MOONFARE

THE CASE FOR SUSTAINABLE INVESTING IN PRIVATE MARKETS

2021

> *"Combating climate change is not just your generation's life or death struggle, but also the single biggest investment opportunity in history.*

Al Gore, former US Vice President and Founding Partner of Generation Investment Management, speaking to millennial investors in San Francisco, November 2019

Why the time is now for sustainable investing: Moonfare's view

By Moonfare Investment Director Sweta Chattopadhyay, who leads the firm's sustainability topics

The sustainable investments segment is growing and impossible for investors to ignore any longer.

There are definitely challenges. The industry is nascent, there is a threat of greenwashing traditional investments without any real sustainable improvements, and there are a lot of emerging managers with less proven track records. However, we are seeing a growing group of managers who have been involved in this effort for some time now, with proven ability to generate strong returns, while making a real difference to the world.

ESG improvements and innovative solutions to our modern-day problems and imbalances are becoming real value-creation drivers. We also see the market recognising this and offering a premium for sustainable companies.

What is going on today is just a glimpse of what is yet to come for sustainable investing.

We are excited about working with high-quality managers and companies in this space - what is going on today is just a glimpse of what is yet to come for sustainable investing.

The rise of sustainable investing

Sustainable investing offers outperforming returns and market resilience while looking after the planet and the well-being of people.

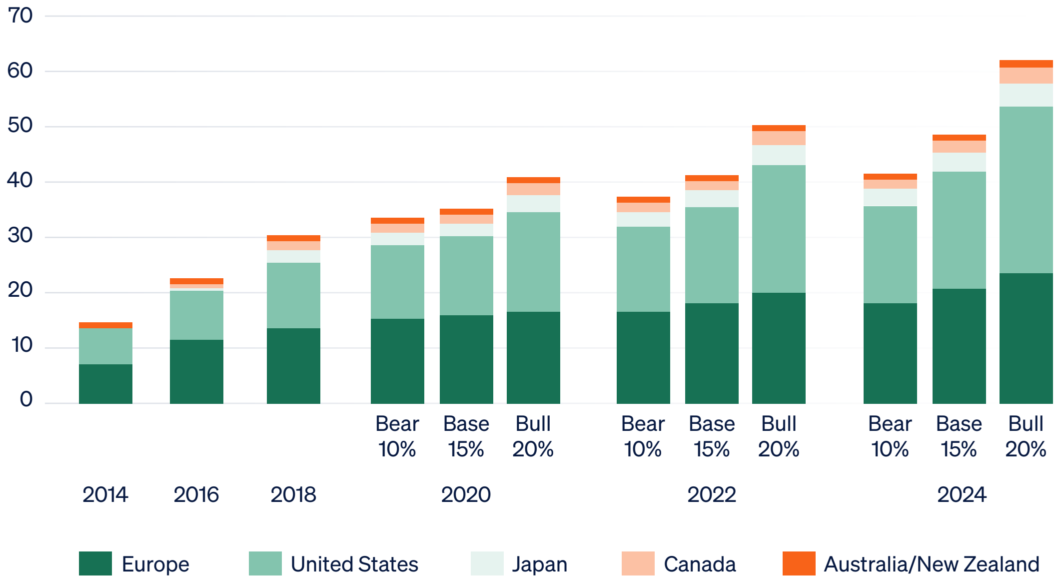
Investors globally are increasingly using their economic clout to address the most pressing challenges of our time such as climate change, plastic pollution and social injustices.

The demand for companies that operate within a sustainability framework - also known as the Environmental, Social, Governance (ESG) principles - has skyrocketed in the last decade.

ESG assets globally are on track to surpass $53 trillion by 2025, which represents more than a third of total projected assets under management. This is up 40 percent from the $37.8 trillion in 2020 and a 130 percent jump compared to 2016, according to Bloomberg analysis[1].

Figure 1: The projections indicate a steady increase in ESG assets across geographies, with the United States overtaking Europe in the next years.

ESG GLOBAL PROJECTED AUM BY COUNTRY ($TN)



Source: GSIA, Bloomberg Intelligence

1 https://www.bloomberg.com/professional/blog/esg-assets-may-hit-53-trillion-by-2025-a-third-of-global-aum/

