously whether assets are in the public or private sector. Otherwise, we risk regulatory arbitrage, whereby asset owners can sidestep public scrutiny by shifting into the private sphere - undermining investors' long-term sustainability goals along the way.

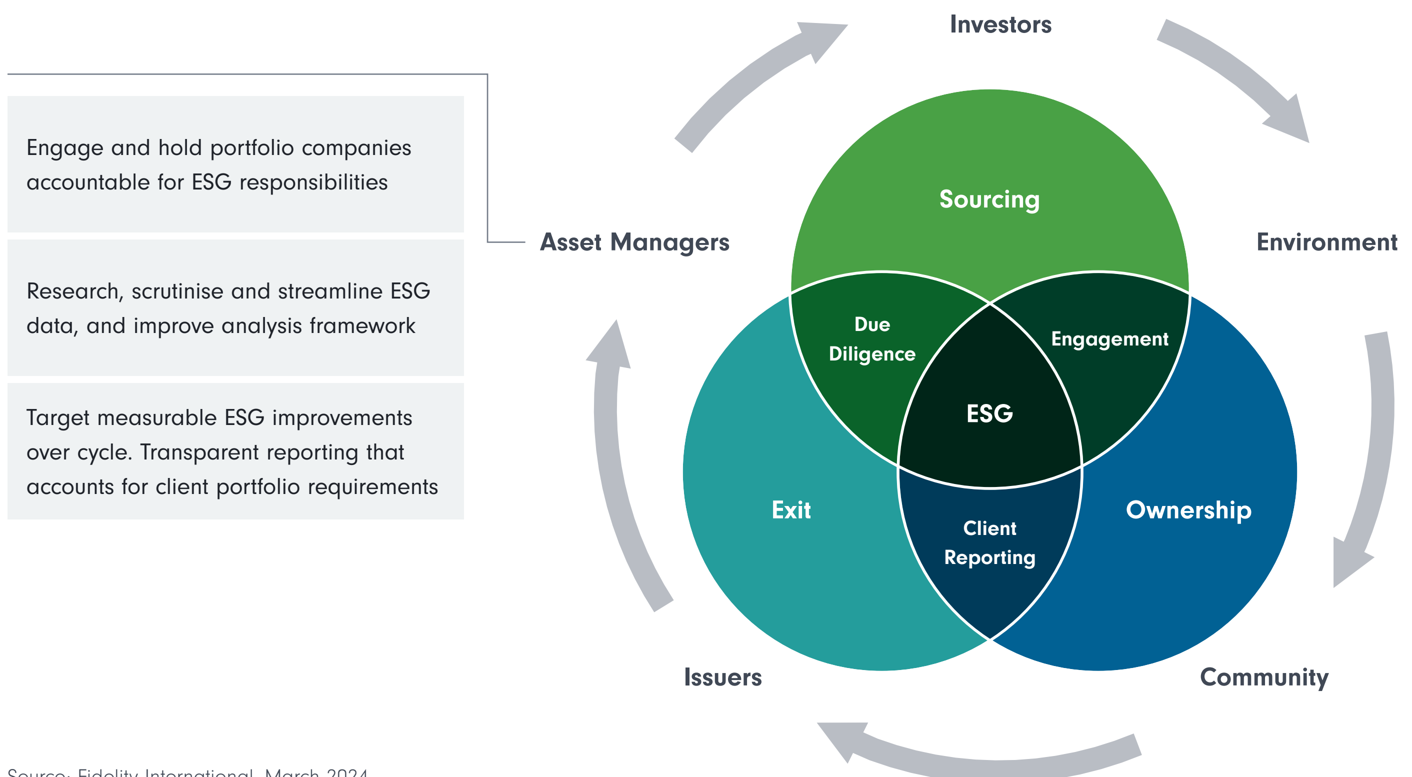
[1] "The road ahead for European fleet electrification", PwC, February 23, 2024.

[2] Guido Giese, Linda-Eling Lee, Dimitris Melas et al., "Foundations of ESG Investing: How ESG Affects Equity Valuation, Risk, and Performance", The Journal of Portfolio Management, July 2019.

[3] "2020 Global Status Report for Buildings and Construction", UN Environment Programme and Global Alliance for Buildings and Construction, December 16, 2020.

[4] "The impact of sustainability on value", JLL, May 27, 2020.

Figure 7: Investment cycle of private assets through an ESG lens



Source: Fidelity International, March 2024.

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