

2022

EU Private Markets: ESG Reboot



Creating alpha
and meeting
investors' needs:
a matter of
survival

Sustainable Finance Series
Private Markets



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About our European Sustainable Finance Series and this report

In the first report in this series, “*2022: the growth opportunity of the century*”, we gave a perspective into the era-defining opportunity that ESG represents for European mutual fund managers and the key actions they should consider taking in order to seize it with both hands. The report also delves into how Europe’s binding regulatory developments, increased investor appetite and shifting societal values will see ESG skyrocket to the front and centre of the region’s investment landscape.

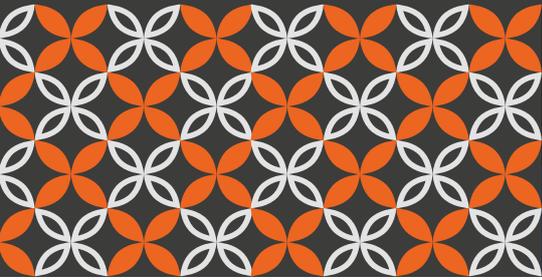
This paper marks the second in our European Sustainable Finance Series. The aim of this report is to take a deep dive into the major trends that are propelling the ESG wave that is already sweeping across European Private Markets, and which is set to accelerate in the years ahead.

We use our findings to make informed recommendations as to the key actions that Private Market participants should consider in order to navigate the changing ESG landscape and unlock the opportunities it presents. We have further enhanced our report based on a wide range of primary data gathered through a Europe-focused survey of 200 GPs and 200 LPs. We also carried out in-depth interviews with a number of GPs and LPs in order to get first-hand accounts of where the players think the industry is going.

Table of Contents

Executive Summary	4
1. ESG moves to the centre stage	8
1.1 Key drivers of ESG adoption	12
1.2 Spotlight on asset classes	31
1.2.1 Private Equity	33
1.2.2 Real Estate	36
1.2.3 Infrastructure	40
1.2.4 Private Debt	44
2. How to create value through ESG	52
3. Conclusion	72
4. Methodology	74
Contacts	77





Executive Summary

As the world around us evolves, it is becoming increasingly apparent that environmental and social challenges – and the actions we must take in order to address them – will define this century. This evolving landscape has changed the course of the global political agenda, with significant knock-on effects on global financial markets. In this new backdrop, ESG¹ and sustainable finance will become a matter of survival to meet the needs of sustainability-conscious investors, increased regulatory requirements and societal expectations. In this context, ESG investing is evolving into a veritable paradigm shift – particularly within the EU.

The EU's Private Markets (PM)² have not been exempted from this shift, with ESG triggering an all-encompassing reboot that stands to reshape the future of the industry. In this fast-evolving landscape, General Partners (GPs) will be increasingly required to adapt along with the winds of change, positioning ESG at the centre of their investment, risk mitigation and ALPHA creation strategies. Those that successfully harness ESG's sheer value creation and protection potential stand to secure or even enhance their competitive positioning.

Creating Alpha through ESG

Buy dirty, sell clean

- Identify and buy low-value businesses with large negative externalities that have already been priced in.
- Implement proven ESG turnaround strategies that significantly reduce environmental/societal costs.
- Sell at profit. Gains are set to be particularly pronounced in traditionally 'non-sustainable' businesses/sectors (e.g., coal, mining...).



Buy cleaner, outperform

- Identify and acquire 'cleaner' companies before externalities are priced in.
- Benefit from competitive outperformance as other operators battle sustainability headwinds and sell at profit.



Identify early, take to scale

- Leverage new datasets and analytics to isolate areas in which environmental and social costs are generated across the economy.
- Identify, evaluate and acquire businesses with products/services that could mitigate these costs, before their potential is visible to the rest of the market.
- Take to scale (or into new markets) and sell at profit.



Benefit from structural shifts

- Identify, evaluate and acquire businesses with products/services that substantially contribute to sustainability goals as defined in the EU Taxonomy to benefit from structural shifts of capital in the markets.
- Take to scale (or into new markets) and sell at profit.



Source: PwC Global AWM Market Research Centre

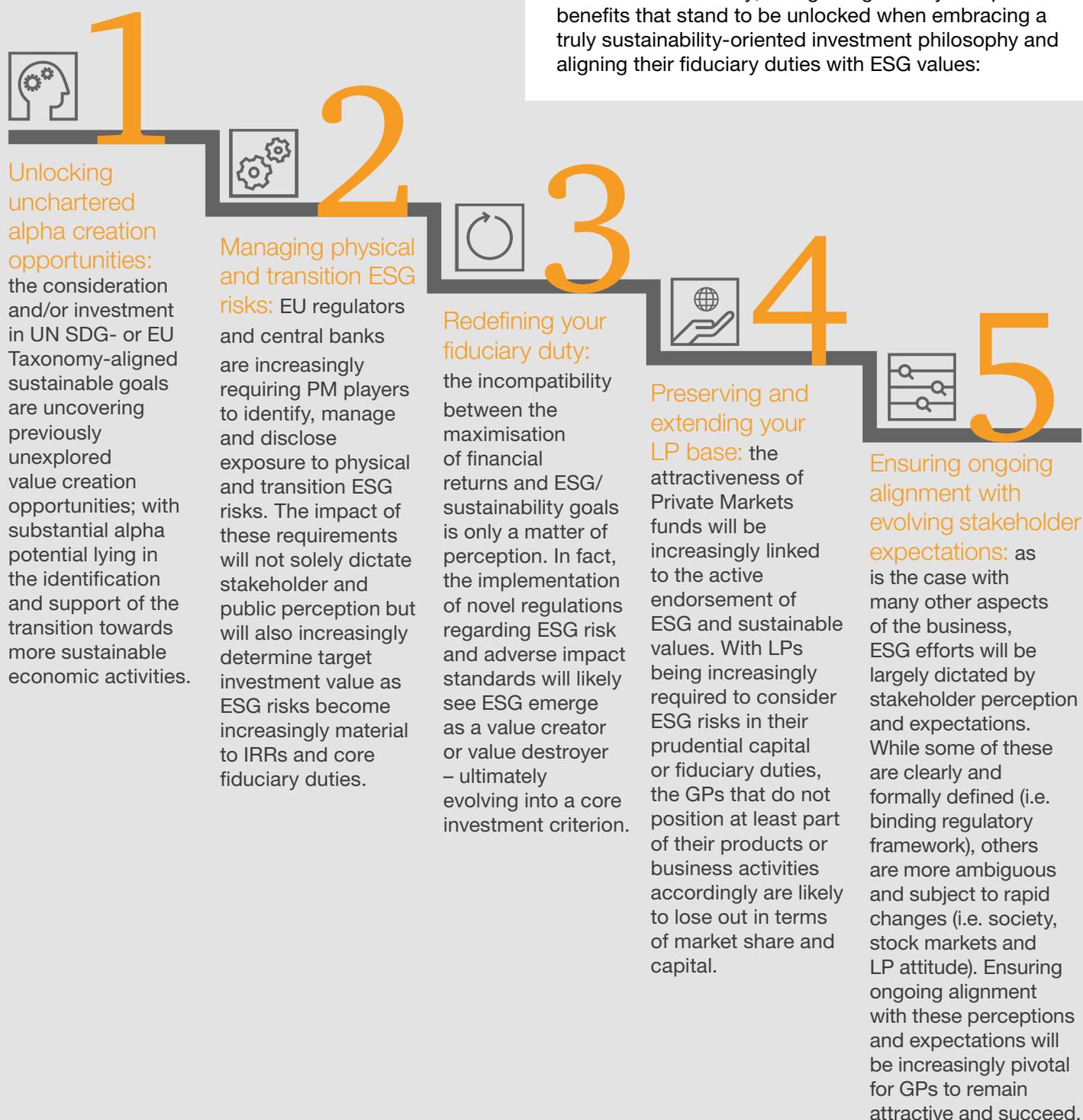
¹ ESG investments are defined as investments which consider Environmental, Societal and/or Governance factors. Sustainable Investments are investments with substantial contribution to a sustainability goal, avoiding harm to other goals and complying with minimum social and governance standards – definition in line with EU Sustainably Finance Disclosure Regulation Art. 2 (17).

² Private Markets encompasses Private Equity, Real Estate, Infrastructure and Private Debt.

That being said, the bulk of the discussion surrounding the sheer transformational impact of ESG on the modern Asset and Wealth Management (AWM) landscape has historically pertained to the traditional realm. This is perhaps unsurprising, given that economic and financial Key Performance Indicators (KPIs), Discounted Cash Flow (DCF) models and discount factors have represented the gold standard which industry players have traditionally relied on in order to inform their decisions.

This 'IRR-centric focus', coupled with the industry's private nature, has served to reinforce the perceived irreconciliation between ESG factors and PM players' fiduciary duties – from both a value creation and valuation risk point of view.

Recent years, however, have seen a historic asset and sentiment shift within European PM, with LPs, society and regulators alike doubling down on their ESG demands. These external drivers notwithstanding, GPs themselves have also been increasingly awakening to ESG's true materiality; recognising the key competitive benefits that stand to be unlocked when embracing a truly sustainability-oriented investment philosophy and aligning their fiduciary duties with ESG values:



Increased recognition of these opportunities, coupled with the aforementioned external drivers, has resulted in a veritable ESG surge in Europe's Private Markets - with PM ESG assets almost doubling in the three-year period running from 2017 to 2020. This rapid growth notwithstanding, we strongly believe that the industry is still in the early stages of its ESG metamorphosis; **fast approaching the precipice of a 'reboot' of historic proportions.** In other words, we believe that ESG is set to primordially reinvent the European PM landscape at a rate and magnitude unparalleled since the ratification of the AIFMD in 2011.

According to our forecasts, European PM ESG assets will skyrocket to between EUR 775.7bn and EUR 1.2tn by 2025 – accounting for between 27.2% and 42.4%

of the entire PM industry's asset base. Real Assets, in particular, are poised to stand at the forefront of this surge; with ESG assets expected to account for 33.7% and 40.6% of Real Estate and Infrastructure's total respective AuM by 2025 (see figure below).

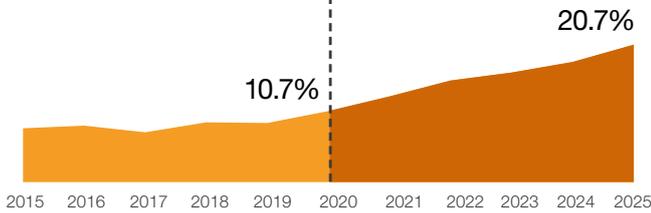
This asset explosion will see Europe alone making up between 31.0% and 35.9% of global ESG PM assets - positioning the region at the pinnacle of the global ESG PM landscape. The sheer extent of Europe's predominance in this realm will ultimately see the region's influence transcending physical borders and spilling across the global landscape.

Meeting investors' needs



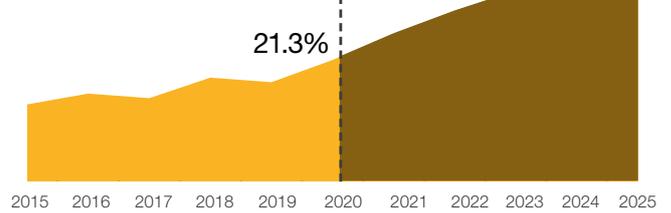
% of ESG AuM over total **Private Equity** AuM

Forecast: Base case



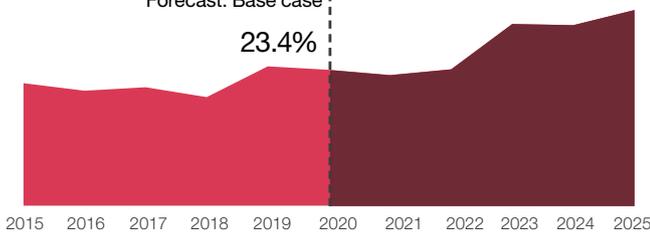
% of ESG AuM over total **Infrastructure** AuM

Forecast: Base case



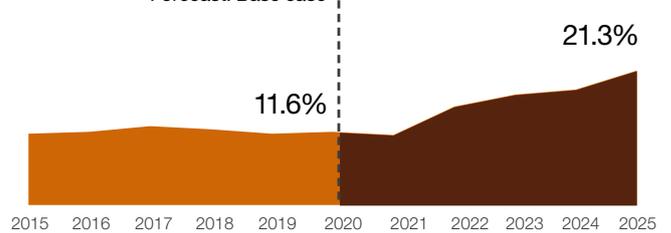
% of ESG AuM over total **Real Estate** AuM

Forecast: Base case



% of ESG AuM over total **Private Debt** AuM

Forecast: Base case



Sources: PwC Global AWM Market Research Centre, Preqin

In light of this, we have developed a set of key recommendations that GPs should consider undertaking in order to ensure the successful implementation of ESG-



Master ESG at the GP level

As the ESG wave approaches the shores of the EU's Private Markets, GPs should make a strategic decision as to which role they would like to play in this new paradigm. The GPs that decide to embrace ESG values and emerge as leaders in the new landscape should consider viewing their entire operations through an ESG lens, spurring the transition towards a sustainable order of operations in all facets of their business – ranging all the way from constructing a core ESG team to revamping their hiring and upskilling practices.



Actively manage ESG risk

Regulatory developments – most prominently in the form of the Sustainable Finance Disclosure Regulation (SFDR) – have been catalysing a veritable institutionalisation of ESG risk management processes, urging GPs to adapt accordingly. Not only this, but GPs are also becoming increasingly cognisant of ESG risk management process' role in avoiding reputational and financial losses within their own operations and those of their portfolio companies. In this context, the GPs that opt to deepen their engagement with their underlying corporates are particularly well positioned to strengthen ESG risk management processes therein – subsequently boosting resilience and enhancing valuations.



Create distinct & transparent reporting

GPs should ensure that their ESG-related reporting practices are not only designed to meet regulator demands, but also evolving – and increasingly stringent – investor expectations. This urges for an ongoing engagement with LPs to ensure their reporting needs are being met; as well as the development of a flexible reporting policy that can promptly accommodate fast-changing and heterogeneous investor needs. Quality, transparent reporting is also instrumental in demonstrating GPs' evolving commitment to ESG to the broader stakeholder base; which could prove particularly effective in strengthening the historically 'tentative' link between PM and ESG.

Will Jackson-Moore

Global Private Equity, Real Assets & Sovereign Funds Leader

W. U. Jackson-Moore

oriented strategies and the effective, sustainable transition of their respective business models:



Construct an 'ESG-enhanced' portfolio

In order to reap ESG's full value creation potential, GPs should ensure that ESG and sustainability considerations are entrenched throughout their entire investment life cycle, from screening to exit. The effective implementation of a truly sustainable investment strategy, in turn, is largely dependent on the formalisation of a transparent and rigorous ESG investment policy, the prioritisation of material ESG issues and the proper identification and tracking of ESG-related KPIs. Long-term success will, in turn, hang largely on adequate engagement with target companies, as well as the extent to which GPs succeed in transitioning these companies towards more sustainable standards and contributions.



Master the data challenge

Effectively tackling ESG-related data challenges is the 'sine qua non' condition for all the aforementioned action points to effectively materialise. That being said, the historical lack of data standardisation within PM and its 'secretive' nature has rendered the effective handling of data a particularly burdensome task. We believe, however, that the regulatory rally towards enhanced transparency and standardisation will help GPs in tackling these shortcomings – ultimately alleviating part of the long-standing transparency concerns. Regulatory developments notwithstanding, the GPs most likely to thrive are those that are willing to leverage on cutting-edge technologies to streamline their ESG data collection processes and rationalise the obtained data in meaningful, insightful ways.



Build a core ESG Team

ESG and sustainability requirements have grown exponentially more sophisticated in recent years – amid rising investor demand and increasingly stringent regulatory developments. In light of this ever-increasing complexity, the success of any and all ESG integration efforts – whether they be at the GP or portfolio level – hang largely on the exhaustive, consistent and effective management of ESG and sustainability related goals, criteria and targets/limits/exclusions. While these skills can be created and obtained through staff upskilling and a clearly articulated corporate structure, we strongly believe that it is absolutely critical that GPs strive to create a core ESG team.

Olivier Carré

Financial Services Market Leader & Sustainability Sponsor Luxembourg

Olivier Carré

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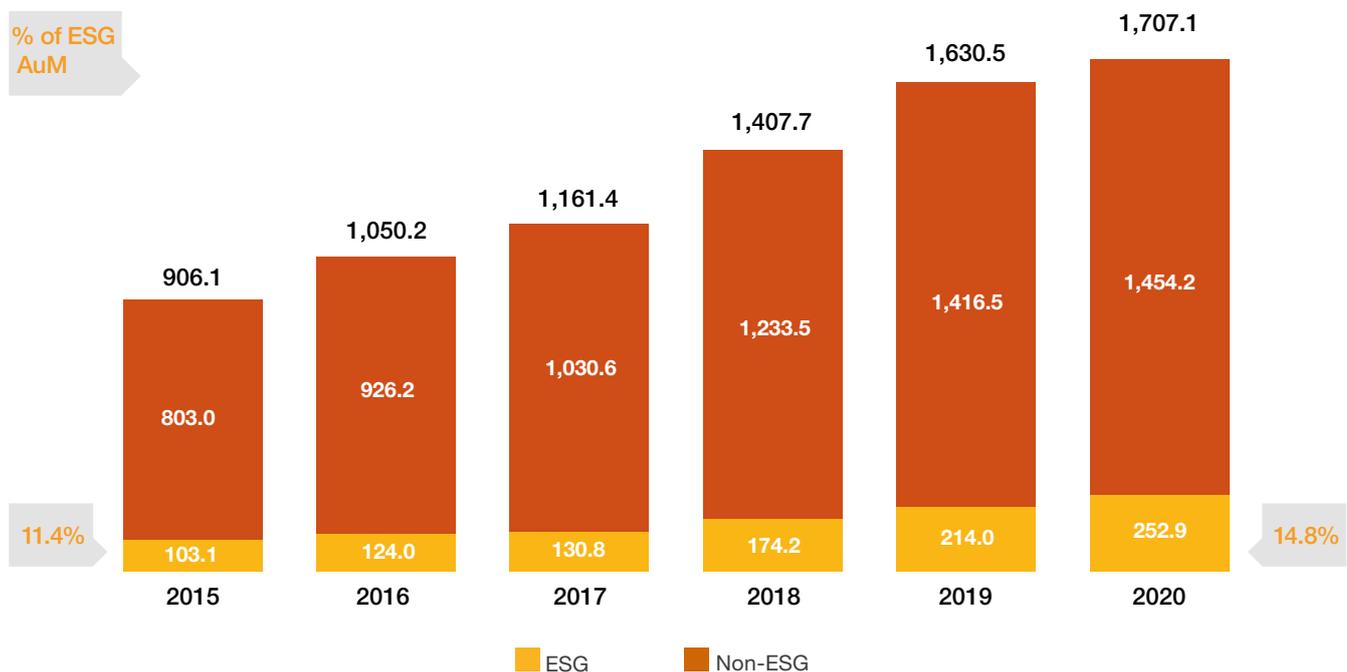
ESG moves to the centre stage

One cannot overlook the rate and scale with which the ESG shift is redefining Europe's Private Markets landscape. We forecast Europe-domiciled ESG PM assets to reach between EUR 775.7bn and EUR 1.2tn by 2025, making up between 27.2% and 42.4% of European Private Market assets – up from 14.8% in end-2020 (cf. exhibit 1).

While this surge will largely be propelled by the rapid expansion of Private Markets themselves – and the increased prominence of ESG as a central investment criterion therein – we believe it is the acceleration of

four overarching drivers that will alter the very fabric of the industry. These include: (i) Shifting societal values, (ii) Changing investor behaviour, (iii) Policy shifts and regulatory changes, and (iv) Increased recognition of ESG's value creation & risk mitigation potential. As these accelerating forces combine, we strongly expect that the European (and potentially global) PM landscape of tomorrow will be virtually unrecognisable to that of today.