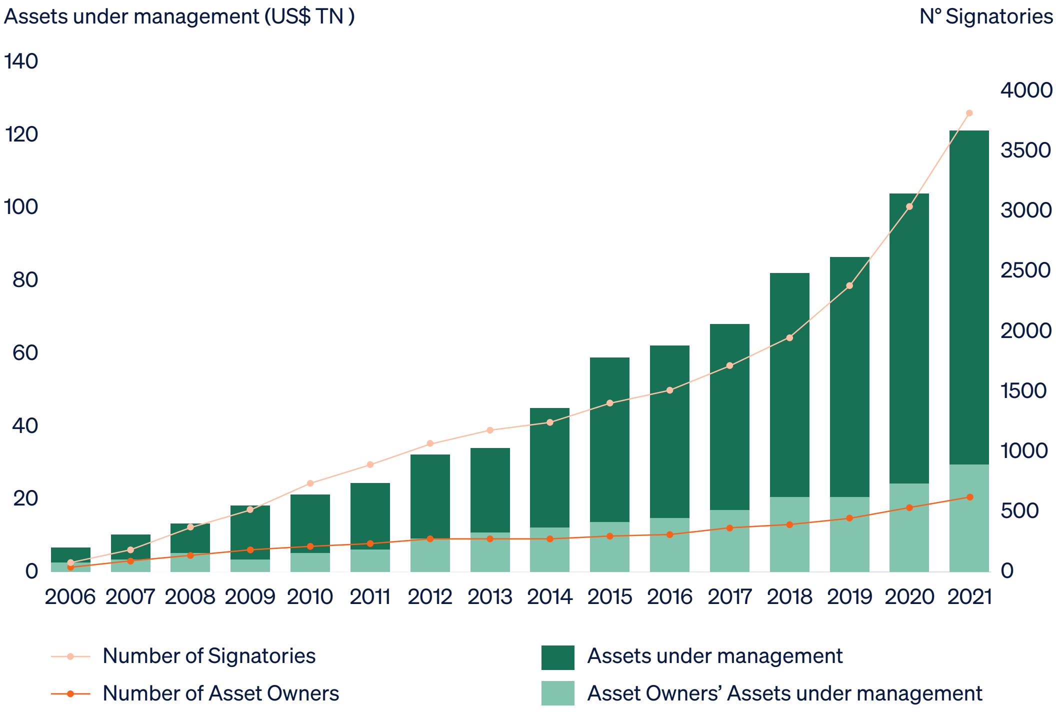
The stakes for investors and fund managers are evidently high, matched only by the enthusiasm of the broader financial industry.

To illustrate, the number of signatories to the United Nations' Principles for Responsible Investment (PRI) network surged 35 percent in 2020 and now numbers more than 4,400 investors and asset managers. Together, these firms manage a staggering $120 trillion of assets.

ESG policies are now regularly on executive board agendas and many asset owners say they actively integrate ESG considerations into their decision-making or will do so soon.

Figure 2: Asset managers are committing to sustainability: the number of PRI signatories has grown every year since it was established in 2006.

PRI GROWTH 2006-2021



Source: UN PRI 2021

The major appeal of sustainable investing is the notion that investing in the greater good doesn't mean sacrificing higher returns. In fact, research consistently shows that sustainability themes generate excellent investment opportunities[2]. They outperform "traditional" strategies across markets and fare better in market downturns, providing a source of resilience against future market shocks.

Sustainable investing is especially compelling for private equity (PE). Every

2 https://www.erm.com/globalassets/documents/insights/2020/unlocking-the-esg-premium-erm-private-equity-report-oct-2020.pdf

fourth PE firm already has a thematic sustainable fund in place[3]. Many fund managers are embracing ESG principles not only as a risk mitigation mechanism but also as a potent driver of value creation, with the capacity to generate a substantial premium at the exit. Studies show that sustainable companies are, on average, simply more attractive.

Against this buoyant backdrop, this paper explores the foundations of sustainable investing and the opportunities it offers to investors, particularly in private markets. The paper focuses on three themes:

1. *Growth drivers - more than just a fad*
2. *Private equity's big bet on sustainability*
3. *What's in it for the investors*

3 https://www.erm.com/globalassets/documents/insights/2020/unlocking-the-esg-premium-erm-private-equity-report-oct-2020.pdf

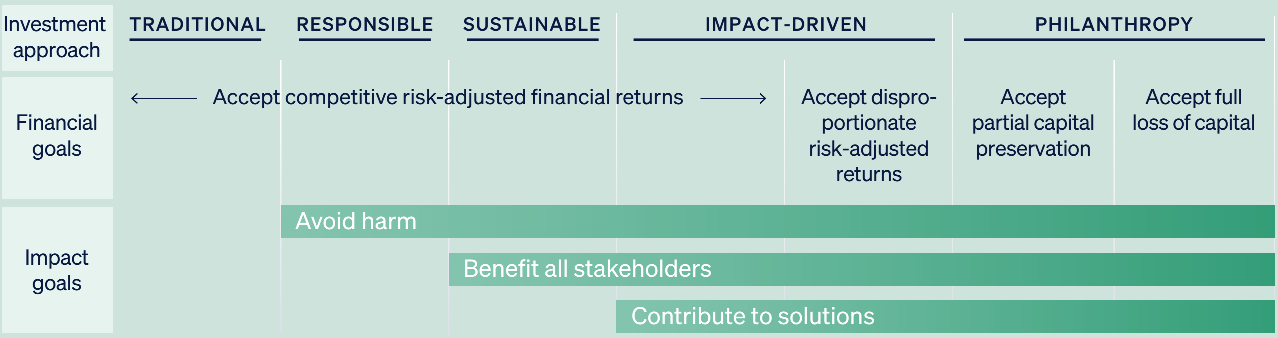
Making sense of the sustainable investing universe

