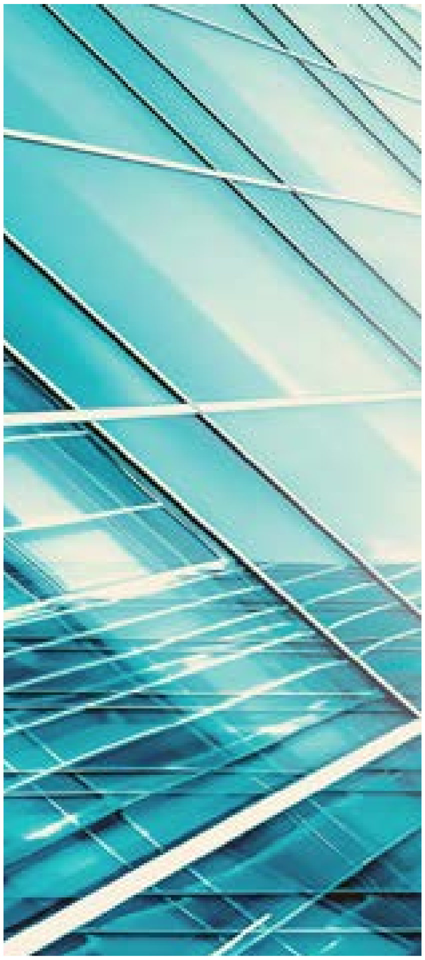
From Corporate Social Responsibility to PE Impact Funds: Investor Interest in ESG and Sustainability Gains Pace

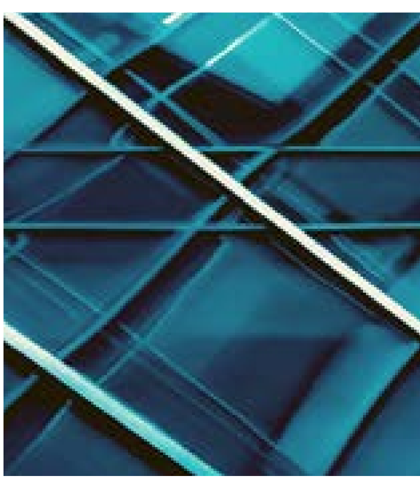


Institutional investors are increasingly accountable for how they deploy capital. More so than the widespread divestment from fossil fuels over the last decade, some capital allocators today are seeking to advance their goals through environmental and social impact investments.

The pressure from shareholders and stakeholders has continued to grow over the past year, and we are now seeing this growing scrutiny of governance and investment strategy become more accepted, or indeed encouraged within the middle-market. Today, over half of private equity firms say environmental, social and governance (ESG)-related issues are discussed in regular board meetings, up from about a third just two years ago.

What began as a movement led by insurance carriers negatively impacted by the risks of climate change and constituent pressure on public pension fund asset allocation, has begun to influence the thought process of private equity and private debt firms' limited partners (LPs)—and, in turn, private capital managers themselves.

Two recent examples illustrate this trend amongst large, publicly listed asset allocators. In BlackRock CEO Larry Fink's annual letter to CEOs this year, he pinpointed climate transition as the next historic investment opportunity. Late last year, the NASDAQ stock exchange filed a proposal with the SEC to require companies listed on the exchange to publicly disclose statistics on the diversity of their boards.



In addition to capital allocation, sponsors and lenders are increasingly incorporating sustainability considerations into their due diligence and reporting processes to gain a better understanding of the companies in which they are deploying their capital. As demand for responsible investing accelerates, which stakeholders often expect capital allocators to mirror, more fund managers are making ESG reporting a core part of their internal investment evaluations and shifting their strategy to better align with investor priorities.

Though enthusiasm for ESG investing has been embraced more slowly in the U.S. than in Europe, the rising interest from investors has been observed globally. We expect the continued adoption of ESG considerations in investment decisions as market participants around the world define their own sustainable investing strategies, and stakeholders—from everyday consumers to private equity LPs—increase pressure to allocate capital responsibly.

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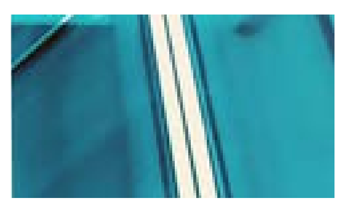

STANDARDIZATION OF ESG REPORTING IS ON THE HORIZON, BUT NOT YET CEMENTED

For lenders and sponsors evaluating investment opportunities, one essential key in this reporting process lies in measurability. When it comes to financing or launching a sales process, demonstrating ESG performance to lenders or investors can be integral to a deal. We have seen many reporting requirements on sustainability initiatives remain based on company self-disclosures, with limited uptake of the newly forming standardized frameworks. The risk remains present for companies to cherry-pick favorable metrics to demonstrate performance.

Sustainability reporting standards are rapidly evolving as LPs look for more transparency into private funds' performance on highly varied and divergent ESG factors. While a universal standard for reporting has yet to be established, regulators and market participants are in the early stages of discovering bespoke reporting and internally developed methods that work for them.

ESG is a process—not an endpoint. Lincoln expects some capital allocators to look for an established framework for future progress around ESG impact. Going forward, we expect continuity of sustainability commitment will be noticed by investors, developing a strategy to achieve sustainability goals should be discussed for companies looking to tap into capital markets.

LINCOLN PERSPECTIVE

Looking ahead, sustainability-linked investor interest is only expected to grow. As private companies, lenders and sponsors grapple with the rapidly evolving ESG landscape, Lincoln has identified several key considerations:

Companies with stated sustainability goals have access to an increasing range of lenders and sponsors
Demonstratable ESG commitment has begun to move from being a differentiator to an expectation. PE sponsors, limited partners, lenders and clients are more broadly demanding that companies commit to sustainability standards for the long-term. In evaluating their investment opportunities on a longer-term basis, capital allocators have begun to gravitate toward companies with clearly established and proven ESG frameworks.

Take a holistic view on sustainability
Steps toward a more sustainable future can be taken regardless of sector. Incremental, measurable progress toward short-, medium- and long-term goals that can be communicated to counterparties, should be the primary consideration. Defining your ESG plan early on—including measurement and communication back to LPs—will set you up for success in the long-term and ensure you are well positioned for a future transaction process.

Tuning in to the latest market happenings proves essential
Though uniform ESG standards may seem far off, regulators and market participants are increasingly rallying for them. The sooner companies and sponsors commit to developing an intentional awareness of the changing ESG landscape, the better prepared they will be when it comes time for a deal process. ESG activity in the public markets can provide private companies with foresight into trends which could move downstream to the middle market. Information collection and communication from front-line employees to boards and shareholders will ensure transparency and active progress.

Active financial advisors serve as a sustainability bellwether for private dealmakers
When predicting forthcoming ESG investing trends and regulation, keeping an eye trained on transaction markets and professionals who are the most active in the space, can help your business stay prepared for what lies ahead. As the ESG landscape continues to change rapidly, engaging with an advisor who is on the cutting edge is critical.

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