Exhibit 1: European Private Markets AuM: ESG vs. non-ESG (EUR bn)



Sources: PwC Global AWM Market Research Centre, Preqin

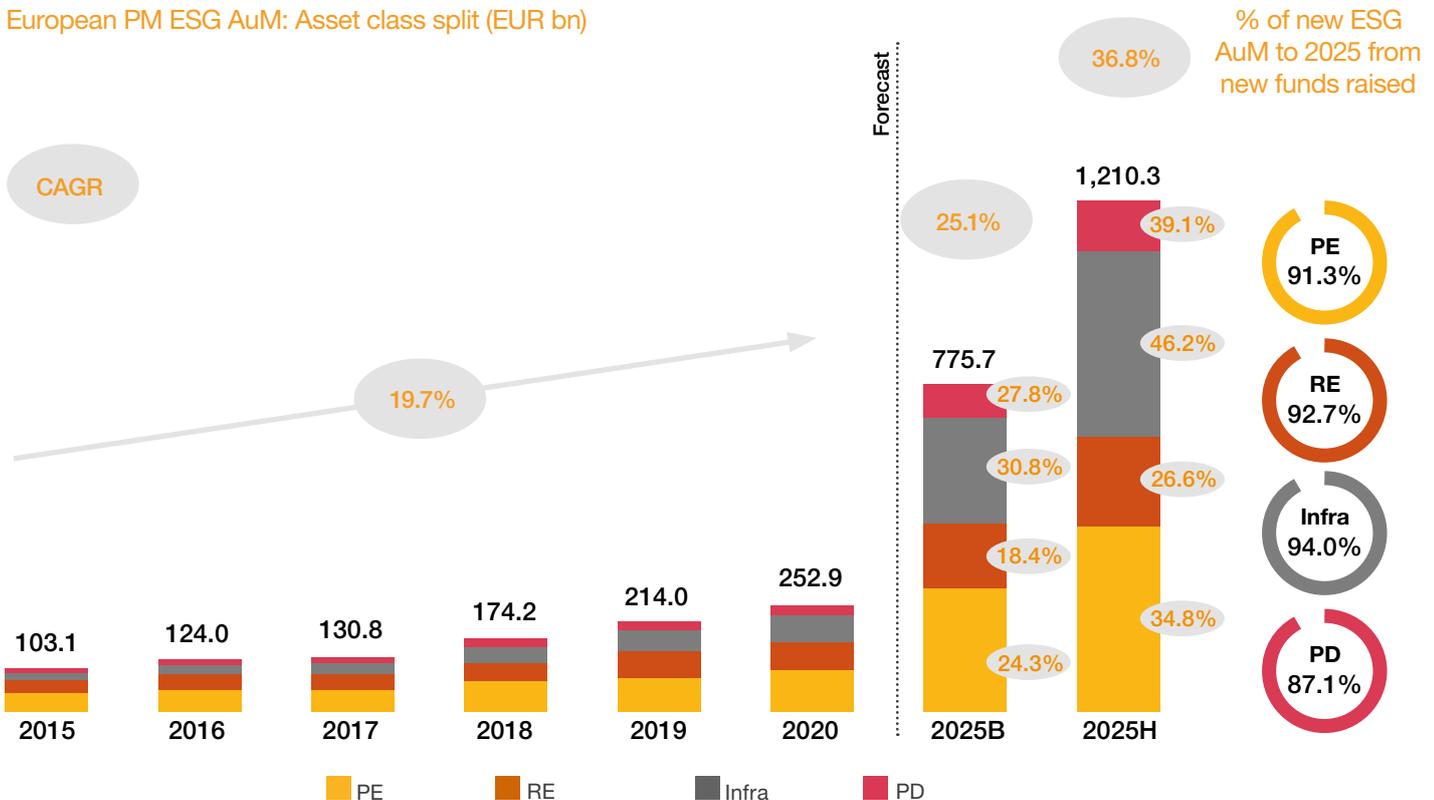
ESG is reshaping the European Private Markets landscape, with all of the industry’s stakeholders attributing an unprecedented degree of importance to sustainability considerations. While this shift has accelerated recently amid rising EU regulator pressure, the origins of this industrywide Rebalancing in priorities long precede this regulatory change. In fact, our analysis shows that Europe’s Private Markets ESG sphere has been undergoing an unabated rise long before this pick up in regulatory momentum - with the volume of PM ESG assets domiciled in the region more than doubling since 2015 to reach EUR 252.9bn as of end-2020 (cf. exhibit 2).

While this evolution is nothing short of formidable, we believe that the European Private Markets landscape may still be in the nascent stages of its ESG metamorphosis. As sustainability becomes increasingly entrenched in

societal norms and values, and the investment ecosystem becomes increasingly sensitive to the role it must play in mitigating and alleviating sustainability risks, we believe that the industry is nearing the precipice of a paradigm shift of unparalleled proportions. That being said, the nature of the ESG shift in Private Markets will differ largely from that being observed in the traditional realm. While the characteristically closed-ended nature of the former will see its ESG shift be propagated by the raising of new ESG funds, the latter’s is being driven by widescale fund strategy conversions. Our own analysis highlights the sheer predominance of new ESG fund launches in tomorrow’s PM ESG asset base – with new funds poised to account for the vast majority of new ESG AuM across all European PM asset classes by 2025 (cf. exhibit 2).

Exhibit 2

European PM ESG AuM: Asset class split (EUR bn)

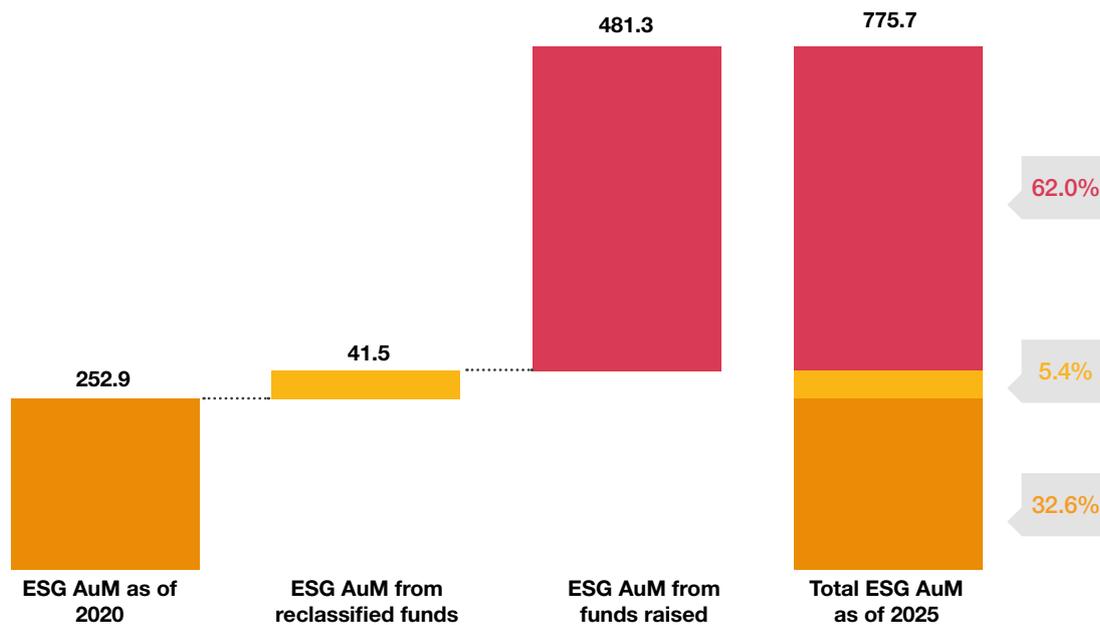


Sources: PwC Global AWM Market Research Centre, Preqin. 'B' refers to base-case forecast scenario, while 'H' refers to high case forecast scenario.

Our base case scenario sees ESG PM AuM surging at a 25.1% CAGR from 2020 to reach EUR 775.7bn by 2025 – by when it will account for 27.2% of Europe’s PM AuM (cf. exhibit 3). Out of this EUR 775.7bn figure: i) EUR 252.9bn (32.6%) will stem from current ESG AuM; ii) EUR 481.3bn (62.0%) will stem from new funds raised; and iii) EUR 41.5bn (5.4%) will stem from reclassified funds (cf. exhibit 3). The ‘modest’ latter figure relates to the aforementioned close-ended nature of Private Markets, which renders the reclassification of funds a particularly

burdensome task. That being said, our baseline scenario represents an almost half-a-trillion-euro opportunity for GPs. This “conservative” scenario is likely to materialise if we see a continuation of current market trends and fund launches – with GPs complying with new regulatory requirements and LP demands, but most opting not to cater to the diversity in investor demand and investable assets through the full endorsement and implementation of ESG across their existing fund offerings.

Exhibit 3: Private Markets ESG AuM to 2025, base-case scenario (EUR bn)



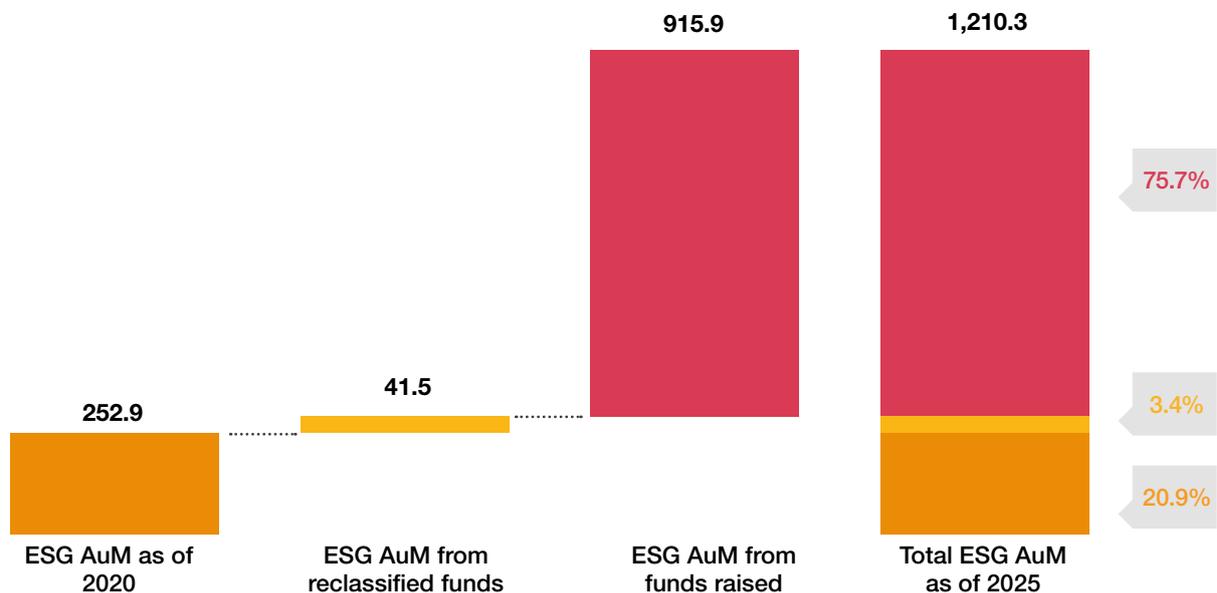
Sources: PwC Global AWM Market Research Centre, Preqin

Our best-case forecast would see PM ESG funds completely redefining Europe's existing PM landscape, with GPs fully embracing and adapting to the ESG revolution. Should this scenario materialise, PM ESG AuM will skyrocket almost five-fold - exceeding EUR 1.2tn by end-2025 and accounting for 42.4% of European PM assets (cf. exhibit 4). Out of this EUR 1.2tn figure: i) EUR 252.9bn (20.9%) will stem from current ESG AuM, ii) EUR 915.9bn (75.7%) will stem from new funds raised; and iii) EUR 41.5bn (3.4%) will stem from reclassified funds (cf. exhibit 4). Thus, the materialisation of our best-case scenario would see more than EUR 900bn in fresh money up for grabs within Europe's Private Markets. In order for an opportunity of this scale to reveal itself, market

participants would need to fully endorse and implement ESG regulations. This scenario would witness GPs launching a significant number of Article 8⁶ and 9⁷ funds with specific ESG strategies in the coming years. The extent to which these trends impact the industry depends largely on stakeholders and GPs' respective approaches to ESG.

While the ESG shift is by no means a Europe-specific trend, the region's strongly ESG-conducive regulatory and societal landscape will likely see it emerge as the global ESG hub for Private Markets. **In fact, we forecast that, by 2025, Europe will account for between 31.0% and 35.9% of global ESG PM assets—up from the current 22.6%.**

Exhibit 4: Private Markets ESG AuM to 2025, best-case scenario (EUR bn)



Sources: PwC Global AWM Market Research Centre, Preqin

⁶ Article 8 funds refer to financial products which promote environmental or social characteristics of the investment, either alone or in combination with other characteristics.

⁷ Article 9 funds refer to financial products which have sustainable investment (as per art. 2(17) of the SFDR) as their investment objective.

1.1

Key drivers of ESG adoption

Our forecasts are based on the acceleration of four key overarching catalysts that are driving change in Europe's Private Markets, as well as the rise of asset-class specific dynamics (which we explore in more depth in the Asset Class Spotlight section of this report). Together, these drivers and dynamics are propagating transformation and placing sustainability/ESG concerns at the heart of the industry. These catalysts are: 1) Shifting societal values; 2) Changing investor behaviour; 3) Policy shifts and regulatory changes; and 4) ESG's value creation and risk mitigation power.

1.1.1 Shifting societal values

A series of increasingly impactful social and environmental events in recent decades – ranging from widening prosperity gaps to devastating forest fires – have highlighted the hazards of our current societal and economic behaviour like never before (cf. figure 1). This has triggered an era-defining shift in the global psyche, with sustainability and environmental risks evolving from a small-scale concern to a central issue on the global, political and societal agenda.

While the underlying causes leading to these events have been occurring for centuries, their prominence on the social stage has been largely propelled by the increased prominence and prevalence of ESG matters within traditional media, social media, and scientific research (for instance, the August 2021 UN Climate Report). In this new backdrop, the consequences of our actions (and inactions) are felt to the point where they can no longer be ignored. This has given rise to a sense of togetherness and community which transcends borders and demographic groups, leading to the increased recognition that a prosperous, equitable and sustainable future is entirely dependent on the effective and timely tackling of environmental risks and ESG values.

“ We are the first generation to feel the effect of climate change and the last generation who can do something about it.

Barack Obama

Figure 1: Timeline of social and environmental events



In this context, businesses and sovereign institutions are being increasingly pressured to demonstrate how their operations impact society and the environment, as well as what concrete actions they are currently (or plan on) undertaking in order to minimise their environmental and social footprint. The Private Markets industry has not been exempted from this pressure, with stakeholders urging LPs and GPs to readapt their activities and philosophies in accordance with these ever-pressing needs. The COVID-19 pandemic served to further amplify this sense of urgency, shining light onto the materiality of ESG issues and demonstrating the real-world impacts of neglecting ESG considerations.

In short, the abovementioned social and demographic shifts have transformed ESG issues from a niche trend to an essential and mainstream factor within the PM industry. This, in turn, will require industry players to rethink their role in mitigating sustainability risks and meeting societal expectations; with those that fail to do so running the risk of falling behind and being labelled as laggards.

“ You need to make certain investments to stay relevant. You want to be seen as someone that takes the right steps and does the right thing - you want to be an early adopter, not a laggard.

Principal, European Private Equity Fund

March 2018: National School Walkout

Student-led movement protesting against gun violence across the U.S.

2019: The Year of Climate Strikes

More than 7.6 million people held climate-related protests around the world.

March 2020: The World Goes into Lockdown

Devastating health, social and economic impacts put Covid-19 as the 'tipping point' for ESG-related change.

May 2020: #BlackLivesMatter

The death of George Floyd and many others expose the unjust killings of Black people by the police.

July 2021: Devastating forest fires and flooding

The Summer of 2021 was marked by raging wildfires and serious flooding across Europe, Africa and South America.

December 2018: Greta Thunberg Speaks at UN COP 24

16-year-old girl tells political leaders that they are failing with their commitments towards future generations.

January 2020: Australian Fires

Australia witnesses unprecedented bushfires that devastated over 180,000 square kilometres of land.

August 2021: Publication of UN Climate Report

The report, which has been deemed a "code red for humanity", states that the world is fast-approaching the irreversible 1.5°C global warming threshold.

1.1.2 Changing investor behaviour

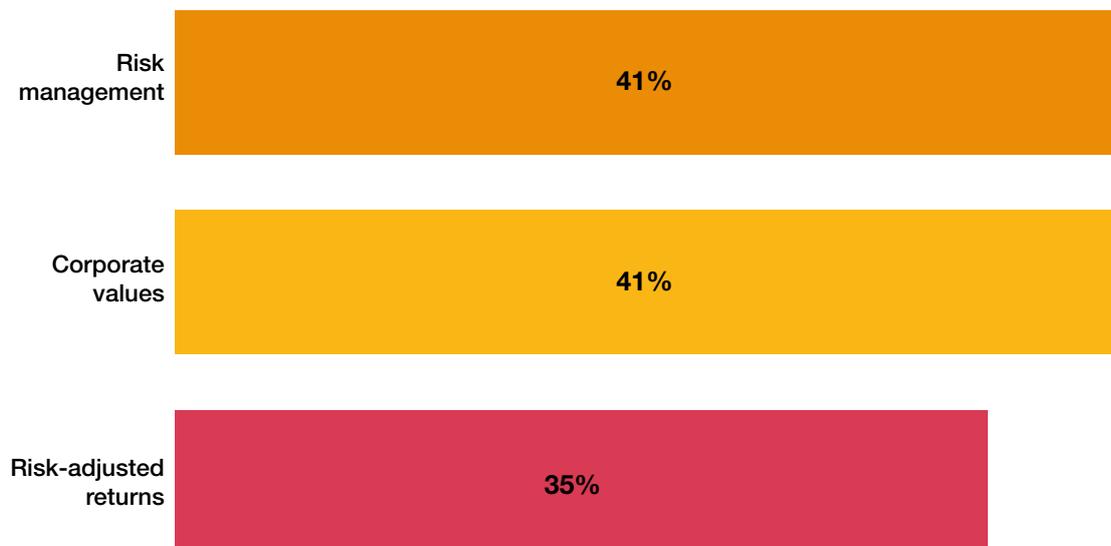
Investors are becoming increasingly cognisant of the importance of effectively managing sustainability risks – as well as the future impact that this could have on societal and economic prosperity. This understanding, coupled with the increased importance of mitigating ESG-related reputational risks, is being increasingly reflected in institutional investors’ investment philosophies. Subsequently, most major EU fiduciary investors have been embracing ambitious ESG strategies in search of a “double materiality” – increasingly prioritising non-financial impacts alongside financial returns. In turn, an ever-increasing proportion of the investor base is demanding that their asset managers allocate their assets towards sustainable products – urging an all-encompassing revolution in the PM industry.

While external drivers such as regulatory change and stakeholder demand have played a role in urging EU investors to rethink their fiduciary duty and incorporate sustainability considerations into their mandates, these do not represent the sole drivers propagating an ESG uptake among investors. In fact, LPs are becoming increasingly cognisant of ESG’s role as an effective lever for value creation and risk mitigation. The risk management dimension, in particular, has risen in prominence - with LPs increasingly observing that ESG considerations have an actual material impact on the future value of their portfolios as well as the ‘external’ corporate image driving shareholder value more broadly. Our survey results highlight this, with risk management – coupled with corporate values and risk-adjusted returns – topping the list of most urging ESG drivers among LPs (cf. exhibit 5).

“ I’m seeing more clients being more and more interested in ESG, we really think this is going to be a ‘do-or-die’ type of matter.