There is a diverse collection of approaches deployed under what we understand as sustainable investing. Admittedly, the discipline lacks tested standards and broadly-accepted definitions, which is also understandable considering its early stage.

At the same time, we see wide-ranging efforts to improve clarity. The Impact Management Project, for example, developed a compelling chart that observes the journey of capital. Under this framework, sustainable strategies reflect investors' goals (financial vs non-financial) and the level of risk they're willing to accept[4].

What we understand as "sustainable investing" in the broadest sense refers to the deployment of capital across the spectrum of capital, from the incorporation of ESG considerations into investment decisions to actively investing in thematic opportunities to address critical issues and contribute to solutions.

Figure 3: A schematic overview of sustainable investment universe.



Source: The rise of impact; UK National Advisory Board on Impact Investing 2017 & Impact Management Project

4 https://www.impactinvest.org.uk/wp-content/uploads/2020/11/NAB-The-Rise-of-Impact-report-October-2017.pdf

ESG and other sustainable strategies

Sustainable investing commonly considers ESG criteria in its decision process.

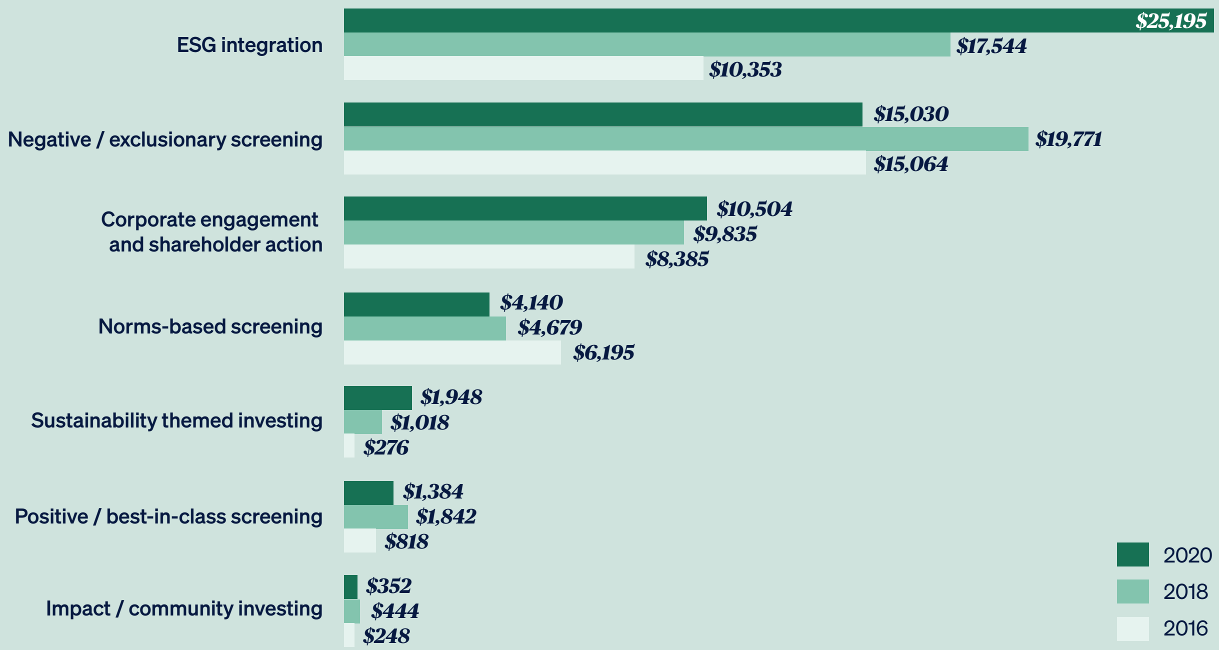
The idea behind ESG integration is to better manage risks and generate long-term financial returns while investing in companies that have a positive (or at least not a negative) impact on the world. ESG issues may encompass climate change initiatives, environmental stewardship, workers' rights or gender diversity.

ESG integration is considered one of the strategies under the umbrella of sustainable investing. Most assets, however, are managed using more than just one strategy. The most common are:

- **ESG integration:** incorporation of ESG factors in fundamental analysis
- **Negative screening:** excluding certain companies or industries
- **Positive screening:** selecting companies with especially strong ESG performance
- **Themed investing:** focus on certain sectors in the sustainability landscape (e.g. fighting climate change, tackling social inequities)
- **Active ownership:** engaging with portfolio companies and influencing corporate behaviour through proxy voting or direct engagement
- **Impact:** allocating funds to companies that make a specific and measurable positive ESG impact, along with delivering a financial return. Impact investing is often directed to traditionally underserved individuals or communities

Figure 4: Global growth of sustainable strategies 2016-2020

ASSET VALUES IN $BN



Source: Global Sustainable Investment Review, 2020; Global Sustainable Investment Alliance

1. Fuelling the growth: trends that transcend economic cycles

The rise of sustainable investing has been fuelled by a convergence of several secular trends. Its growth is, primarily, underpinned by an accumulation of global distress surrounding the world's most pressing issues, creating what we believe is a lasting shift towards more sustainable business practices.

We can already observe subtle changes in the economic models of Western-style capitalism. The focus is shifting from shareholder capitalism to a so-called stakeholder version, centred around a "triple bottom line" where companies also measure their social and environmental impact—in addition to the financial performance. Some call this new accounting practice the "three P's": profit, people and the planet.

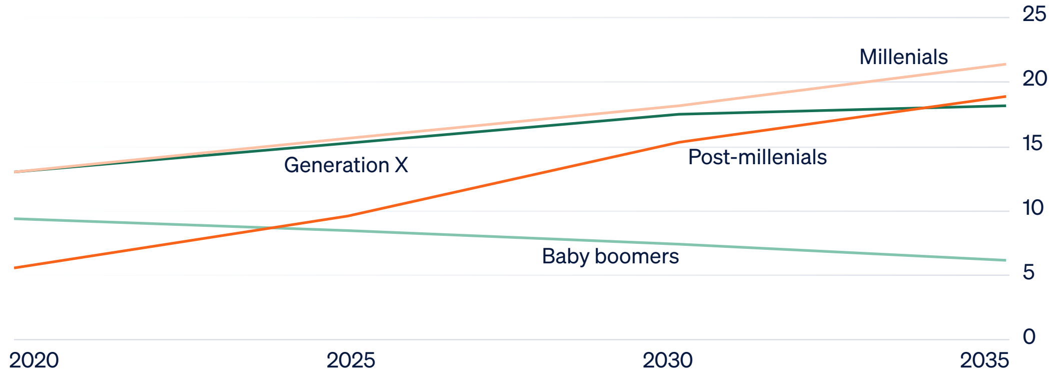
Other powerful megatrends that underpin the ongoing sustainability evolution include:

Generational wealth transfer and value shift. Millennials (born between 1981 and 1996) are increasingly aware of the sobering realities of global challenges such as climate crisis, plastic pollution and social injustices. Their convictions are reflected in their investment preferences: around 95 percent are interested in sustainable investing, according to a Morgan Stanley study[5]. Millennials are also twice as likely to invest in companies with significant positive social or environmental impacts when compared to older investors[6].

All this is especially important considering the ongoing intergenerational wealth transfer to millennials - by some estimates, millennials have already surpassed older generations in global spending.

Figure 5: Millennials are now the biggest global spenders.

FORECAST ANNUAL AGGREGATE INCOME, BY GENERATION ($TN)



Source: World Data Lab

5 https://www.morganstanley.com/pub/content/dam/msdotcom/infographics/sustainable-investing/Sustainable_Signals_Individual_Investor_White_Paper_Final.pdf
6 https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/financial-services/ey-sustainable-investing-the-millennial-investor.pdf

More generally, today's investors are more likely to follow their conscience. According to a recent report by Schroders, the majority will not budge on investing against their beliefs, even if returns might be higher[7].

Pressure from investors. Pension funds, sovereign funds, mutual funds, endowments and other institutional investors are being pushed to consider the impact of their portfolios. As a result, ESG is "almost universally top of mind for the executives", according to the authors of a 2019 survey of senior executives at 43 global institutional investing firms, published in Harvard Business Review. In their view, corporate leaders will soon be held accountable by shareholders for ESG performance—if they aren't already[8]. A similar sentiment is echoed by the Edelman Trust Barometer Report. It found that investors are changing their voting and engagement policy to be more attentive to ESG[9].