Head of ESG & Sustainability, European Private Equity firm

Exhibit 5: What are your main drivers to invest in ESG?* (LPs, top 3 answers)

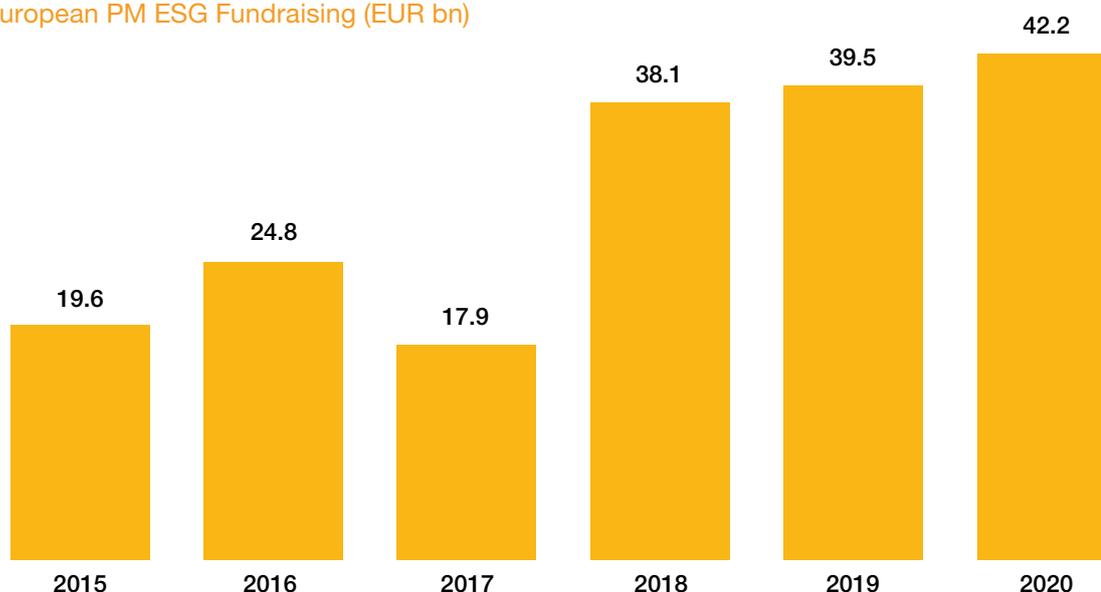


In order to visualise the extent of LPs' growing appetite for ESG, one need look no further than the funds raised by European PM ESG funds in recent years. While overall fundraising in Europe's Private Markets has undergone a marked deceleration in the last four years, ESG PM fundraising figures have shown no sign of faltering. We have in fact observed EUR 119.8bn in PM ESG fundraising between 2018 and 2020 – almost double the EUR 62.2bn figure observed over the previous three-year period. Even the pandemic-induced volatility and uncertainty did not dissuade LPs, with ESG fundraising in fact reaching an all-time high of EUR 42.2bn in 2020 (cf. exhibit 6).

Looking forward, we strongly expect demand for sustainable investment to intensify as sustainability considerations become increasingly anchored within global corporate governance and as investors become

increasingly aware of the key opportunities that stand to be unlocked. We expect this demand shift to materialise in two forms. First, we expect a veritable surge of historically ESG-agnostic investors 'ESG-fying' their investment philosophies so as to not fall by the wayside in the 'ESG race' – primarily through the exclusion of economic activities that could 'damage' their corporate branding. Our survey results highlight the sheer scale of this imminent shift, with 100% of the LPs we surveyed that do not invest in ESG PM funds planning to do so in the coming 24 months. Second, we expect to see a strong uptake in demand for ESG funds from already ESG-invested LPs; with 63% of those we surveyed planning to increase their allocation to ESG funds in the same timeframe – with over half targeting increases of between 10% and 20% (cf. exhibit 7).

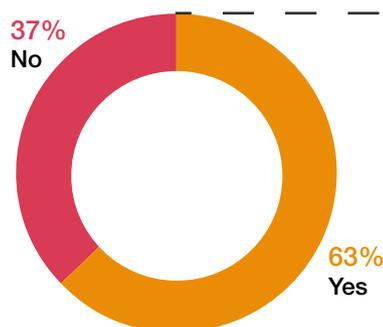
Exhibit 6: European PM ESG Fundraising (EUR bn)



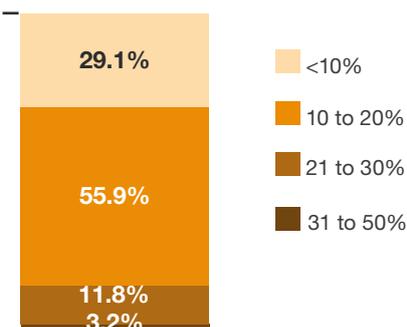
Sources: PwC Global AWM Market Research Centre, Prequin

Exhibit 7

Do you plan to increase your allocation to ESG funds in the next 24 months? (LPs)



If yes, by how much? (LPs)



Source: PwC Global AWM Market Research Centre

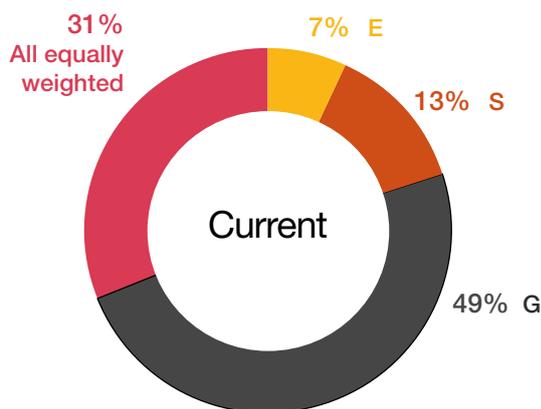
However, investor behaviour is not solely poised to change with respect to their heightened demand for ESG-oriented products, but also with respect to the relative importance they attribute to the 'E', 'S' and 'G' aspects of ESG. Among the LPs that we surveyed, the majority report that Governance has the highest weighting within their current ESG investments allocation. However, our survey results indicate an upcoming rebalancing of LP priorities, with the weight of Environmental considerations predicted to nearly double in the next 24 months; while Social considerations are expected to rise from 13% to 20% during the same period (cf. exhibit 8). Besides reflecting regulatory

pressure and commitments towards climate change mitigation, the increased emphasis on the 'E' and 'S' aspects mirrors the aforementioned rising sense of environmental and societal responsibility; likely exacerbated by recent ESG-related developments and the COVID-19 pandemic.

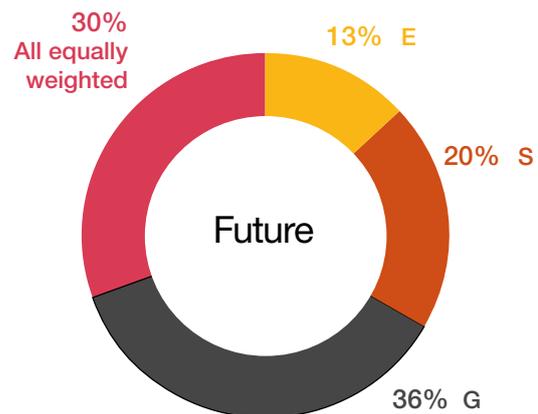
In short, ESG has redefined the very way LPs perceive the industry and their role within it. This strong appetite for ESG, coupled with their sheer influence and prominence within the PM realm, is set to further propel the already ongoing 'ESG shift' within Private Markets.

Exhibit 8

Within your current ESG investments, which aspect of ESG has the highest weighting? (LPs)



In the next 24 months, which aspect of ESG do you believe will be most prevalent in your investments? (LPs)



Source: PwC Global AWM Market Research Centre

“ We are seeing an increasing number of large investors demanding that their money is managed in a way that makes an ESG impact – an impact which often goes far beyond the current regulatory framework.

Senior Advisor, European Private Debt Fund

Changing investor behaviour: Implications for the industry

We strongly believe that this change in investor behaviour will catalyse a paradigm shift in European Private Markets, solidifying ESG as one of the industry's central tenets. Subsequently, this urges GPs to undergo a primary rethink of their operational and investment methodologies.

Demand for non-ESG funds will continue to fall

- As regulators and society increasingly urge LPs to incorporate sustainability considerations within their investment policies and operations – and as these LPs increasingly awaken to ESG's value creation and risk mitigation potential – GPs will likely see the demand for their non-ESG funds slow considerably. Some GPs, in fact, are already witnessing plummeting demand for their Article 6⁸ funds across major asset classes – demand that we expect to all but disappear as ESG considerations increasingly redefine investor psyche.
- Thus, GPs will be required to quickly revamp and expand their ESG offerings while simultaneously tackling a variety of challenges such as transitioning to ESG without jeopardising legacy products and ensuring alignment with evolving regulations.
- GPs should also decide on the extent of this revamping – choosing whether to completely halt non-ESG fund launches, or to continue offering non-ESG funds alongside ESG ones. Opting for the latter, however, may undermine their credibility in the eyes of strongly ESG-oriented LPs.

'Talking the walk and walking the talk' becomes as crucial as ever

- LPs' deepening commitment to sustainability has translated into an increasingly meticulous assessment of GPs' ESG track records. In fact, virtually all the LPs we surveyed indicated that they center their GP selection process on some kind of ESG/sustainability criteria.
- In this context, it has become imperative that GPs enhance their transparency and reporting, 'talking the walk and walking the talk' in order to increase their credibility and foster trust with their LP base. GPs should demonstrate their commitment to ESG both at a portfolio and at an organisational level even beyond standard regulatory requirements.
- Reluctance to do so could result in a loss of competitiveness vis-à-vis GPs that are able to clearly and consistently illustrate to LPs – and to the broader stakeholder base – how ESG permeates their operations. As such, in this new landscape, it is the GPs that actively demonstrate that their funds and practices strongly align with ESG principles that will thrive.

LPs have their own ESG roadmap

- While regulatory compliance is set to represent the 'standard minimum requirement' for GPs, many LPs have already set up their own ESG roadmap independently of regulatory developments.
- These LPs have their own ESG 'rulebooks' – with ESG methodology and reporting standards often going beyond those imposed by regulation. Some LPs may even have more stringent ESG requirements than those exhibited by some Article 8 and Article 9 funds.
- As a result, there is a growing disconnect between LPs' actual demands and what GPs are regulatorily required to provide. Thus, in order to attract and retain investors, GPs will be pushed to 'tailor' their ESG approach in accordance with LPs' respective ESG rulebooks while simultaneously ensuring regulatory compliance.

GPs' fund offerings should reflect the whole ESG spectrum

- While PM players – especially within the PE realm – have traditionally put a disproportionate emphasis on the 'G' aspect of ESG, novel societal and regulatory demands are set to stimulate an increased prioritisation of 'E' and 'S' issues among LPs.
- Traditionally 'Governance'-oriented GPs should be prepared to enhance their commitment to 'E' and 'S' aspects, which also implies being able to elucidate the environmental and social impacts of their portfolios through quantifiable and comparable metrics.

GPs to manage global differences in 'fiduciary duties'

- Through the ratification of the Climate Law and comprehensive changes in the fiduciary frameworks of MiFID, IDD, Solvency and IORP, the EU has implemented a basis for the assessment and consideration of non-financial criteria as a level playing field goal for GPs, if disclosed to the investors in accordance to SFDR Art. 8 or Art. 9 standards.
- The fiduciary duties in other regions of the world are less clear with regards to the consideration of ESG and overall sustainability goals, potentially compromising the return on investment or the investable universe of assets.
- GPs should tackle this global heterogeneity by implementing a transition strategy - encompassing different levels of ESG criteria considerations and sustainability outcome management to cater to varying investor needs and regulatory requirements.

⁸ Article 6 funds refer to financial products which do not promote any form of sustainability

1.1.3 Policy shifts and regulatory changes

1.1.3.1 Policy shifts

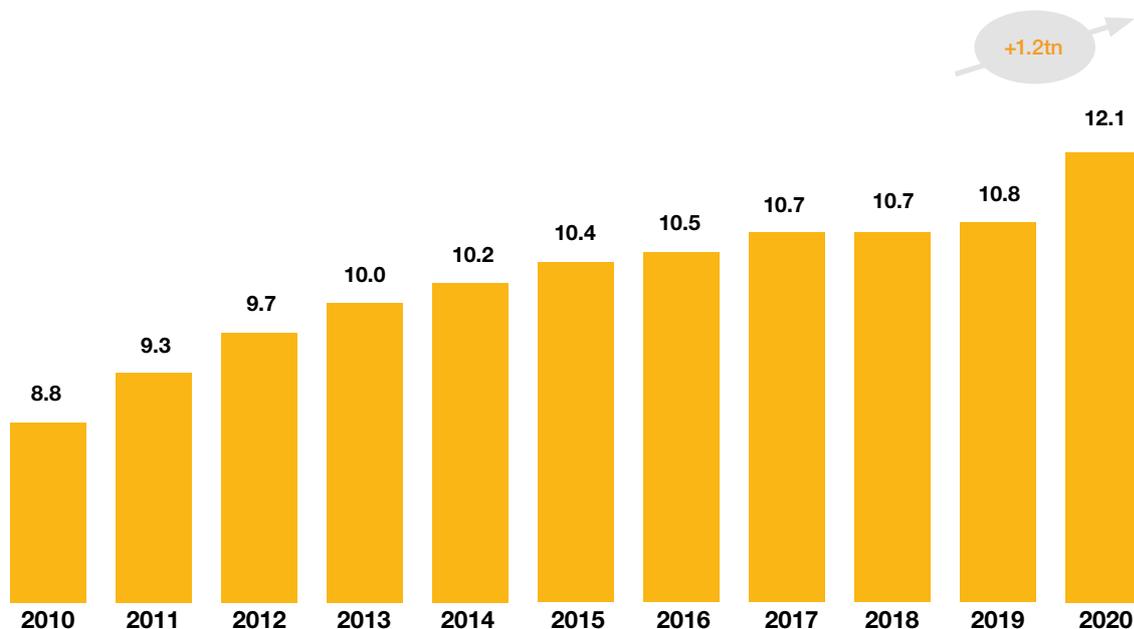
The aforementioned shift in societal psyche has urged a primary rethink of the global policy agenda, with actors worldwide undergoing concerted efforts to develop policies aimed at supporting the transition towards a cleaner, more sustainable economy. The UN SDGs and the Paris Climate Agreement, in particular, inaugurated a new era of policy; one in which sustainability is viewed as essential to attaining global parity and prosperity.

These initiatives have shone the spotlight onto the instrumentality of policymaker action in mitigating sustainability risks like never before, in turn triggering a wave of region-specific policy efforts. European policymakers, in

particular, have strongly positioned themselves as the flag-bearers of this shift through the development of actionable plans aimed at tackling sustainability challenges (especially those related to climate risk). The EU Green Deal – which aims at transforming the EU into ‘an economy with net-zero greenhouse gas emissions’ by 2050 – likely represents the regions’ most ambitious transitional effort in this regard.

Given the scale of these initiatives, and the significant transformation that is required to achieve them, it is no surprise that their successful completion will require an unprecedented level of capital mobilisation – with the EU Green Deal alone requiring investments in excess of EUR 1.0tn. The sheer scale of this required investment is urging for financing sources outside of the public sphere, especially amid mounting public debt levels – which have been further aggravated by the massive fiscal challenges brought about by the COVID-19 pandemic (cf. exhibit 9).

Exhibit 9: EU-27 Government debt levels (EUR tn)



Source: PwC Global AWM Market Research Centre, Eurostat

This has seen governments drawing initiatives aimed at mobilising private capital in order to ensure that these transitional efforts materialise. In fact, the EU Commission has recently launched a new Sustainable Finance Strategy aimed at facilitating the channelling of private capital into sustainable economic activities. This initiative is directly linked to the Green Deal's objective of achieving a carbon-neutral economy by 2050.

In this context, the sheer magnitude of the AWM industry puts its players in a particularly privileged position to 'step in' and help fund the ESG agenda set by governments. Within AWM, Private Market players' ability to quickly deploy vast amounts of capital towards specific targets – coupled with the industry's record dry powder levels – renders it particularly conducive to spurring change.



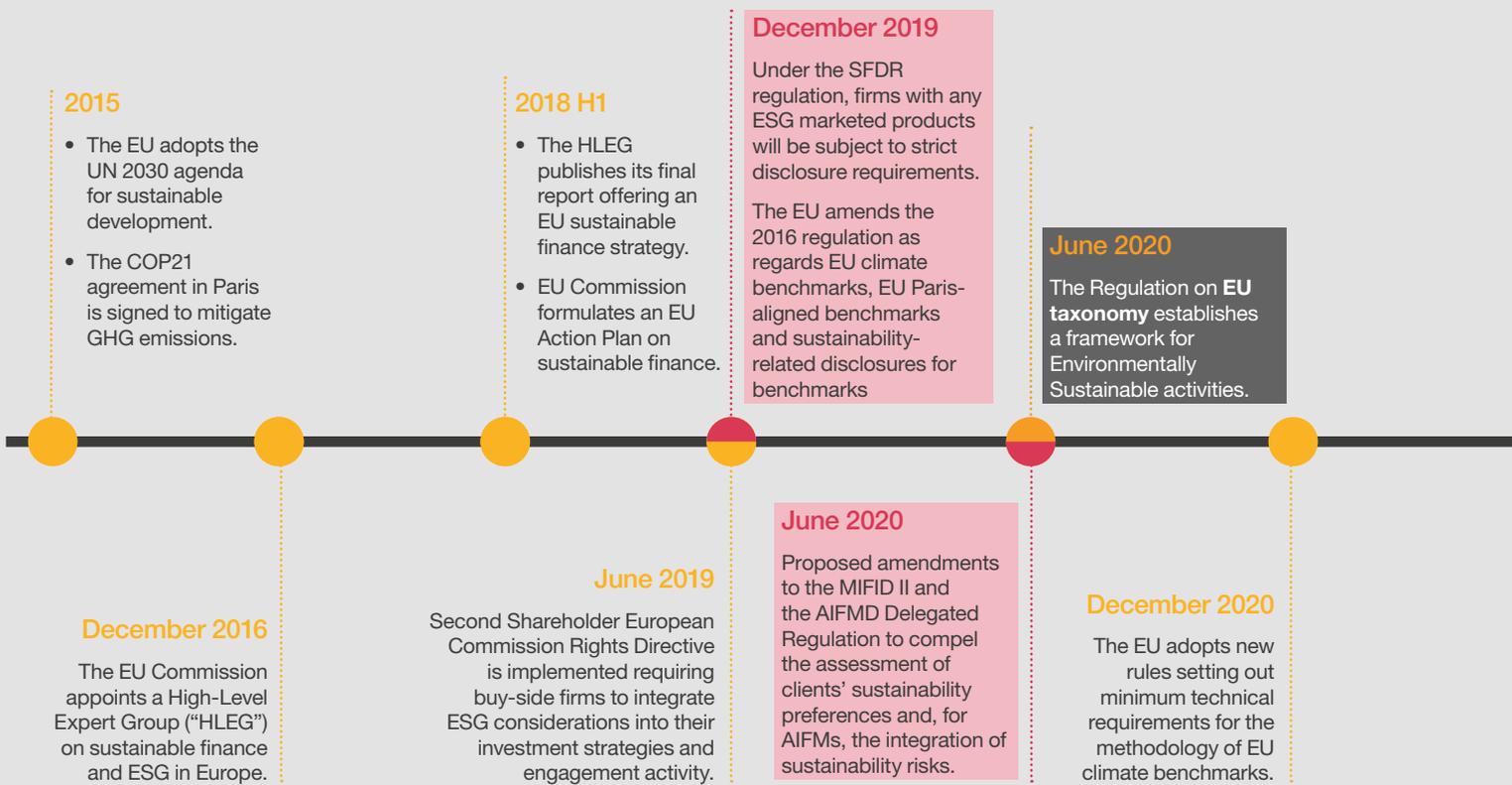
1.1.3.2 Regulatory changes

As policymakers awaken to the point that they need private sector capital in order to attain sufficient financing, they have been calling on the FS industry’s support to make this shift towards a sustainable future. The EU’s strong regulatory momentum towards ESG is the wind pushing the ESG wave towards the shores of the region’s Private Markets. Attempts to codify ESG principles have been a long time coming, with the 21st century witnessing mounting efforts to institutionalise ESG and contribute to sustainability goals. However, these have historically been limited to voluntary and non-binding initiatives that carried little to no obligatory weight. Recent years, however, have seen the EU take a far more hard-line approach to cementing sustainability within its financial ecosystem; significantly rigidifying its regulatory and legislative structure with respect to ESG.

“ Across Europe, particularly in the Nordics, it already feels that ESG is mandatory in Private Markets – there is no ‘way out’ for ESG-cynical GPs

Global Head of Product, Global Asset Management firm

Figure 2: Regulation timeline





March 2021

The main provisions (Level 1) of the SFDR enter into application and the more detailed disclosure requirements relating to the RTS (Level 2) are drafted

01/01/2022

Application date of Taxonomy technical screening criteria for the environmental objectives:

- Climate change mitigation;
- Climate change adaptation.

2022

1st reporting deadline SFDR PAI product statement
1st SFDR and Taxonomy reporting

H1 2021

Proposal of the Sustainable Finance Package, comprised of:

- The EU Taxonomy Climate Delegated Act;
- A new Corporate Sustainability Reporting Directive (CSRD) and;
- Six amending Delegated Acts including the proposed changes to the MIFID II and the AIFMD

30/6/2021: Principal Adverse Impact of investment decisions on sustainability factors (SFDR) at the entity level.

Adoption of the Renewed Sustainable Finance strategy.

1/7/22

Application date of RTS detailing the SFDR and Taxonomy requirements “Single rulebook” (Level 2)

Aug./Nov. 2022

Application date of:

- MiFID II amendments;
- UCITS / AIFMD amendments;
- IDD amendments;
- Solvency II amendments.

30/12/2022

Principal Adverse Impact of investment decisions on sustainability factors (SFDR) at the fund level.

01/01/2023

Application date of Taxonomy technical screening criteria for the other of the environmental objectives.

In recent years, the European Commission has begun to implement a comprehensive framework of new regulations and amendments to existing regulations with the sole aim of embedding ESG and sustainability considerations at the heart of Europe's financial landscape. In doing so, the regulator is urging an unparalleled shift from suggested, voluntary initiatives towards mandatory, binding ones - largely taking the decision to consider ESG risks or sustainability contributions out of managers' hands and into those of their investors. This accelerating regulatory momentum has seen ESG evolve from an optional consideration to a structural commitment, an era-defining evolution which may ultimately see ESG and sustainability emerge as the new standard for investing in the EU investment landscape.

By implementing the harmonisation and standardisation of ESG-related definitions and metrics, the EU Taxonomy and Sustainable Finance Disclosure Regulation (SFDR) quite possibly represent the European Union's most transformational ESG regulatory efforts (cf. figure 3) since the introduction of the UCITS and AIFMD standards. As these take hold, and players adjust their operations in accordance with their provisions, we strongly believe that the investment landscape of tomorrow will be near unrecognisable to that of today.

Figure 3: SFDR & EU Taxonomy – Objectives and challenges

	SFDR	Taxonomy
Objectives	<ul style="list-style-type: none"> Introduces sustainability disclosure obligations for: <ol style="list-style-type: none"> Issuers of financial products towards end-investors regarding the integration of sustainability risks; and Financial advisors in relation to their investment processes. Additional obligations apply to products that “promote, among other characteristics, environmental or social characteristics” or that have “sustainable investment as their objective”. Also includes disclosure obligations regarding the adverse impacts of an investment decision/advice. 	<ul style="list-style-type: none"> Establishes an EU-wide classification to provide investors and financial market participants with a list of environmentally sustainable economic activities. An activity must satisfy the following: <ol style="list-style-type: none"> Must contribute substantially to one of the pre-specified six environmental objectives; Must do no significant harm to any of the other listed environmental objectives; and Must comply with minimum safeguards.
Challenges	<ul style="list-style-type: none"> The ratification of the SFDR has taken place prior to that of the RTS, which has left certain managers struggling to categorise their products, increasing the risk of inadequate implementation or misclassification. Another concern is that of over-regulation, insofar that managers will incur a significant increase in costs in order to comply with the data-challenging and potentially onerous SFDR requirements. The disclosure requirements are imposed at the fund level before being imposed at the portfolio company level, leading to the risk of asymmetry and unreliability of ESG data. 	<ul style="list-style-type: none"> Once technical standards are ready, in-scope AIFMs will not have much time to prepare the mandated disclosures. AIFMs fundraising through 2021 must be especially conscious of deadlines to ensure that pre-contractual disclosures can be made before closing. Investment processes and policies must be reviewed accordingly. Leveraging technology or partnering with data science firms can help facilitate ESG assessments and reporting process. AIFM's will be required to report on Taxonomy alignment before such reporting requirement being imposed on portfolio companies.
Actions/ Opportunities for GPs	<ul style="list-style-type: none"> Poised to stimulate an industry-wide active management of product range/offering towards Art. 8 and Art. 9 products. Supports GPs and investors alike in the identification of new themes and opportunities in terms of investment strategies. Alpha creation focusing on sustainability “transition management”. Risk mitigation focusing on ESG/sustainability harm exclusions or limitations as well as active risk management involvement. 	

The changes brought about by the SFDR and EU taxonomy will have important, multi-faceted implications for the business models and product offerings of fund managers; essentially transforming ESG integration from a 'nice to have' to 'do or die'. This is already impacting GPs, with 29.8% of our survey respondents cited regulatory developments as one of their primary drivers for revamping their investment processes with respect to ESG (cf. exhibit 10, left).

In the same breath, however, regulatory compliance also represents a hindrance in many GPs' ESG integration processes, with over half of our respondents highlighting regulatory compliance as the main challenge they faced in the ESG integration process (cf. exhibit 10, right). This is largely attributable to the inherent complexity of these regulations, given the sophisticated level of assessment testing required to attain regulatory compliance. In addition, the GPs who opt to launch ESG funds (or reclassify their

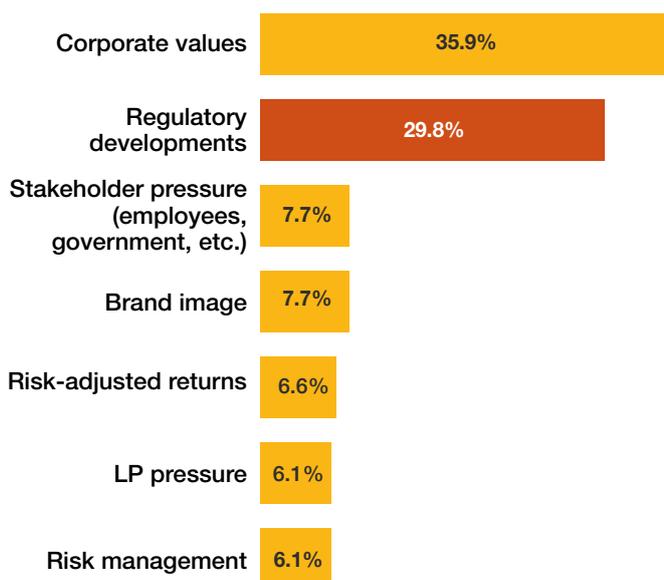
legacy funds as such) are likely to incur higher costs as a result of heightened data requirements in order to monitor and assess their ESG impacts. This may disproportionately impact smaller players, as they are generally less well-equipped in terms of internal resources and cost-absorbing capabilities. Despite this, we strongly expect that regulations will represent less of a hurdle to ESG integration in the medium and long-term, as costs are absorbed and the upcoming implementation of technical standards provides much needed clarity.

“ We know that, from 2022 onwards, a product shelf lacking in Article 8 products will struggle to draw investors

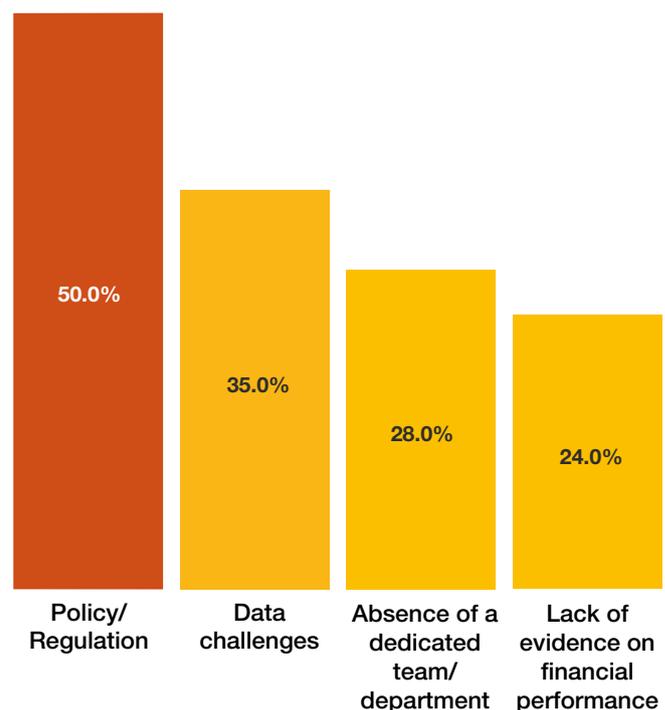
Head of ESG & Sustainability, European Private Equity firm

Exhibit 10

What is the main driver in the adoption of ESG in your investment process? (GPs)

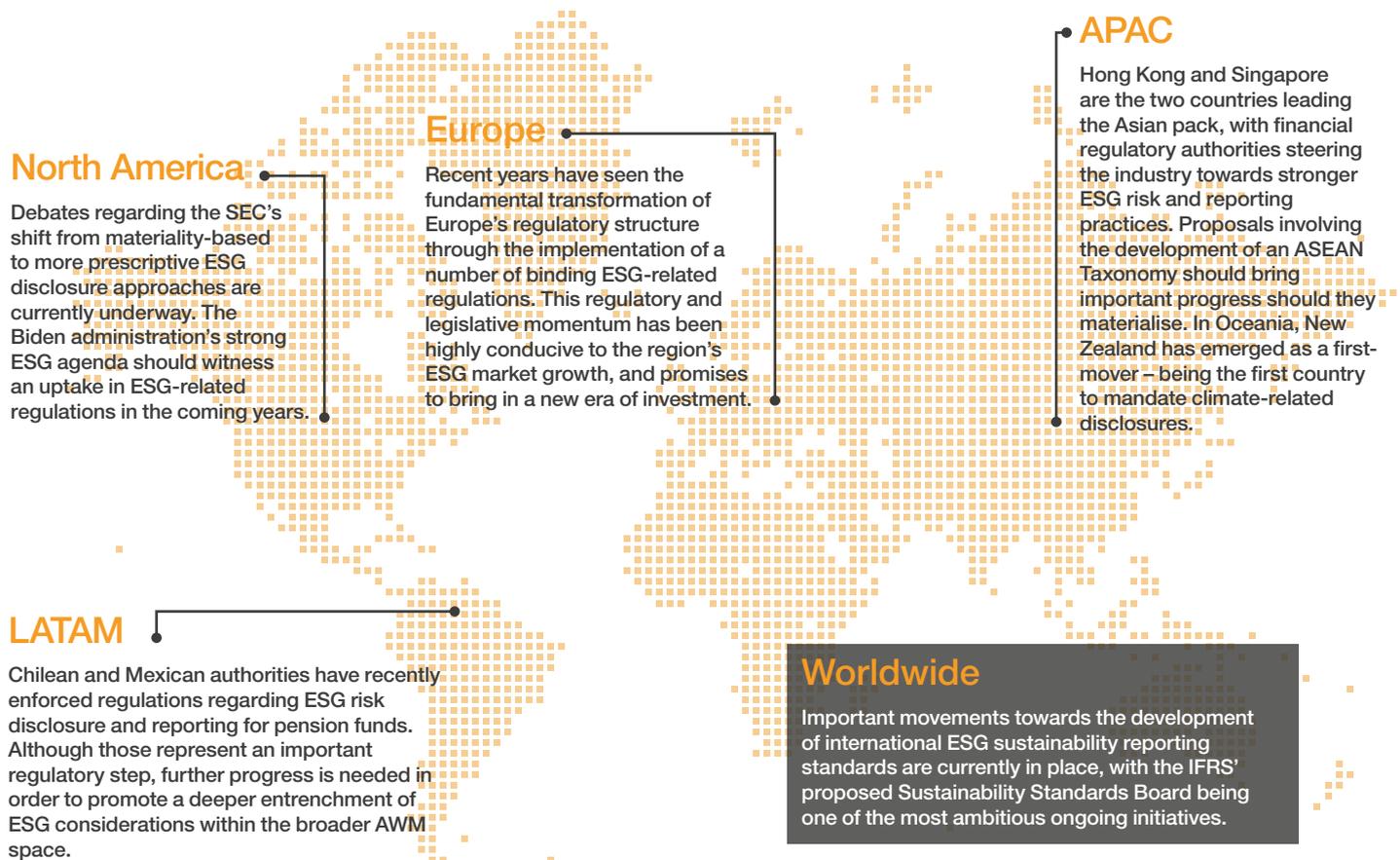


What are the main challenges when adopting ESG? (GPs)



*Multiple answers possible

Source: PwC Global AWM Market Research Centre

Figure 4: Worldwide ESG-related regulatory developments

Source: PwC Global AWM Market Research Centre

Although Europe inarguably stands at the forefront of the ESG regulatory revolution, the regulatory rally towards a more sustainable standard for investing is by no means an EU-specific trend – with other regions also aiming to promote a 'ESG-fication' of their respective financial landscapes (cf. figure 4). Europe's status as a driver of regulatory momentum, however, has seen other regions using European standards to ratify comparable ESG-related initiatives (with the ASEAN Taxonomy, for instance, drawing largely on its EU counterpart). These novel regulatory developments are set to shape the opportunities, risks and threats that PM players will face in virtually every region.

However, given the AWM industry's global nature – and the fact that societal and environmental risks transcend physical borders – a truly universally accepted set of sustainability standards is necessary to guide the financial landscape towards a unanimous vision of what a sustainable future entails and which actions must be taken for it to materialise.

The IFRS foundation's proposed 'Sustainability Standards Board' – aimed at the development of a set of standards to improve the comparability and consistency of corporate sustainability reporting on a global scale – represents quite possibly the most far-reaching attempt to promote the harmonisation and entrenchment of sustainability standards and metrics in the global financial system.

In summation, changes brought about by the global regulatory rally stand to primordially restructure the entire global PM landscape, bringing sustainability considerations to the centre of any and all decisions. Europe's status as the leader of this revolution will urge European-operating GPs and LPs to swiftly and thoroughly revamp their operations and product ranges in order to ensure that they not only survive but thrive in this rapidly changing landscape.

Regulatory changes: Implications for the industry

Looking forward, the global shift from voluntary to binding ESG-related regulation is set to change the rules of the value creation game. This will have multi-faceted implications not only on the future Private Markets landscape, but on the entire Financial Services ecosystem of tomorrow. In this new landscape, ESG integration will represent an absolute must-have for managers seeking to future-proof their operations and attract investors.

Regulatory developments draw a new baseline of standards

- The shift from voluntary to binding ESG-related regulation is drawing a new baseline of non-financial standards for AWM players. The implementation of the SFDR, for instance, has seen certain GPs treat Article 8 funds as a 'minimum offering' standard to their clients.
- As regulations evolve and ESG becomes increasingly embedded – and mandatory – within the PM space, players best suited to thrive will be those that not only comply with these new standards but that also choose to splice ESG considerations into their organisational DNA. The key in the first phase of the ESG transition is to take all necessary efforts to not lag behind. However, in order to emerge as a trend setter and win market share, a more active management of these new standards will be required.

Regulatory developments move towards double materiality

- Recent and upcoming developments have been evidencing EU regulators' commitment towards the incorporation of 'double materiality' concepts in their regulatory endeavors.
- This shift from traditionally 'narrow', financial-based definitions is set to reshape – both directly and indirectly – AWM players' approach to materiality.
- Given Europe's status as a 'trend-setter' in the ESG regulation sphere, these developments could inspire other regions' regulators to follow suit.

ESG standards to become a 'global standard'

- Novel regulatory developments are also laying a foundation for ESG standards to become increasingly extra-territorial – e.g., with the EU Taxonomy making non-EU AIFs marketed in the EU subject to its mandatory disclosures. Subsequently, we will likely see international regulation following the EU example, particularly in light of mounting global political commitments towards tackling ESG and sustainability issues.
- As regional regulations become increasingly stringent and as efforts towards the development of global ESG standards intensify, PM players – especially those willing to compete at a global level – will be increasingly pushed towards an all-encompassing alignment of their products and operations with ESG.

Regulation promoting transparency in Private Markets

- By enforcing ESG and sustainability-related disclosures, novel regulatory developments have been promoting a veritable shift towards the transparency of non-financial metrics.
- While these represent a veritable milestone for the whole AWM universe, they are especially 'ground-breaking' within the traditionally 'opaque' PMs – and could serve to alleviate the long-standing perception of PMs' incompatibility with ESG.
- As stakeholders' appetite for transparency increases alongside regulatory pressures, PM players willing to go beyond minimum transparency requirements are set to gain considerable competitive advantage.

Creating value in an increasingly sustainability-oriented investment environment

- The increased importance attributed toward addressing ESG risks and contributing towards sustainability goals has exerted mounted regulatory pressure on GPs and LPs, who must subsequently absorb additional costs and exert additional effort in order to attain compliance and remain relevant.
- That being said, the consideration of ESG excellence and sustainability contributions (or the transition thereto) is opening up a value creation opportunity of unparalleled proportions for PM investors and GPs alike. In fact, turnaround and transition management is at the heart of the Private Markets' value proposition, offering a new dimension for value creation and investment selection.

1.1.4 ESG’s value creation and risk mitigation

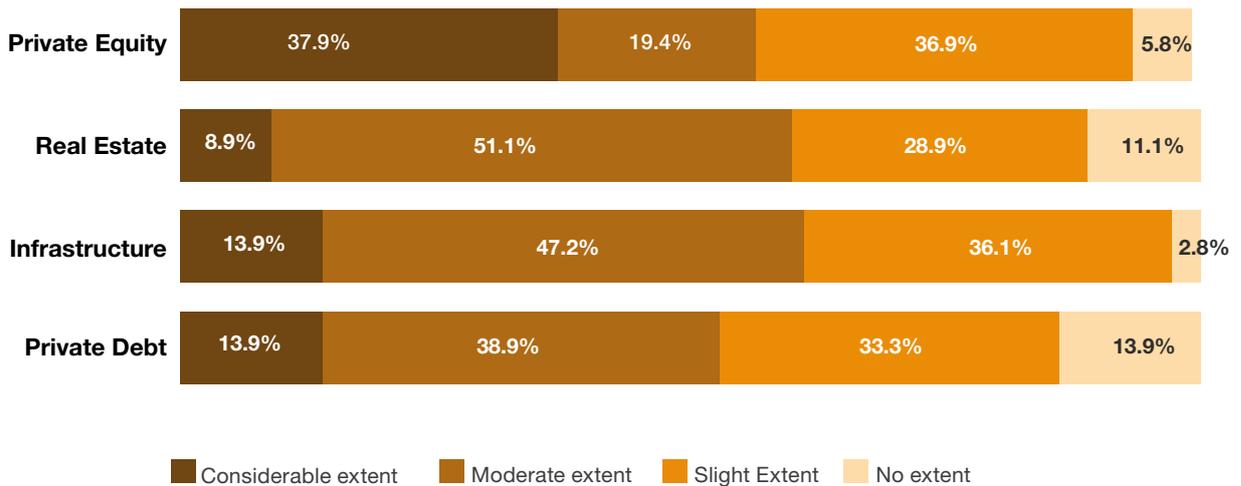
The widescale ESG shift that is taking place across European Private Markets is not solely being propagated by external drivers; with GPs also increasing their ESG focus of their own volition. This is perhaps best explained by the increasing cognisance that ESG is not solely a box ticking exercise or niche strategy but is in, fact, material to businesses and operations – both in terms of protecting existing value and uncovering previously uncharted value creation opportunities.