Evidently, institutional investors already have broader mandates to purchase ESG-focused assets, as we can observe from the increased allocations to ESG bonds[10].

COVID-19 boost. The pandemic and its aftermath have bolstered the imperative to introduce ESG-guided business practices. Investors see strong ESG performance as a bulwark against systemic shocks, especially in light of the impending climate crisis. Social issues, too, have entered the spotlight as COVID-19 wreaked havoc across communities. The pandemic has brought occupational health, safety nets, worker protection and similar topics onto their radar.

The pandemic has brought occupational health, safety net, worker protection and similar topics onto the radar of investors.

Large stimuli targeting green outcomes. The pandemic has also created a unique momentum for the ongoing transition into carbon-neutral economies, as countries double down on their sustainable initiatives. Thirty percent of the EU's €750 billion recovery fund, for instance, is earmarked for mitigating climate change[11]. Stimulus packages, tied to green results, are already showing results by creating tailwinds for ESG assets[12].

Breakthroughs in data analytics. ESG analysis starts by aggregating and processing huge volumes of data - emission data, news articles, extracts from corporate systems, public records - that investors use for investment screening. Data-driven insights, only enabled by the fairly recent advancements in processing technology, are essential for transparent ESG reporting and help govern sustainability at scale. It's important to note that ESG monitoring is still evolving and with challenges abound: inconsistent data and lack of tested standards are the big two elephants in the room.

7 https://www.schroders.com/en/sysglobalassets/_global-shared-blocks/gis-2020/theme-2/schrodersgis2020_t2_full-report_za.pdf
8 https://hbr.org/2019/05/the-investor-revolution
9 https://cdn2.hubspot.net/hubfs/440941/Edelman%20Trust%20Special%20Report%20II.pdf
10 https://www.pionline.com/esg/investors-increasingly-drawn-esg-bonds-survey
11 https://ec.europa.eu/info/strategy/recovery-plan-europe_en
12 https://www.reuters.com/article/us-sustainable-funds-efama-idUSKBN2B314T

2. Private equity's big bet on sustainable investing

Going mainstream

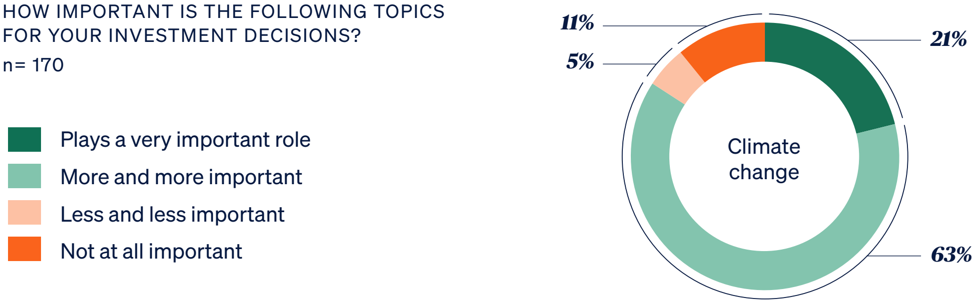
The momentum for sustainable investing in private markets is building.

Private equity firms are increasingly positioning ESG considerations at the centre of their investment strategies. This is largely because investors are demanding it - a large majority of limited partners are either already evaluating ESG risk factors or will be doing so shortly[13].

This shift was also captured by Moonfare's 2021 Market Panel. The survey found that climate change already "plays a very important role" for 63 percent of investors in their decision making. Clean water, healthy oceans, responsible supply chains and workers' rights also seem to increasingly drive their allocations.

Figure 6: Results of the recent Moonfare survey showed that ESG topics have become a top-of-mind priority for investors.

HOW IMPORTANT IS THE FOLLOWING TOPICS FOR YOUR INVESTMENT DECISIONS?
n= 170



Source: Moonfare Market Panel 2021

As a reaction to investors changing preferences, fund managers have started adjusting their screening processes. Six in ten general partners have already declined to invest in a company due to ESG or ethical considerations in 2021, according to Investec's annual GP Trends survey - up from 55 percent a year prior[14].

Bolstered by the impetus of the broader financial industry, ESG funds are sprouting up across the private markets universe.

Every fourth PE firm already has a thematic ESG fund in place, according to

13 https://pitchbook.com/news/reports/2020-sustainable-investment-survey
14 https://www.investec.com/en_gb/focus/gp-trends.html

ERM survey of 50 global PE executives[15]. General Atlantic, for example, is launching a $3 billion fund to back companies with the potential to combat climate change[16]. Carlyle recently secured “the largest ESG-linked private equity credit facility in the US” for $4.1 billion. They say it’s the first to focus exclusively on advancing board diversity[17].