The perceived value of ESG within the PM realm was initially limited to its role as a compliance exercise or niche strategy for more ESG-oriented industry ‘outliers’. It was not until recently that ESG and sustainability has begun to be recognised as a genuinely material matter, with tangible risk and value impacts on businesses and operations.

The initial recognition of ESG’s materiality, however, was largely centred around the perception that foregoing ESG considerations could lead to some type of loss – primarily in the form of reputational or financial damage on GPs, LPs and underlying corporates. This perception stemmed primarily from ESG-oriented entities’ strong degree of adaptability and constant surveillance of ESG risks, which rendered them particularly resilient to market, industry and reputational downturns. These risk-related impacts are also at the heart of regulations and considerations in terms of prudential capital requirements for financial markets intermediaries.

Our survey results highlight the extent to which GPs capitalise on ESG’s ‘risk mitigation power’, with over half of our respondents using ESG as a downside risk mitigation factor to either a ‘considerable’ or ‘moderate extent’ (cf. exhibit 11). Similarly, 41% of LPs cited ESG’s risk mitigation features as their primary motivator to integrate ESG into their investment methodologies.

Exhibit 11: To what extent does your company use ESG as a downside risk-mitigation factor? (GPs)



Source: PwC Global AWM Market Research Centre

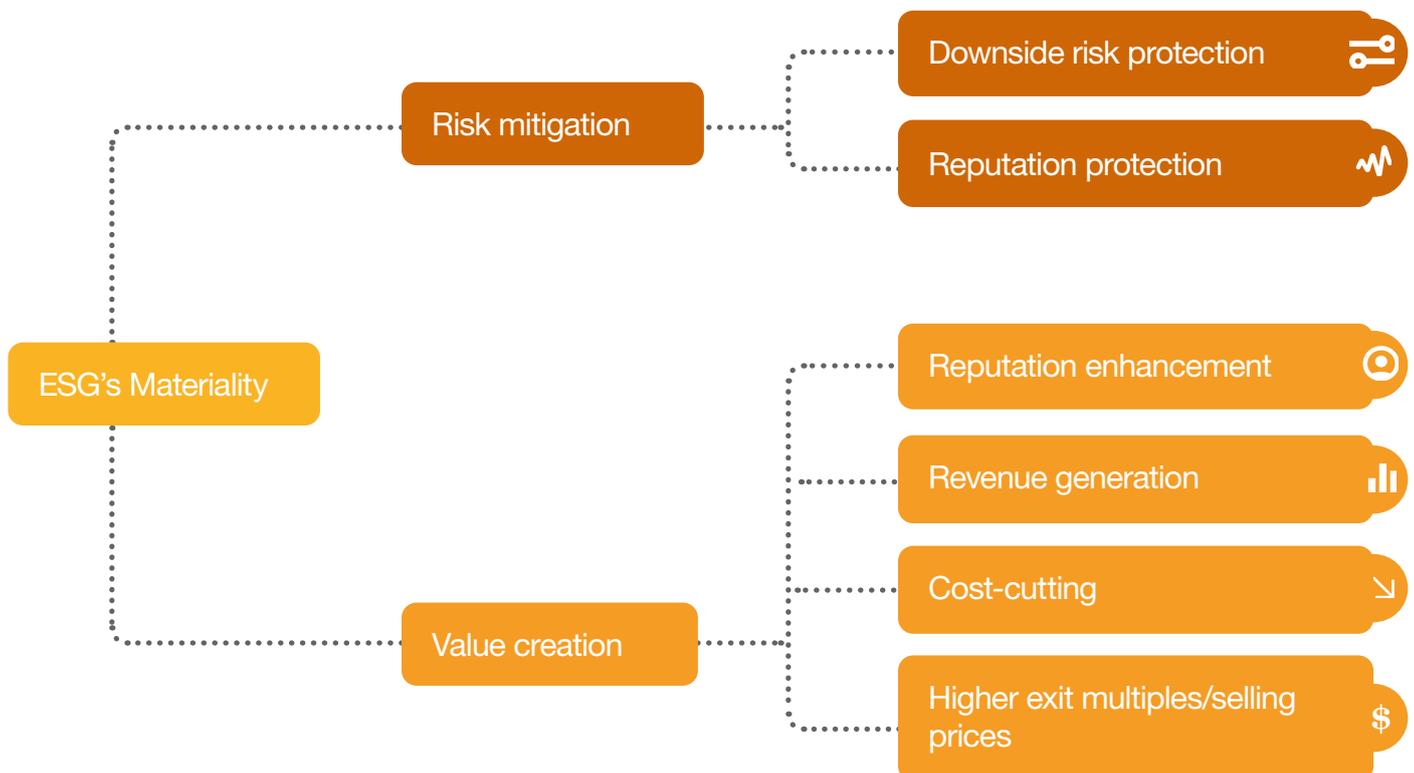


The pandemic, in fact, has strongly attested to ESG’s risk mitigation power, with private ESG funds – unlike their non-ESG peers – showing no signs of fundraising deceleration during H1 2020. Likewise, in the traditional realm, non-ESG funds witnessed considerable outflows amidst the pandemic while their ESG equivalents continued to register significant inflow activity.

While ESG’s risk mitigation potential cannot be understated, recent years have seen industry players wake up to ESG’s

power to prevent losses *while simultaneously unlocking value*. There has, therefore, been an increased recognition that the effective implementation of ESG not only *protects* value but also actively *creates* it – be it through enhanced reputation or tangible financial gains. While this dimension is not formally acknowledged by the regulator, the EU’s formal goal to ‘re-orient capital flows towards more ESG or sustainable economic activities’ hints at an increased institutional recognition of ESG’s value creation potential.

Figure 5: ESG materiality: Value protection & Risk mitigation



In this context, the entrenchment of ESG values in a given entity’s operation can reap the following benefits:

Reputational enhancement: while disregarding ESG can lead to reputational damage, its effective incorporation can also prove instrumental in boosting branding and reputation. As sustainability considerations rise up the list of society’s priorities, it follows that strongly ESG-oriented companies/assets will become increasingly well-perceived by the wider customer base.

Revenue generation: companies/assets which boast strongly ESG-centric operations and product offerings not only stand to generate strong levels of societal good will but are also able to meet the demands of ESG-focused markets and customers that are unsatisfied by their non-ESG competitors. This, combined with customers’ increased propensity to pay a ‘green premium’ for products, can ultimately translate into heightened revenues.

Cost-cutting: the integration of sustainability considerations can lead to important operational savings (e.g., through reductions in water, power and waste expenditures). Although the initial investments required may dissuade players from undergoing ESG integration, these costs will be offset in the medium- to long-term as ESG boosts operational efficiencies and streamlines daily activities. Besides, as governments and policymakers put an increased cost on non-sustainable activities (e.g., through carbon taxes or more restrictive lending conditions, etc), this cost-cutting feature is set to become increasingly evident. The combination of ESG’s revenue-boosting and cost-cutting features ultimately translates into a unique opportunity to attain strong and sustained profit margins.

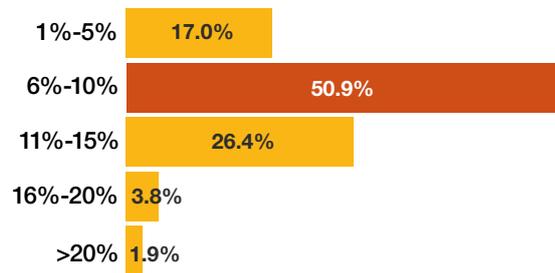
In light of this, it comes as no surprise that prospective bidders/buyers are more willing to absorb the ‘ESG premium’ or ‘transition discount’ during the acquisition stage - ultimately translating into higher exit multiples for GPs and, consequently, into enhanced returns for LPs. Although the exact impact of ESG and non-ESG aspects on valuations are difficult to disentangle from one another, our survey results strongly attest to GPs’ recognition of ESG’s impact on exit multiples. Within PE, over 50% of GPs witnessed exit multiples between 6% to 10% higher after embedding ESG within their investment life cycles; with more than 25% suggesting this increase to range between 11% and 15% (cf. exhibit 12). Real Assets GPs witnessed even higher ESG premiums, with almost one quarter of Infrastructure GPs estimating green infrastructure prices to surpass their non-green equivalents by more than 15%. In the real estate realm, almost half of surveyed GPs estimate green buildings’ premiums of around 6%-10%, and almost 30% suggest these to range between 11%-15%.

The value creation opportunities for GPs are not solely confined to higher exit multiples at the portfolio level. By anchoring ESG values within their own organisational philosophy, GPs also stand to see analogous benefits to their own brand, reputation and cost synergies. However, the change towards sustainable business activities and ESG standards will not happen instantly. As such, the main task at this stage in the ESG shift is to ‘transition’ the economy and businesses and transform their value chain to consider ESG standards and substantially contribute to a sustainability goal. This transition management is formally recognised by the EU Taxonomy.

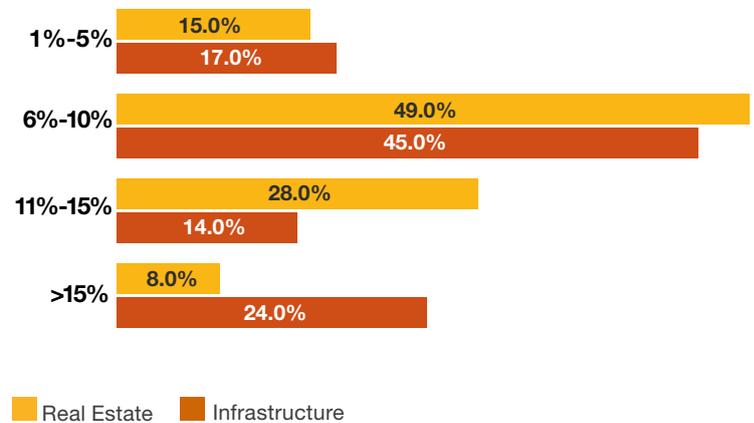
Finally, by mitigating negative externalities and generating (and rewarding) positive ones, employing ESG as a value creation tool not only has the power to generate heightened returns for GPs and LPs but ultimately translates into added value for society overall.

Exhibit 12

By approximately how much did incorporating ESG into the investment cycle yield high exit multiples? (PE GPs)



What is the approximate premium applied to the price of green real estate/infrastructure? (RE and Infra GPs)



Source: PwC Global AWM Market Research Centre

ESG's value protection & risk mitigation: Implications for the industry

Traditional value creation levers will no longer suffice

- As the PM environment grows increasingly competitive and valuations reach all-time highs (especially within PE), GPs will be increasingly required to look outside the box, going beyond 'traditional' cost-out/financial engineering solutions in order to create value.
- In this context, using ESG as a value creation tool will not only bear reputational or compliance benefits, but will soon stand as a 'do-or-die' type of matter. In a similar vein, failure to embed ESG considerations could also translate into increasingly higher capital costs – or even blocked access to finance – for portfolio companies and GPs alike.

Premium gap between ESG and non-ESG will continue to widen

- As the regulatory dust settles and players adapt accordingly, the incorporation of ESG will become so deeply entrenched in investment decisions and portfolios that non-ESG assets will be regarded as truly unattractive; ultimately losing value.
- As the discount on these increases, the spread between ESG and non-ESG assets will continue to widen. Even if the premium on the former increases only moderately, the discount on the latter is deemed to be such that the discrepancy between the two is poised to widen as time progresses.

Regulatory compliance will increasingly determine exit valuations

- As ESG develops within the PM realm, exit valuations will not only be determined by GPs' capacity to leverage on ESG to create value, but also by the extent that underlying assets/companies align with regulatory requirements – especially with the EU Taxonomy.
- Those that, by the end of the holding period, fail to comply with existing regulations will likely witness their exit valuations – as well as the number of potential bidders – decline.

Value creation strategies as a way to cater to ever-increasing LP demands

- Amid rising stakeholder and regulatory pressure, LPs are becoming increasingly demanding in their GPs' commitment to ESG. An ever-increasing share of the LP base wants their money to 'be put to good use' and propel transformation, while simultaneously generating satisfactory returns.
- In this context, leveraging on ESG in order to create value allows GPs to deliver higher returns while simultaneously generating a proven, positive impact.

Despite these drivers, GPs remain reluctant to halt non-ESG fund launches...

In response to these aforementioned drivers, European GPs are increasingly viewing their operations through an ESG lens – with 77% of the 200 GPs we surveyed voicing plans to increase their ESG AuM in the coming two years (cf. exhibit 13). This, however, has not yet reflected in the widespread intention to halt their non-ESG funds; with only 41% of our surveyed GPs intending to do so (cf. exhibit 13).

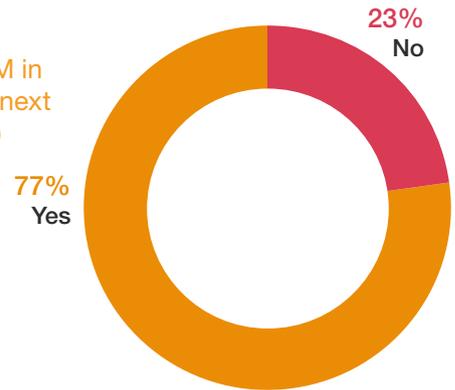
This reluctance may translate into important competitive disadvantages, as the continuous promotion of non-ESG funds alongside ESG ones may undermine GPs’ credibility in the eyes of increasingly ESG-oriented LPs. We have in fact observed a number of large LPs (particularly within the Nordic nations) completely removing non-ESG investments from their portfolio and explicitly stating their aversion to engage with GPs whose fund offerings are not purely ESG-oriented. As these first movers are generally ‘trend setters’, we expect other LPs to follow suit.

It is clear, however, that larger players are more ready and willing to undergo this change, with willingness to increase ESG AuM and intention to halt non-ESG fund offerings being disproportionately prominent among the largest GPs in our respondent base (cf. exhibit 14). These discrepancies are likely related to larger GPs’ abilities to cope up with the costs that come with the higher degrees of oversight and analysis inherently linked to ESG, as well as the regulatory and data requirements that need to be met in order to qualify funds as sustainable. Nonetheless, small GPs

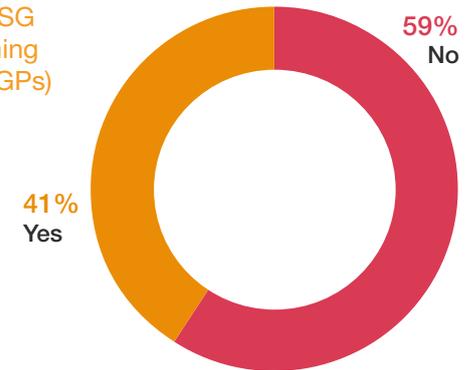
willing to fully embed ESG within their operations – thus becoming true ESG providers – are set to unlock significant opportunities by differentiating themselves in the market.

Exhibit 13

Do you intend to increase your AuM in ESG funds in the next 24 months? (GPs)



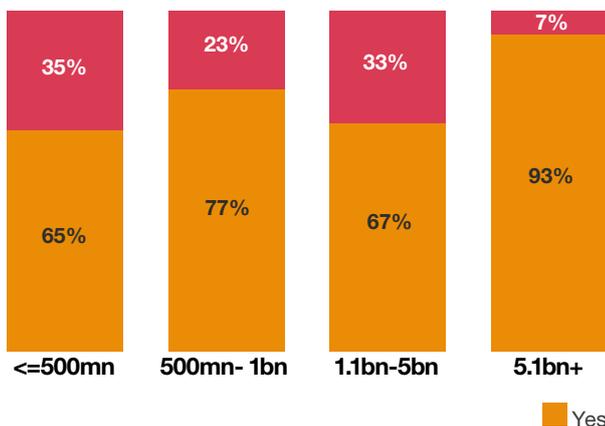
Do you intend to stop launching non-ESG funds in the coming months/years? (GPs)



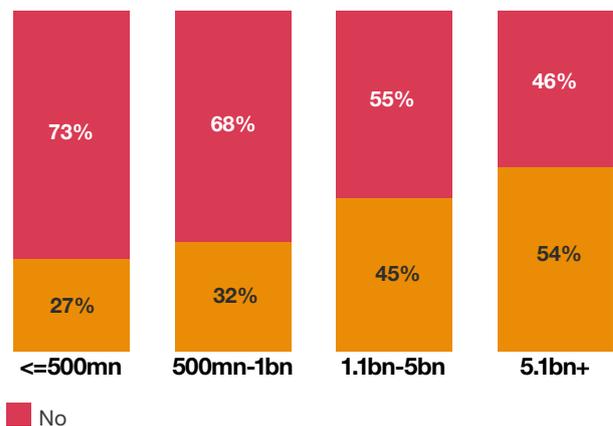
Source: PwC Global AWM Market Research Centre

Exhibit 14

Do you intend to increase your AuM in ESG funds in the next 24 months? (GPs)



Do you intend to stop launching non-ESG funds in the coming months/years? (GPs)



Source: PwC Global AWM Market Research Centre



1.2

Spotlight on asset classes

While these drivers have been catalysing a veritable ‘ESG shift’ within the European PM landscape, our analysis highlights considerable asset class heterogeneity in terms of current and expected ESG entrenchment. While Real Assets have demonstrated deeper ESG commitment, PE and PD have not yet displayed similar degrees of uptake.

The aforementioned catalysts have been stimulating a marked ESG surge within European Private Markets, with ESG assets almost tripling between 2015 and 2020. However, our analysis highlights that the penetration of ESG considerations within the industry remains limited, with Real Estate – which has long represented ESG’s most prominent and vocal ESG proponent within PM – boasting a modest 23.4% of its AuM classified as ESG as of end-2020.

This historically shallow penetration can be attributed to the relative nascence of ESG within the Private Markets industry, but also to a number of structural and perceptual challenges that have historically hindered further ESG uptake therein. Although the magnitude of these challenges varies by asset class, they are largely cross-sectional in nature.

A number of characteristic drawbacks have traditionally hindered ESG uptake within PM



Burdensome ESG KPI assessment:

- **Data shortcomings:** Private Markets’ inherent opacity has resulted in the ESG data market being traditionally skewed towards public markets. This has resulted in the data gathering process historically being left down to the GPs, who often struggle with poor data quality and a lack of ESG commitment from underlying corporates.
- **Cross-sectoral/geographical heterogeneities:** PM portfolios’ deep sectoral and geographic heterogeneity have further complicated the data collection and analysis process, preventing a ‘one size fits all’ assessment of ESG-related considerations and metrics across portfolio companies/assets.
- **Lack of consensus on relevant ESG metrics:** While the past decade has witnessed the emergence of a variety of frameworks aimed at orienting the implementation and measurement of ESG considerations (e.g. GRI) a lack of standardisation regarding which ESG aspects are the most material/relevant across sectors remains.



Perceived immateriality of ESG in Private Markets:

- **Agnosticism on ESG’s compatibility with PM:** One of the key barriers preventing greater ESG adoption by both LPs and GPs has been the preconceived notion that the ‘private’ and ‘IRR-focused’ nature of PM rendered the industry inherently incompatible with ESG, especially in the PE realm.
- **Lack of objective evidence on ESG financial materiality:** PM’s perceived incongruity with ESG was also reinforced by the belief that ESG considerations were largely financially immaterial for businesses/assets – often leading to players to forego ESG considerations altogether. Difficulties associated with the appropriate quantitative measurement of ESG-related performance reinforced this perception even further.

However, we expect these challenges to blur as current and upcoming regulations standardise ESG metrics and taxonomies – facilitating ESG integration at the fund level and rendering ESG's material impact more evident. Further,

we have identified a number of characteristics inherent to Private Markets which lead us to believe that the industry bears all the hallmarks of a fertile soil from which an ESG oriented or focused investment strategy can flourish.

Private Markets: a fertile soil for ESG to flourish

1

A 'flag bearer' of patient capital: PM's longer investment horizons accommodates the consistency and far-sightedness essential to the long-term implementation of and transition towards ESG considerations within underlying assets.

2

Deep engagement with underlying corporates/assets: GPs' direct engagement with portfolio companies/assets puts them in a particularly privileged position to promote ESG-related transformations therein, especially in comparison to their public markets' counterparts.

3

Institutional investors' prominence within Private Markets: as institutional investors face increasing stakeholder pressure to be ever-more ESG-demanding, they are increasingly urging GPs to rethink their fund offerings. This, coupled with institutional investors' cross-strategy exposure to all asset classes within PM, is set to broaden and deepen the entrenchment of ESG values within the non-traditional realm.

4

Relevance shift: PM's proven ability to deliver resilient returns may serve to remedy LP agnosticism regarding ESG's financial materiality. This, coupled with regulation and market-driven expectations, are poised to strengthen the case for the relevance of ESG and sustainability considerations. As LPs' propensity towards ESG increases in lockstep with PM's attractiveness, the case for ESG in the PM realm is expected to strengthen even further.

These features – paired with the aforementioned drivers propelling the investment ecosystem towards a more ESG-conscious standard of investing – render Private Markets particularly well-positioned to represent a bastion of ESG within the Asset Management industry. As these drivers rise in prominence and the investment community increasingly prioritises ESG impacts alongside financial impacts, we forecast European ESG PM assets to skyrocket to between EUR 775.7bn and EUR 1.2tn by 2025. We also expect to see a significantly deeper penetration of ESG considerations across the PM realm in the coming years – with Infrastructure and RE standing in the pole position, with a respective 40.6% and 33.7% of their assets being allocated towards ESG funds by 2025.

“ There's a lot you can do in the Private Markets space to be truly and directly impactful. There's plenty of opportunity.

Head of ESG & Sustainability, European Private Equity firm





1.2.1 Private Equity

Despite having grown at a CAGR of 17.8% from 2015 to reach EUR 98.3bn in 2020, PE still lags considerably behind its public and PM equivalents in terms of ESG uptake; with only 10.7% of European PE assets being allocated towards ESG funds as of end-2020.

Besides the aforementioned characteristic drawbacks which have historically limited ESG integration within PM, PE's status as an ESG laggard can largely be attributed to the long-held perception that its IRR focus renders it ultimately incongruent (or even incompatible) with ESG.

The equally strong-held misconception regarding ESG's negligible – or even negative – effects on performance has further served to reinforce this perception. The presence of small-scale boutique-like players in the PE industry (be it the portfolio companies or the PE firms themselves) has also served to hinder a further ESG uptake, as these players traditionally lack the appetite and ability to absorb the high(er) costs necessary to integrate ESG within their investment or economic activities.

Yet, these baseline conditions have altered and are set to structurally change. We believe that PE players possess the perfect toolbox to drive change and synonymise ESG and sustainability with value creation/protection; not only within Private Markets but across the entire financial landscape:

Active ownership and transition management: PE players' influence over portfolio companies' operations, strategy and governance is quite possibly the asset class' most distinguishing feature. Those that correctly leverage on this characteristic will find themselves in a uniquely strong

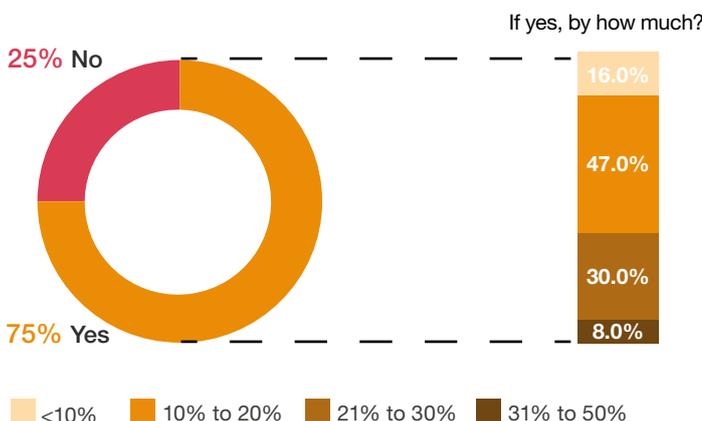
position to thoroughly and effectively drive ESG transition within underlying corporates, regardless of the initial level of ESG entrenchment they present. Such transition is directly recognised by future regulations (i.e. EU Taxonomy) and will affect the present and future value of underlying assets.

Record dry powder levels: with dry powder levels reaching an all-time high of EUR 1.7tn in 2021, PE players are particularly well-equipped to drive a 'sustainable' reshaping of the post-pandemic financial landscape. Besides, PE's ability to quickly deploy capital amid the wave of COVID-induced business disruptions represents a major opportunity for the asset class to not only help kickstart the economy but also to do so through an ESG lens.

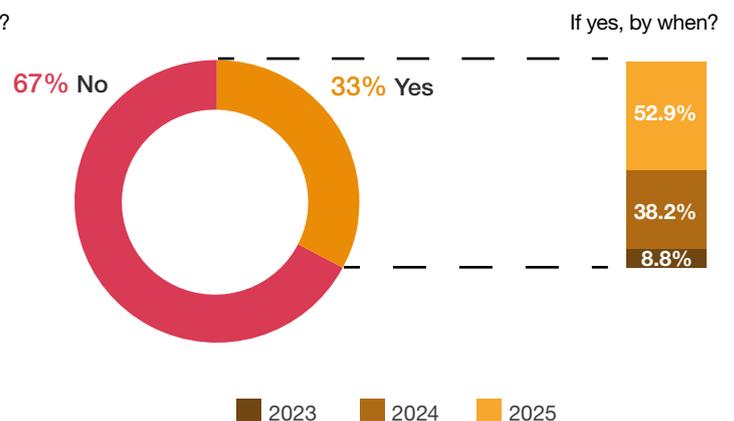
Our survey mirrors the early stages of the ESG journey in which PE players find themselves, as well as their gradual awakening to the societal and stakeholder calls for ESG integration. While less than half of our surveyed GPs have been incorporating ESG into their investments for over two years, 75% voiced plans to increase their ESG AuM in the coming 24 months, of which almost 40% target increases of over 20% (cf. exhibit 15, left). This willingness, however, has not yet translated into a commitment to halt future non-ESG fund launches; with only a third voicing their intentions to do so – the lowest response rate amongst all asset classes (cf. exhibit 15, right). While this figure seems discouraging, we believe that increased recognition of ESG's powerful value creation/protection potential, along with the ongoing ESG shift within PM should see a reversal of this trend – with an increasing number of PE players opting to launch new Article 8 and Article 9 funds.

Exhibit 15

Do you intend to increase your AuM in PE ESG funds in the next 24 months? (PE GPs)



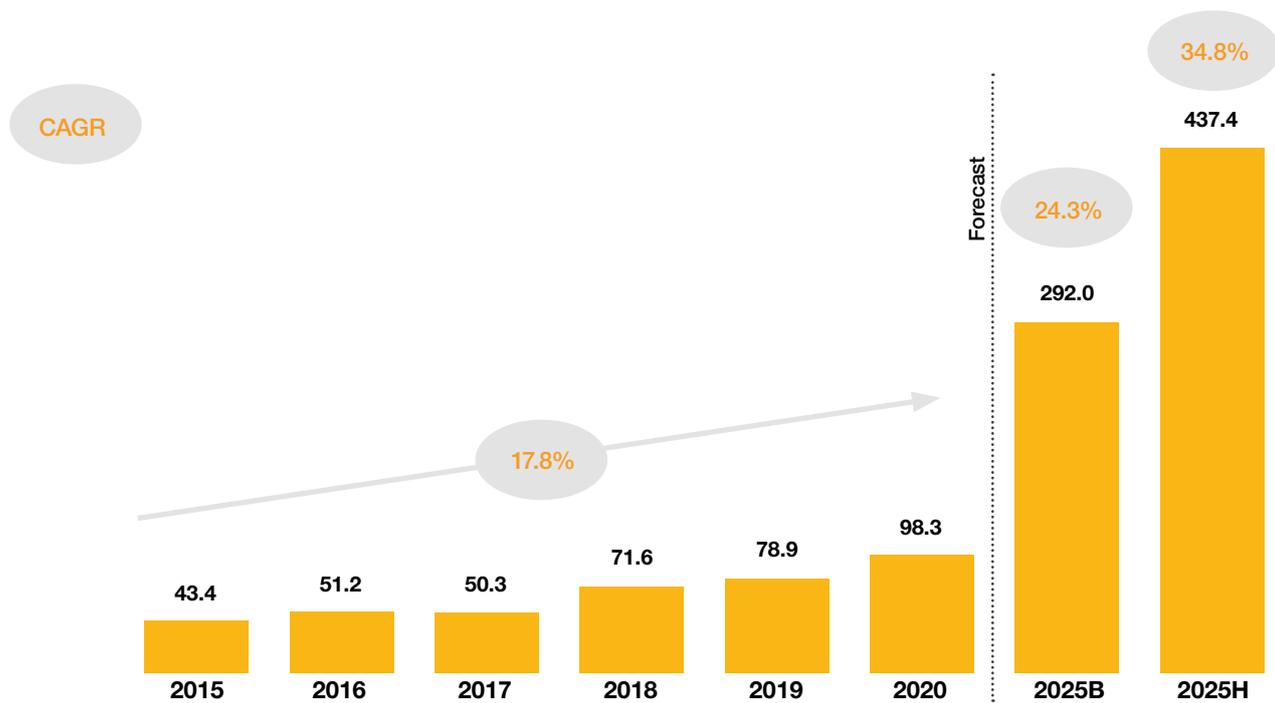
Do you intend to stop launching non-ESG PE funds in the coming months/years? (PE GPs)



In summation, while ESG has yet not redefined the PE realm to the same extent as it has public markets, we are observing the early stages of an ESG revolution – with a growing number of PE players ‘letting go’ of the long-held misconceptions that have historically dissuaded them from anchoring ESG considerations within their investment methodologies.

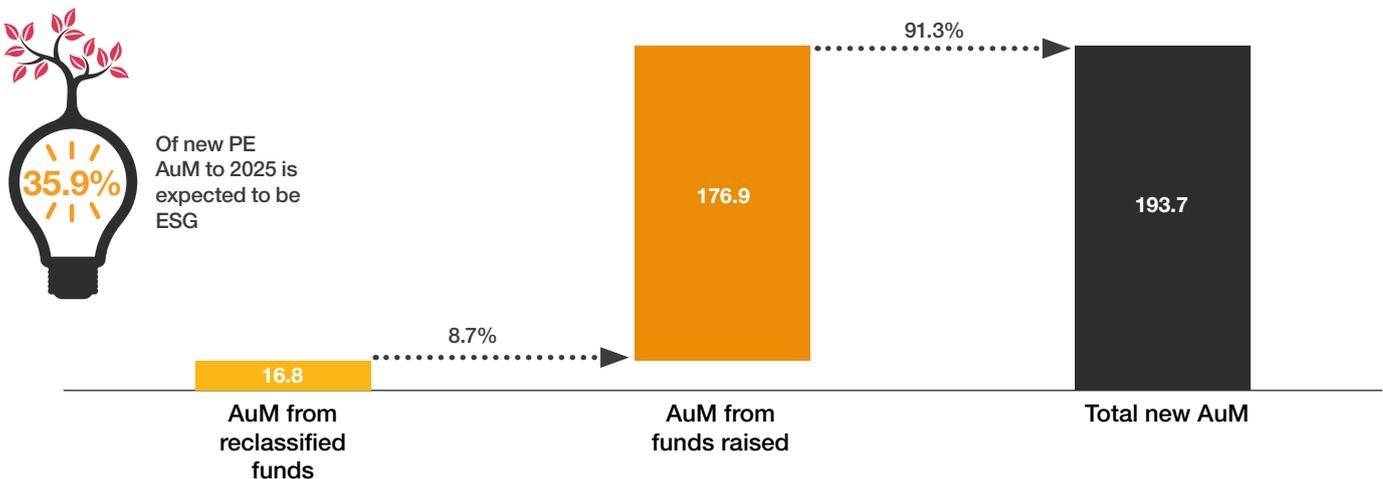
This, coupled with the aforementioned ESG drivers, lead us to expect PE ESG AuM to skyrocket to EUR 292.0bn by 2025 under a base case scenario – making up 20.7% of total PE assets (cf. exhibit 16). Over 90% of this EUR 193.7bn increase is expected to stem from new funds; representing a more than EUR 175.0bn opportunity for the most proactive GPs (cf. exhibit 17).

Exhibit 16: European PE ESG AuM: Forecasts to 2025 (EUR bn)



Sources: PwC Global AWM Market Research Centre, Preqin. ‘B’ refers to base-case forecast scenario, while ‘H’ refers to high case forecast scenario.

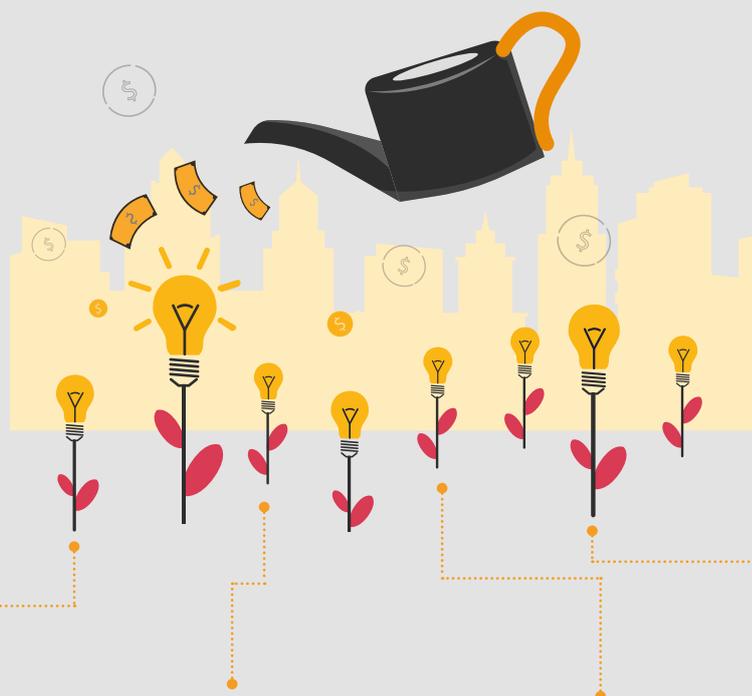
Exhibit 17: New PE ESG AuM to 2025 (base-case scenario, EUR bn)



Sources: PwC Global AWM Market Research Centre, Preqin

Private Equity through an ESG lens

We have identified a set of tools on which PE GPs can leverage in order to unlock the EUR 176.9bn opportunity, while simultaneously creating value to themselves, their LPs and the broader stakeholder base. These range from 'ESG-ifying' previously 'non-ESG' companies, all the way to acquiring sustainable businesses and benefiting from competitive outperformance.



Buy dirty, sell clean

- Identify and buy low-value businesses with large negative externalities that have already been priced in.
- Implement proven ESG turnaround strategies that significantly reduce environmental/societal costs.
- Sell at profit. Gains are set to be particularly pronounced in traditionally 'non-sustainable' businesses/sectors (e.g., coal, mining...).

Buy cleaner, outperform

- Identify and acquire 'cleaner' companies before externalities are priced in.
- Benefit from competitive outperformance as other operators battle sustainability headwinds and sell at profit.

Identify early, take to scale

- Leverage new datasets and analytics to isolate areas in which environmental and social costs are generated across the economy.
- Identify, evaluate and acquire businesses with products/services that could mitigate these costs, before their potential is visible to the rest of the market.
- Take to scale (or into new markets) and sell at profit.

Benefit from structural shifts

- Identify, evaluate and acquire businesses with products/services that substantially contribute to sustainability goals as defined in the EU Taxonomy to benefit from structural shifts of capital in the markets.
- Take to scale (or into new markets) and sell at profit.



1.2.2 Real Estate

ESG assets in the European Real Estate universe have more than doubled since 2015 to reach EUR 65.8bn in 2020. ESG AuM currently accounts for 23.4% of total RE assets – the highest degree of ESG penetration across the entirety of European Private Markets.

This deep entrenchment of ESG considerations within the RE industry's DNA is largely attributable to the tangible, high-impact nature of real estate – which alone accounts for 40% of global energy consumption and almost a third of carbon emissions. Our analysis encapsulates the extent of this entrenchment; with over 85% of surveyed GPs integrating ESG considerations into their investment processes.

Real estate's tangibility, coupled with its exposure to ESG risk, has stimulated the development of a series of well-established frameworks and initiatives aimed at identifying which ESG metrics are the most relevant/material across different real estate sectors. Despite their voluntary nature, these frameworks were largely well-received within the real estate space – largely facilitating the homogenisation of ESG standards therein. This has resulted in a degree of standardisation and codification of ESG, that has facilitated the incorporation of ESG considerations by RE players.

We expect a series of asset-class specific dynamics to further strengthen the case for ESG within Real Estate:

Rising regulatory drive towards sustainable real estate: growing recognition of the role that real estate sphere has played in aggravating environmental degradation has put the industry at the centre of policymakers' discussion surrounding the transition to a low-carbon economy. The European Green Deal, for instance, contains initiatives aimed at improving the energy efficiency of all buildings, as well as the 'green refurbishment' of existing properties.

Increased standards: past and current 'voluntary' standards calling for the integration ESG within Real Estate (such as GHG protocol Corporate Accounting and the GRESB) are set to be enhanced through the introduction of binding rules on ESG and sustainable goals and the implementation of standards/limits set for the commitments taken. As such, even in light of the relatively high level of ESG assets within the RE industry, the changes brought about by the new standards are set to be as structural and significant as those observed within other PM investment strategies.

COVID-catalysed demand for green buildings: as society becomes ever-more environmentally and socially aware, people are increasingly prone to hold higher standards and expectations as to where they live, work, or establish their businesses. This sustainability-oriented manner of thinking was catalysed during the Covid-19 pandemic which will likely witness – and continue to witness – an increased demand for high-quality, sustainable buildings.

'S&G' considerations catalysed by the pandemic: the pandemic has also highlighted governments' limited ability to address ever-widening demands for affordable housing, education and healthcare facilities. Real Estate's ability to address these shortages provide a strong opportunity for private RE players to increase their focus on the 'S&G' dimensions of ESG.

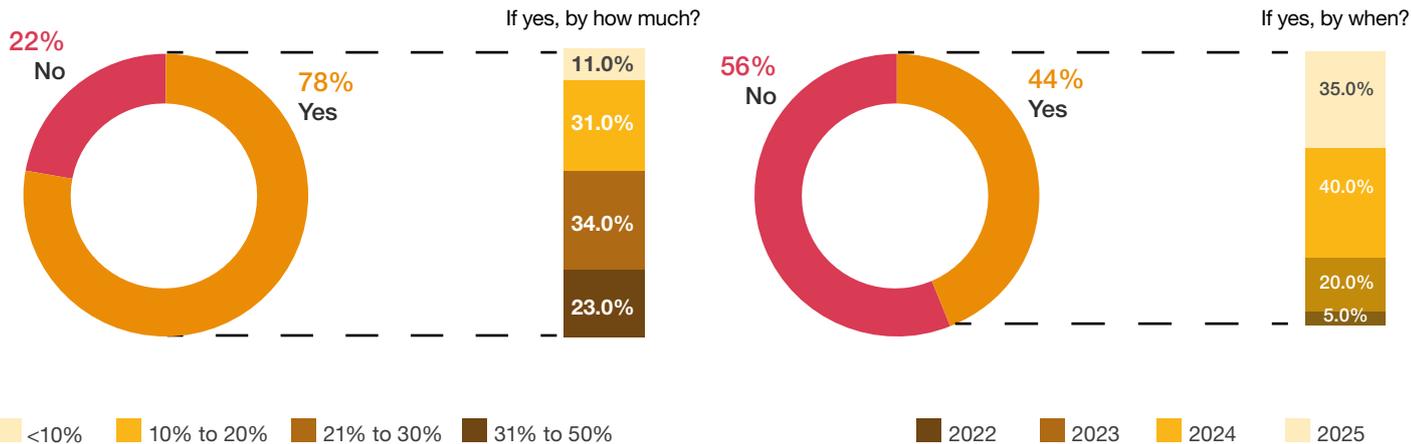
In short, as these dynamics unravel and society and its stakeholders increasingly move towards the normalisation of ESG values, we strongly believe that Real Estate players are particularly well-equipped to drive the coveted shift towards a sustainable financial landscape.