Even more, the ESG fervour is pushing some PE institutions to consider linking asset managers’ compensation to ESG performance[18].

Value creation driver

ESG consideration has evolved beyond a risk mitigation instrument. PE firms increasingly use the criteria to identify value creation opportunities and to potentially deliver outperforming returns. In fact, a premium on value creation is cited as the top driver of ESG initiatives in private equity[19].

Value creation is understandably a compelling feature for private equity. The nature of the asset class allows PE investors to be more closely involved in strategic decisions of the portfolio holdings.

The size of the performance premium, however, is difficult to determine. Current evidence is limited and largely anecdotal.

The high-sustainability companies significantly outperformed their counterparts in terms of both accounting and stock market performance.

One paper from 2014, for example, looked at 90 matched pairs of companies — one “high sustainability” and one “low sustainability” company from the same sector. The high-sustainability companies significantly outperformed their counterparts in terms of both accounting and stock market performance.[20]

How can sustainable practices contribute to better business performance? Some of the more significant ways ESG drive value creation include:

- **Sales boost:** consumers are attracted to sustainable products and services. Research from NYU Stern’s Center for Sustainable Business determined that sales of products marketed as sustainable grew 5.6 times faster than those that were not[21].
- **Increased employee productivity:** there is compelling evidence that purposeful work increases workforce productivity and loyalty. A global talent trends survey found that three out of four highest-performing employees work for a company with a strong sense of purpose[22].
- **Lower costs:** By doing ESG right, companies can reduce operating expenses. According to McKinsey research, these costs can affect operating

15 https://www.erm.com/globalassets/documents/insights/2020/unlocking-the-esg-premium-erm-private-equity-report-oct-2020.pdf
16 https://www.penews.com/articles/general-atlantic-plans-4bn-strategy-focused-on-climate-change-20210716
17 https://www.carlyle.com/media-room/news-release-archive/carlyle-largest-esg-linked-credit-facility-us-4-billion-board-diversity
18 https://www.wsj.com/articles/private-equity-weighs-linking-manager-pay-to-esg-performance-11622545202
19 https://www.pwc.com/gx/en/services/sustainability/publications/private-equity-and-the-responsible-investment-survey.html
20 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1964011
21 https://hbr.org/2019/06/research-actually-consumers-do-buy-sustainable-products
22 https://www.mercer.com/our-thinking/career/voice-on-talent/people-first-mercers-2018-global-talent-trends-study.html

profits by as much as 60 percent[23].

- **Less government interference:** Continued compliance with changing legal and regulatory requirements provides strategic freedom to do business, while improving the potential for access to subsidies and government support.
- **Decreased cost of capital:** Sustainable companies are better positioned to attract financing options, such as green bonds. PwC reviewed 30 studies and found that in 90 percent of cases the cost of capital falls when ESG measures improve[24].
- **Innovation:** Practicing ESG engagement almost inevitably requires that companies step up their innovation engines. Pursuing ESG implementation helps businesses deliver new solutions, better address customer needs, develop more efficient internal processes or unearth original ways to attract talent.

23 https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/five-ways-that-esg-creates-value
24 https://www.pwc.nl/en/insights-and-publications/services-and-industries/deals/quantifying-ESG-strengthens-valuations-in-mergers-and-acquisitions.html

3. Sustainable investing: what's in it for investors

Outperforming returns

The burning question on most investors' minds is about the performance of sustainable investing. Does it come with financial tradeoffs? Do investors need to sacrifice higher returns for pursuing holdings that also aim to generate environmental or societal value?

A growing body of research shows that investing in the greater good doesn't hamper performance.

One piece of German meta-research, for example, looked into 2,200 individual studies. The authors found that roughly 90 percent of studies showed a non-negative effect of ESG on corporate financial performance. More importantly, a large majority (63 percent) report a positive correlation[25].

Furthermore, data provider Morningstar examined the long-term performance of 745 Europe-based sustainable funds. The study showed that the majority of sustainable funds have outperformed their traditional peers over one, three, five and 10 years[26].

According to the same analysis, sustainable funds also have higher survivorship rates. Of sustainable funds available to investors ten years ago, 72 percent have survived, compared with less than half of traditional funds. "There is no performance trade-off associated with sustainable funds," say Morningstar.