RE GPs are set to play both a proactive and reactive role in this transformation, adjusting their operations to LP and policymaker expectations while also being drivers of change themselves. Our survey results highlight the extent to which RE GPs will rethink their investment philosophies with respect to ESG, with almost 80% of our respondents intending to increase their ESG AuM in the coming two years – with the majority targeting increases between 21% and 30% (cf. exhibit 18, left). Certain GPs are set to adopt a more radical approach in the ESG transition, making ESG the status quo – with over 40% of RE GPs intending halt non-ESG RE funds altogether in the near future (cf. exhibit 18, right).

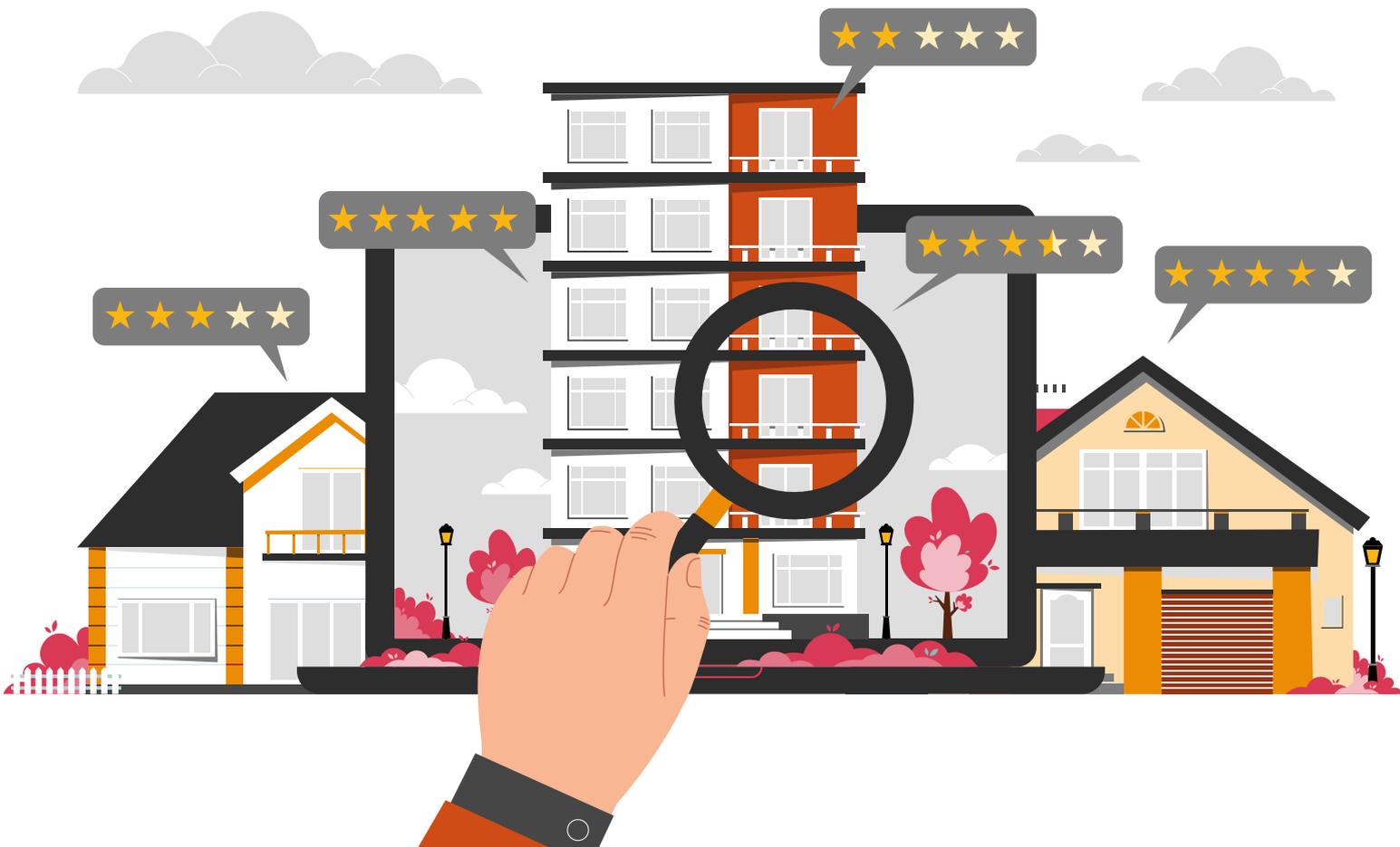
Exhibit 18

Do you intend to increase your AuM in RE ESG funds in the next 24 months? (RE GPs)

Do you intend to stop launching non-ESG RE funds in the coming months/years? (RE GPs)



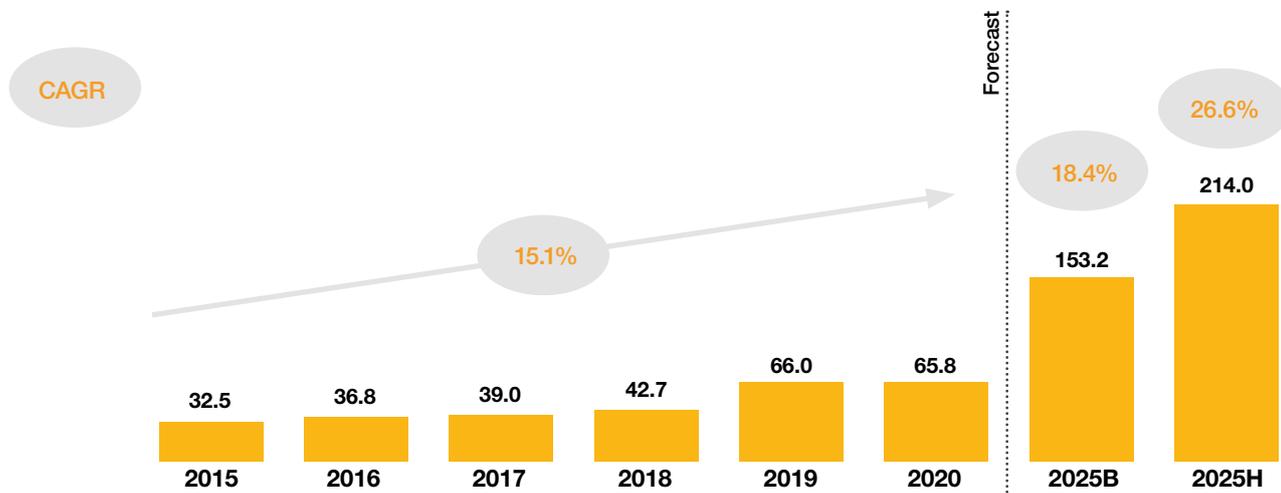
Source: PwC Global AWM Market Research Centre



In light of the above, we strongly expect the degree of ESG entrenchment in the Real Estate landscape to deepen considerably. **According to our baseline forecast scenario, RE ESG AuM is set to rise by EUR 87.4 bn in the coming five years, reaching EUR 153.2bn –**

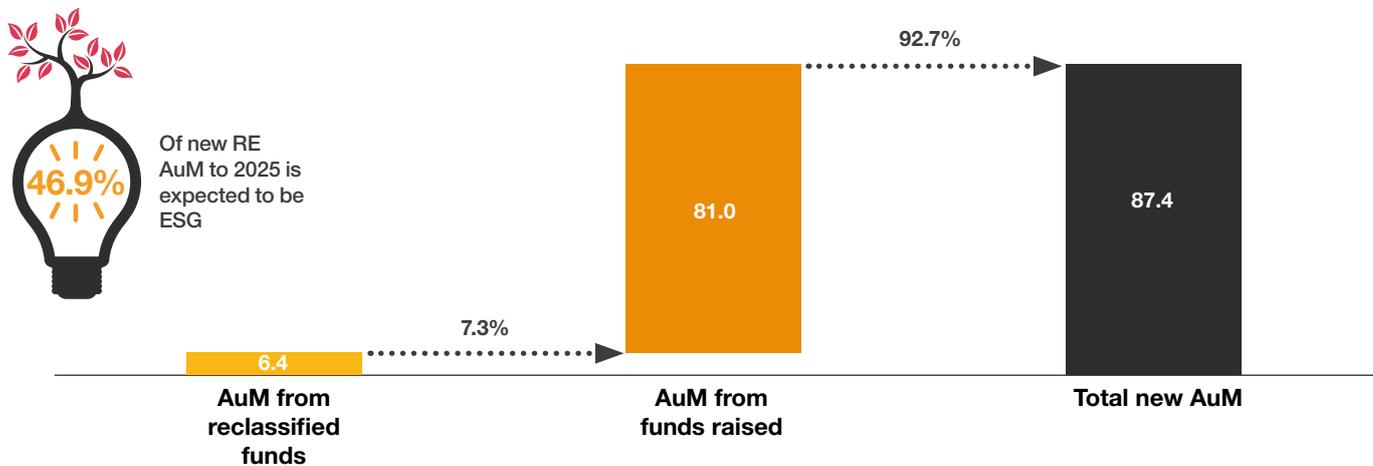
accounting for 33.7% of RE’s overall asset base (cf. exhibit 19). Furthermore, only 7.3% of this expected increase is poised to come from reclassified funds; with the remaining share representing a EUR 81.0bn opportunity for RE GPs (cf. exhibit 20).

Exhibit 19: European RE ESG AuM: Forecasts to 2025 (EUR bn)



Sources: PwC Global AWM Market Research Centre, Prequin. ‘B’ refers to base-case forecast scenario, while ‘H’ refers to high case forecast scenario.

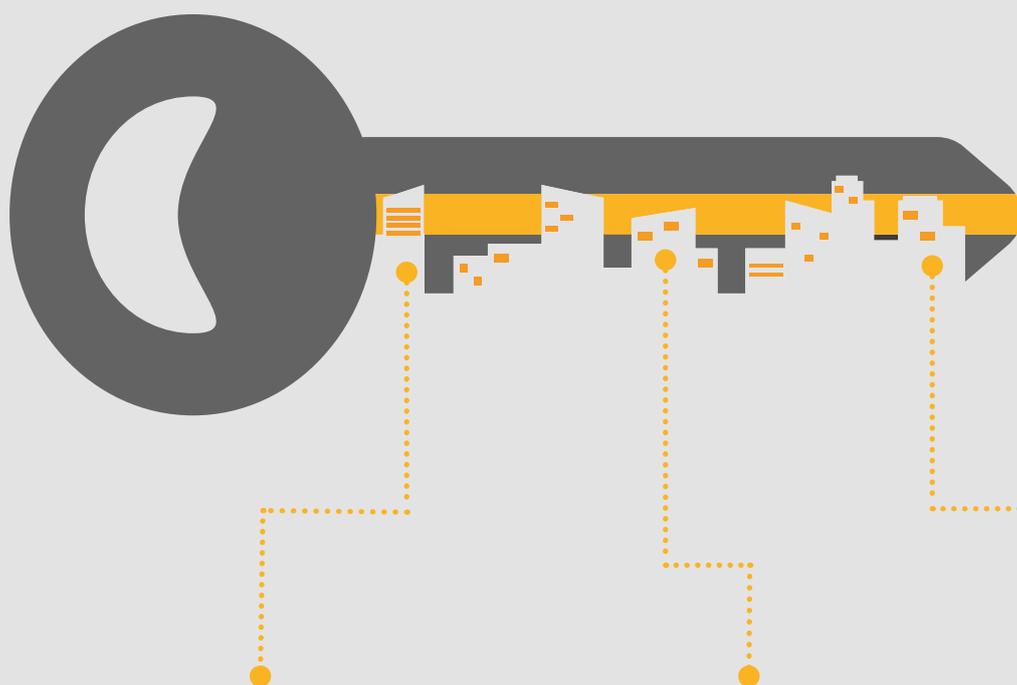
Exhibit 20: New RE ESG AuM to 2025, base-case scenario (EUR bn)



Sources: PwC Global AWM Market Research Centre, Prequin

Real Estate through an ESG lens

We have identified a set of tools on which RE GPs can leverage in order to unlock the EUR 81.0bn opportunity, while simultaneously creating value to themselves, their LPs and the broader stakeholder base.



Buy cheap, 'ESG-fy', profit

- Identify and buy high-impact, low-value buildings and implement impact-reducing strategies (e.g., the installation of water/energy-efficient systems).
- Benefit from more advantageous financing conditions, driven by the positive impacts of ESG considerations on the prudential capital and credit risk assessments of EU credit institutions.
- During holding, profit from higher rents, lower operating costs/tenant turnover and reduced liabilities' risk. Upon exit, sell at profit.

Build it, green

- Identify opportunities for designing ESG buildings from scratch.
- Benefit from reduced operating costs and liabilities, as well as from higher rents and lower tenant turnover. Sell at profit.

Secure and/or increase rental return and occupation levels

- The GHG and CO2 footprint of rental properties is emerging as a key selection criteria for businesses to rent facilities and office space, as well as a key determinant of the level of rental return over the mid- to long-term.
- In this context, the greenification of previously non-sustainable buildings – or the acquisition and marketing of already sustainable ones – represents an opportunity to generate heightened rental returns and occupation levels.



1.2.3 Infrastructure

Following a five-year period of 33.0% compound annual growth, European Infrastructure ESG AuM reached EUR 65.7bn in 2020. This veritable surge has been propelled by the increased sustainability-oriented mentality within the Infrastructure landscape, paired with the unabated rise of the asset class as a powerful diversifier and source of strong, resilient returns.

ESG considerations have long been entrenched within the Infrastructure realm – which boasts the second highest degree of ESG integration across the entire European Private Markets sphere. Our survey results reflect the extent of ESG entrenchment in the Infrastructure landscape, with over 90% of the Infrastructure GPs we surveyed incorporating ESG considerations into their investment processes – the highest figure among all asset classes.

This entrenchment of ESG values within the Infrastructure realm is primarily driven by the tangible nature of infrastructure investments, their high susceptibility to ESG risk, stakeholders' perception of Infrastructure's key role in mitigating sustainability risks, and the prominence of Public-Private Partnerships (PPP) in the industry. Not unlike its Real Assets peer, this has stimulated the development of a number of initiatives that aim at identifying the most relevant and material KPIs across different infrastructure subsectors. This, in turn, has largely facilitated the objective assessment of ESG metrics across projects and – consequently – across portfolios; helping to cement ESG considerations within the Infrastructure realm.

We expect a series of asset-class specific dynamics to further strengthen the case for ESG within Infrastructure:

Policymaker rally and post-COVID recovery: the increased perception of Infrastructure's role in mitigating sustainability risks (namely physical and indirect climate risks) has led to a veritable rally among global policymakers in recent years. In particular, the unveiling of the European Green Deal in December 2019 – aimed at transforming Europe into a carbon-free economy by 2050 – stands as the most urgent call to action for infrastructure industry players in recent memory. This, paired with comparable global initiatives, represents a paradigm shift in the societal and policymaker perception of infrastructure's role in driving the transition towards a zero-carbon future. As public institutions are deeply involved with infrastructure projects alongside private players, the portion of ESG within infrastructure investments is set to rise the strongest. This trend has

been further accentuated by post-COVID recovery programs, which are set to implement ESG and sustainability policies in the allocation and subsidisation of various economic sectors.

Widening infrastructure gaps: chronic public sector underinvestment, aggravated by surging public debt levels and rapid social and demographic shifts, have stimulated the expansion of a global infrastructure financing gap – which is expected to exceed EUR 12tn by 2040. The sheer magnitude of this gap – as well as the risks of not mobilising sufficient capital to close it – is calling for financing methods outside of the public scope. Not only does this represent an opportunity for private players to increase their participation in the funding and provision of infrastructure, but also to do so through an ESG lens.

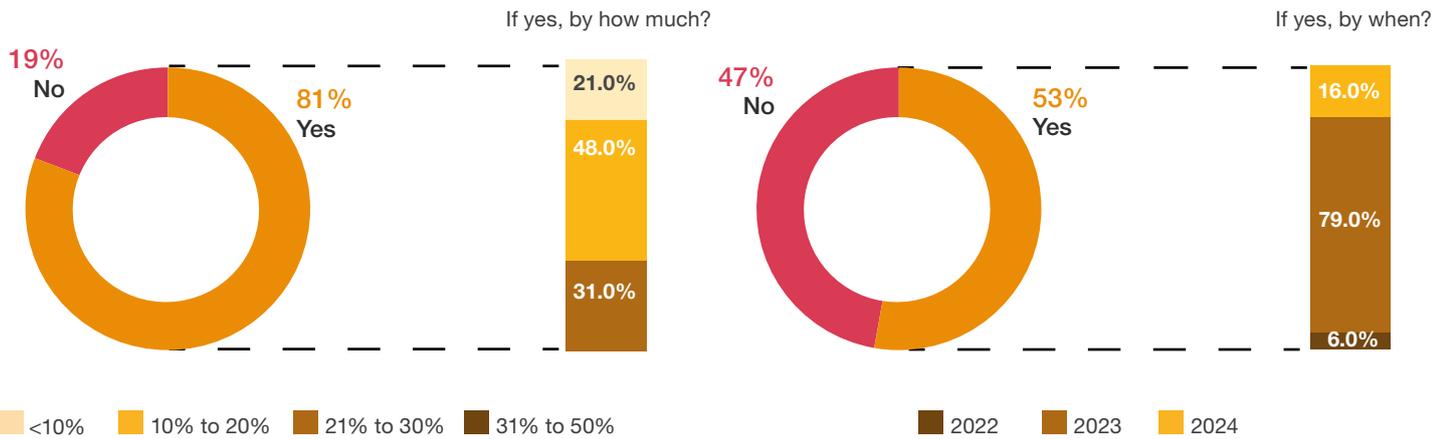
Our survey results strongly reflect the expected strengthening of ESG considerations within the Infrastructure realm. Over 80% of the Infrastructure GPs we surveyed voiced intentions to bolster their ESG AuM in the coming 24 months – of which approximately half target allocations of between 10% and 20% (cf. exhibit 21, left). The ever-deepening entrenchment of sustainable considerations within the Infrastructure realm is also illustrated by the asset class' strong appetite for green energy projects, in which over 80% of surveyed GPs plan to invest in coming two years; compared to less than 3% in non-green energy ones.

This notwithstanding, there is perhaps no better illustration of ESG's entrenchment within the Infrastructure realm than the fact that 53% of GPs plan to halt their non-ESG fund launches altogether – of which almost 80% intend to do by as soon as 2023 (cf. exhibit 21, right). Given this, we strongly believe that the Infrastructure landscape is on the verge of a veritable ESG explosion, with GPs being particularly well-positioned to light the fuse.