Figure 7: Sustainable funds are considered more successful than their "traditional" counterparts

SUCCESS RATES BY MORNINGSTAR CATEGORY (%)

	SUCCESS RATE OF SUSTAINABLE FUNDS			
CATEGORY	1-YEAR	3-YEAR	5-YEAR	10-YEAR
Global Large-Cap Blend Equity	75.1	73.7	76.9	67.3
Global Large-Cap Growth Equity	60.3	43.2	37.5	56.7
Global Emerging Markets Equity	41.3	60.0	58.8	50.0
US Large-Cap Blend Equity	76.4	71.4	76.9	81.3
Europe Large-Cap Blend Equity	71.1	75.0	67.2	55.1
Eurozone Large-Cap Equity	63.5	63.0	60.6	62.3
EUR Corportate Bond	58.0	58.5	62.2	33.3
All Categories	**65.6**	**65.6**	**64.4**	**58.8**

Note: To calculate success rates, Morningstar used a composite of traditional fund returns and count the number of sustainable fund returns that rank higher than this composite.

Source: Morning Direct. Morningstar Research. Data as of 31/12/2019.

25 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2699610&mod=article_inline
26 https://www.morningstar.com/content/dam/marketing/emea/shared/guides/ESG_Fund_Performance_2020.pdf

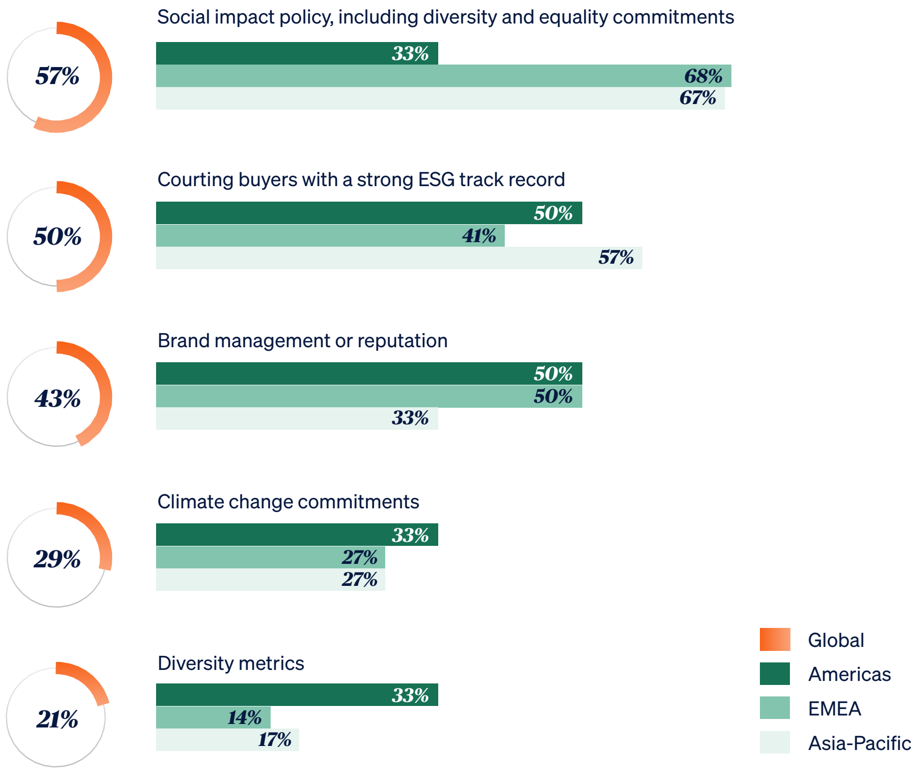
ESG premium at exit

Part of private equity's bet on sustainable investing is that ESG will help firms maximise value on sale. By acquiring a strong ESG label, companies may strengthen their position in the market. As the interest for ESG business is increasing, it also drives up the multiples[27].

The race for ESG best-in-class investments is already underway. Almost three-quarters of PE executives expect to capture an ESG premium in portfolio companies they are considering exiting[28]. They are similarly confident that ESG sell-side diligence will play a considerably larger role in the next five years[29].

Figure 8: The majority of investors and asset managers globally believe that having social impact policies and a strong ESG track record will help them make better exit deals.

QUESTION: WHERE ARE YOU FOCUSING YOUR EFFORTS TO CAPTURE AN ESG PREMIUM IN EXITS?



Source: EY 2021 Global Private Equity Divestment Study

27 https://www.pwc.nl/en/insights-and-publications/services-and-industries/deals/quantifying-ESG-strengthens-valuations-in-mergers-and-acquisitions.html
28 https://www.ey.com/en_gl/divestment-study/private-equity
29 https://www.erm.com/globalassets/documents/insights/2020/unlocking-the-esg-premium-erm-private-equity-report-oct-2020.pdf

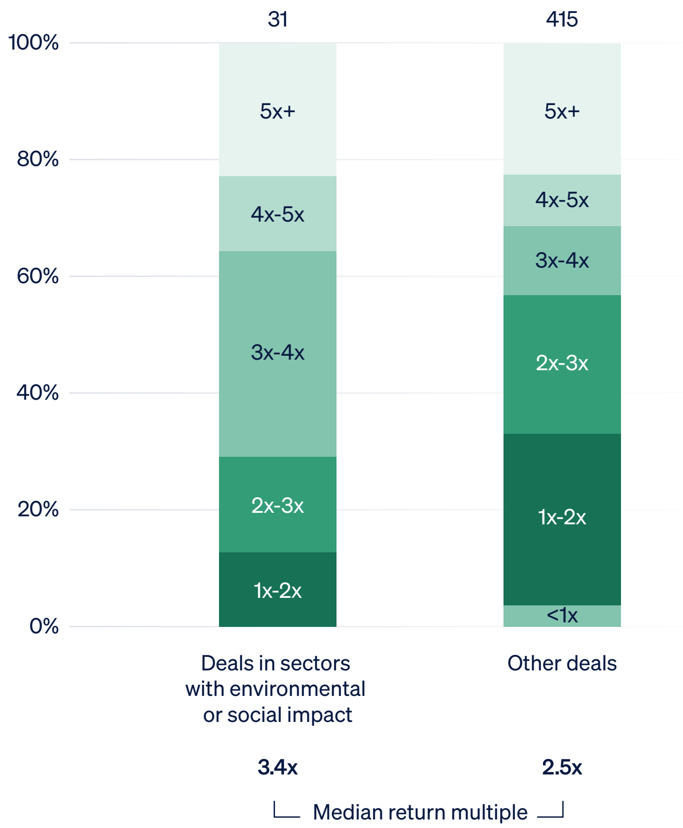
Currently, however, there is limited research on how ESG credentials influence valuations in private companies, but early findings point to a substantial upside.

First research on how ESG credentials influence valuations in private companies shows a substantial upside.

Management consultancy Bain & Company, for example, analysed a sample of 450 PE-led exits conducted in the past five years in the Asia-Pacific region. Then they've picked those that either involved impact funds or focused on sectors that score high on ESG such as cleantech and education[30]. The authors found that the median multiple on invested capital was 3.4x for deals with social and environmental impact, compared with 2.5x for other deals.

Figure 9: Deals in environmentally and socially responsible sectors are correlated with better results in Asia-Pacific PE.

DISTRIBUTION OF MULTIPLES ON INVESTED CAPITAL FOR ASIA-PACIFIC PE-LED EXITS, 2014-2018



Note: Deals were classified as having social and environmental impact if the investor is an impact investor or if the sector is closely related to ESG focus (water, waste, education, clean tech, ecology, renewables, etc.)

Source: AVCJ; Preqin, Bain & Company

30 https://www.bain.com/contentassets/3ff71feadbfb4649bb4ae7c9a279226e/bain_brief_private_equity_investors_embrace_impact-investing.pdf

These results reflect the expectation of the industry. Global executives and investment professionals say they would pay a 10 percent median premium to acquire a company with a positive record for ESG issues over one with a negative record, according to a recent McKinsey survey[31]. The distribution of responses is wide, but in favour of ESG. One-quarter of respondents, for example, say they would be willing to pay a premium of 20 to 50 percent.

Market resilience

It seems ESG investments are better positioned to weather market downturns and provide better risk-adjusted returns, compared to traditional assets.

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According to BlackRock data, 88 percent of sustainable funds outperformed their non-sustainable counterparts in the first four months of the pandemic year of 2020[32]. Morningstar and Morgan Stanley Institute for Sustainable Investing reported similar conclusions. The latter believes that sustainable funds reduced investment risk during the coronavirus outbreak in 2020[33].

The resilience of sustainable strategies has been observed in past market downturns as well. In 2015-2016 and 2018, for example, sustainable indices tended to outperform their conventional counterparts[34].

31 https://www.mckinsey.com/business-functions/sustainability/our-insights/the-esg-premium-new-perspectives-on-value-and-performance
32 https://www.blackrock.com/corporate/literature/investor-education/sustainable-investing-resilience.pdf
33 https://www.morganstanley.com/ideas/esg-funds-outperform-peers-coronavirus
34 https://www.blackrock.com/corporate/literature/investor-education/sustainable-investing-resilience.pdf

Moonfare's sustainability efforts

Sustainable Investments is also an exciting area of growth for Moonfare. As a young organisation with a strong responsible investment ethos and a long-term perspective, we see the area as one that is constantly evolving.

Over the last 12 months, we have refined our ESG processes in all our analysis and due diligence and signed up to the UN PRI. We are currently developing our sustainable investments offering further, alongside selected high-quality managers in this segment.

Disclaimer

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