Exhibit 21

Do you intend to increase your AuM in Infrastructure ESG funds in the next 24 months? (Infra GPs)

Do you intend to stop launching non-ESG Infrastructure funds in the coming months/years? (Infra GPs)



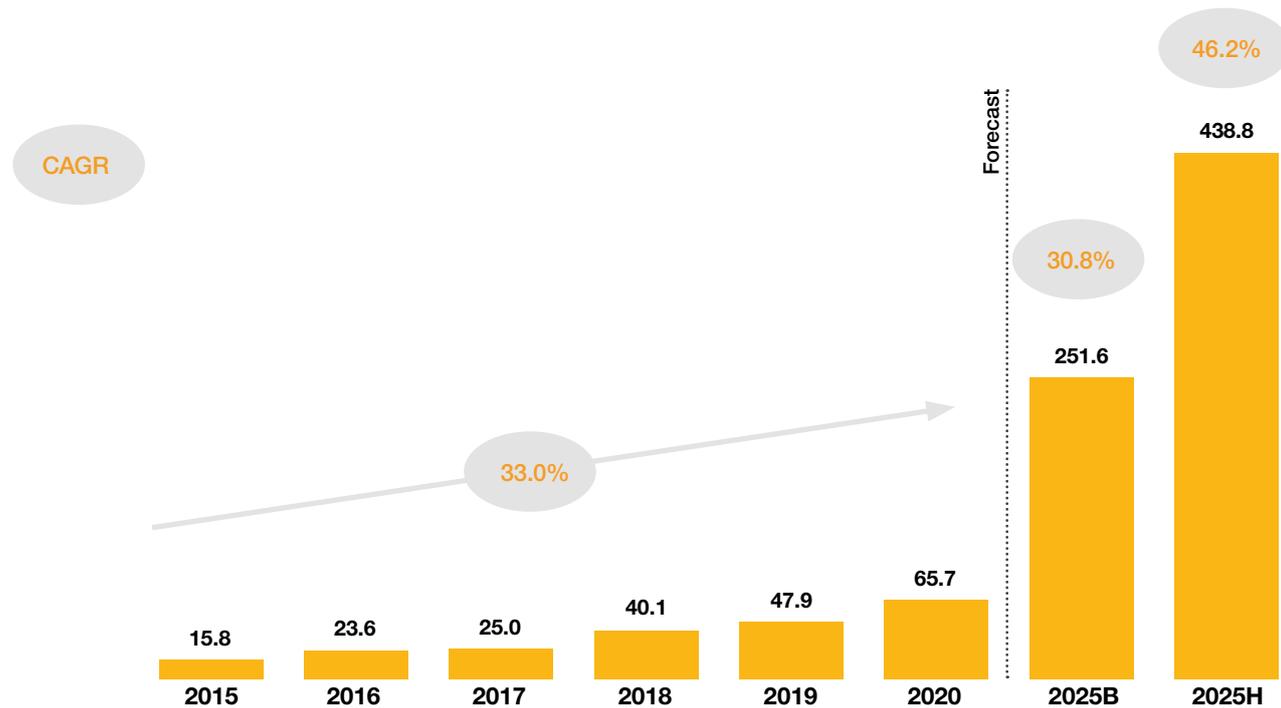
Source: PwC Global AWM Market Research Centre



As the infrastructure industry grows increasingly ESG-oriented, we strongly expect to see a surge of ESG Infrastructure assets. **Under a base-case scenario, Infrastructure ESG AuM is expected to reach EUR 251.6bn by end-2025 – accounting for 40.6% of total Infrastructure AuM (cf. exhibit 22). Out of this EUR**

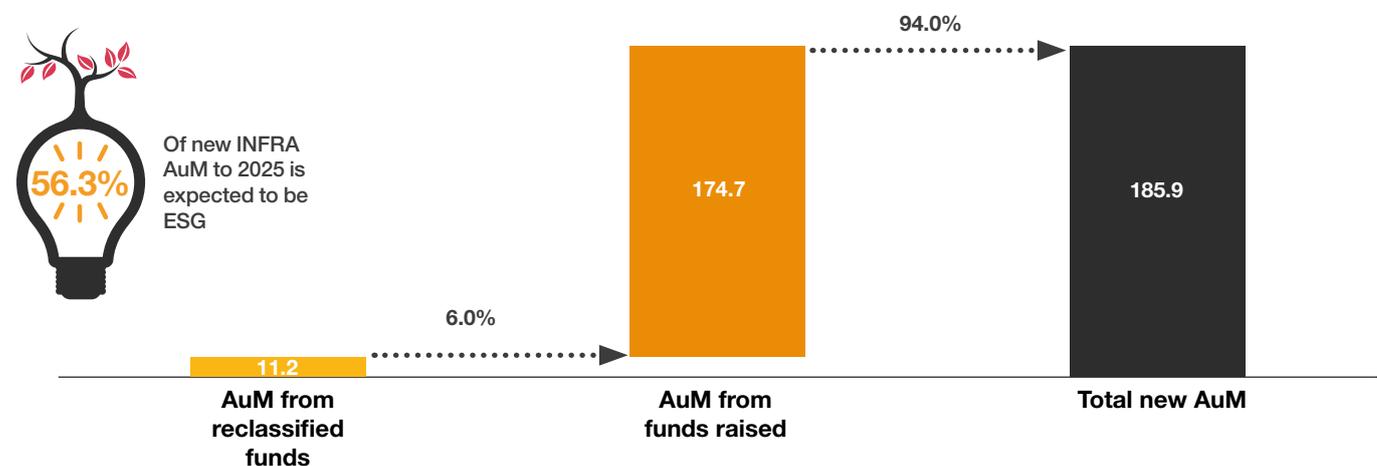
185.9bn increase, 6.0% is expected to stem from fund reclassifications, with the remaining 94.0% coming from new funds raised. The latter, in turn, represents a more than EUR 174bn opportunity for Infrastructure GPs (cf. exhibit 23).

Exhibit 22: European Infrastructure ESG AuM: Forecasts to 2025 (EUR bn)



Sources: PwC Global AWM Market Research Centre, Prequin. 'B' refers to base-case forecast scenario, while 'H' refers to high case forecast scenario.

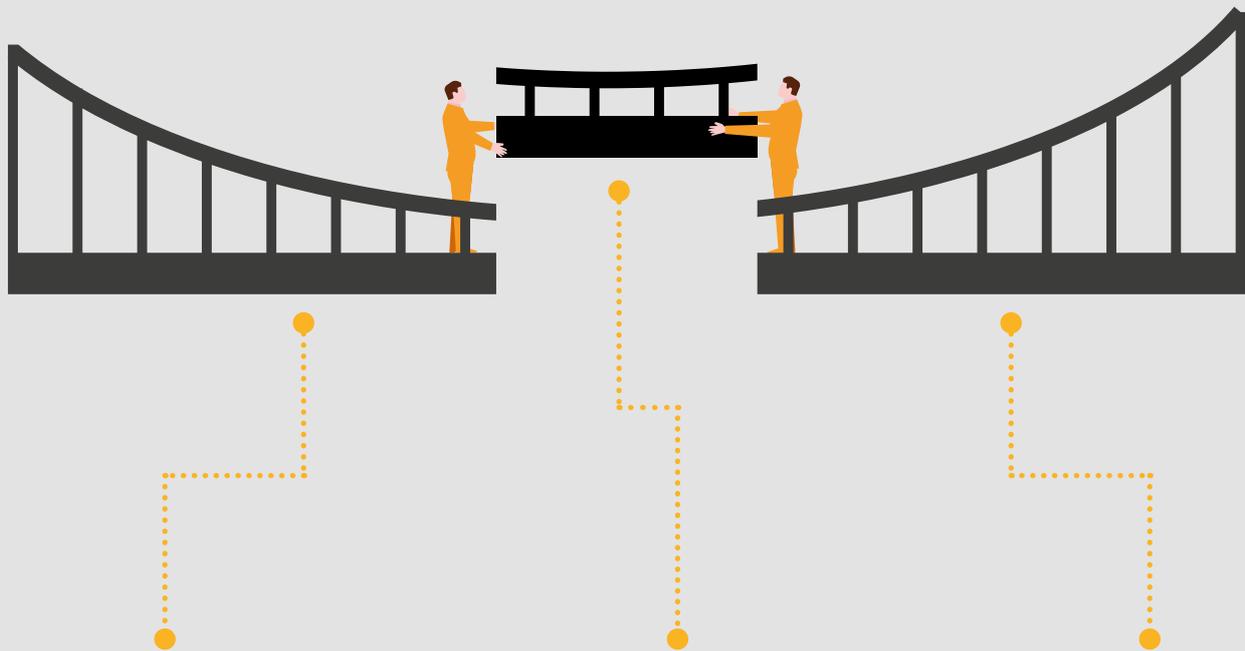
Exhibit 23: New Infrastructure ESG AuM to 2025 (base-case scenario, EUR bn)



Sources: PwC Global AWM Market Research Centre, Prequin

Infrastructure through an ESG lens

We have identified a set of tools on which Infrastructure GPs can leverage in order to unlock the EUR 174bn opportunity, while simultaneously creating value to themselves, their LPs and the broader stakeholder base.



Take on legacy, 'ESG-fy'

- Identify projects aimed at repositioning legacy assets.
- Repurpose/modernise legacy infrastructure through an ESG, low-impact perspective and profit from reduced environmental/societal risks, enhanced synergies and reduced costs.

Build new, go green

- Identify novel ESG-oriented project opportunities.
- Benefit from outperformance as non-ESG-oriented projects bear with costs associated with environmental/social risks and operational inefficiencies.

Benefit from structural shifts

- Develop or acquire facilities that substantially contribute to sustainability goals as defined in the EU Taxonomy to benefit from structural shifts of capital in the markets.



1.2.4 Private Debt

Following a 5-year period of 15.3% compound annual growth, Private Debt ESG AuM reached EUR 23.1bn in 2020. Although this growth is far from negligible, PD currently demonstrates the second lowest percentage of ESG assets over total AuM across Private Markets.

This stunted uptake with respect to other asset classes can be largely attributed to the ‘lender rather than owner’ nature of PD. This has in turn led to many PD players underestimating their role in promoting and propagating transformation within their portfolio companies and, by extension, within the PM realm itself. Further, the competitive nature of the European PD landscape has seen certain GPs forego the requirement of ESG-related information during due diligence out of concern that this would overly complicate the lending process – thus putting them at a competitive disadvantage to their less ESG-demanding counterparts.

However, we expect a series of asset-class specific dynamics to further strengthen the case for ESG within Private Debt:

Power to finance: as stringent capital requirements and surging pandemic-induced defaults constrain banks’ lending capabilities to retail customers and SMEs, PD will continue to strengthen its position as an alternative source of financing. As SMEs constitute a staggering 99% of EU businesses– and the lion’s share of PDs’ lendee base – PD GPs are well-positioned to drive change through the imposition ESG-related lending conditions; thus advancing the strategic case for ESG both in the PM realm and the real economy.

ESG as a thermometer of credit risk: traditional credit institutions and PD GPs are growing increasingly cognisant that ESG risk translates into credit risk – especially in the SME sphere. The requirement set by regulators to consider ESG risk as a ‘thermometer’ of counterparts’ ability to repay (and refinance) should witness ESG considerations to become an ever-increasing part of the ‘standard information package’ provided by prospective borrowers, strengthening the embeddedness of ESG within the entire credit landscape.

ESG-related lending conditions become increasingly widespread: PD players have been ramping efforts to overcome the ‘lack of ownership’ hurdle, namely through the development of a series of tools aimed at promoting lendees’ alignment with ESG considerations. These range from the provision of lower lending rates to ESG-oriented borrowers all the way to refusing loans altogether. We expect these tools to increase in popularity as the industry embraces the ESG revolution, and as an increasing share of PDs recognise that their status as lenders rather than owners puts them at no strategic disadvantage with respect to their PM counterparts when it comes to driving change.

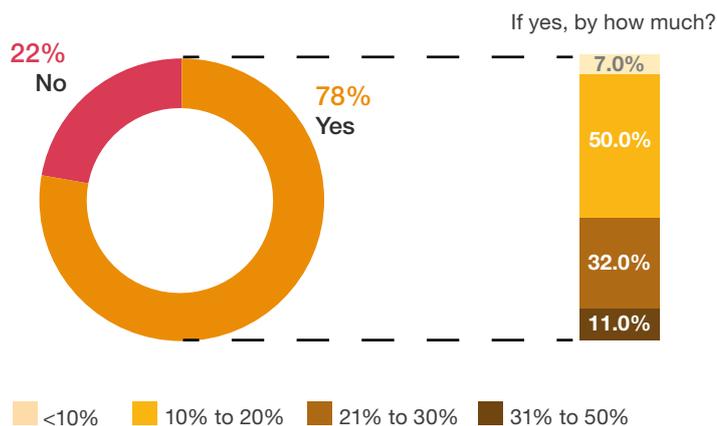
Despite its historical role as the ESG laggard of the PM landscape, we expect ESG’s transformational impact to strongly reveal itself within the PD space moving forwards. Our survey results attest to the increasing degree of ESG commitment in the PD landscape, with almost 89% of the GPs we surveyed planning to increase their ESG AuM in the coming two years (cf. exhibit 24, left). Moreover, a large proportion of our respondents demonstrated willingness to anchor sustainability considerations at the heart of their operations, with 47% of surveyed PD GPs intending to halt their non-ESG fund launches (cf. exhibit 24, right) and a further 67% planning to refuse loans to non-ESG oriented borrows in the future.

“ The ESG shift in Private Debt is obvious. 6 years ago, none of our LPs were asking about ESG, whereas today they are all asking.

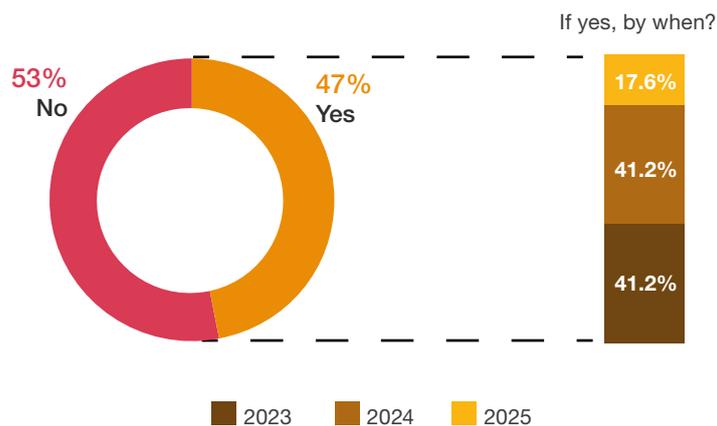
Head of CSR/ESG, European Private Debt firm

Exhibit 24

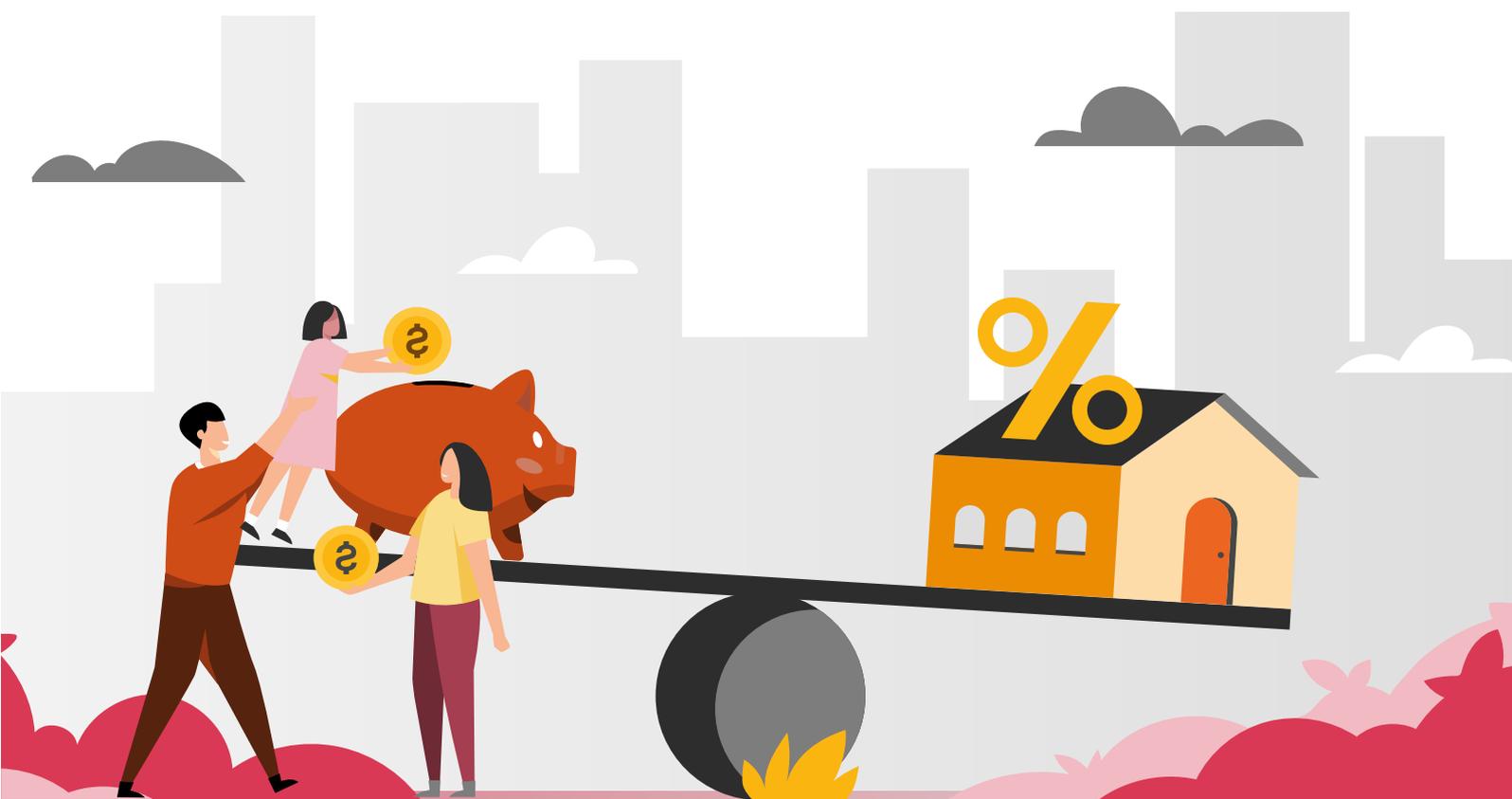
Do you intend to increase your AuM in PD ESG funds in the next 24 months? (PD GPs)



Do you intend to stop launching non-ESG PD funds in the coming months/years? (PD GPs)



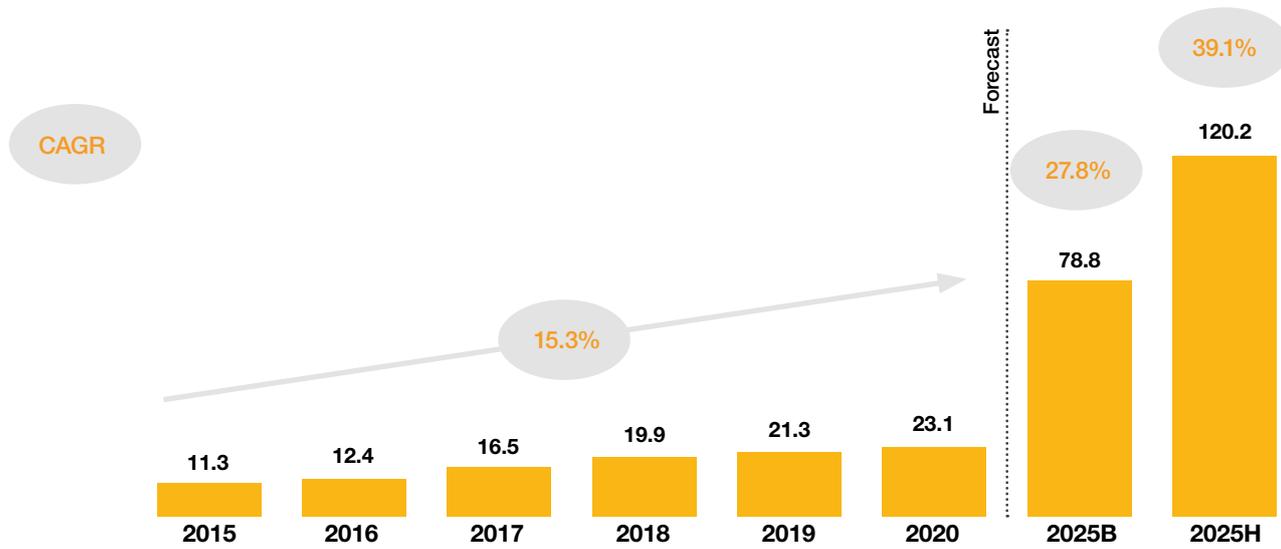
Source: PwC Global AWM Market Research Centre



This rising sense of optimism and willingness to drive change points to the imminence of a veritable ‘sustainable shift’ within the European PD realm. As the wheels of change continue to turn – driving the PD market towards more sustainable aims – we strongly believe that tomorrow’s PD industry will be far more ESG-centric than that of today.

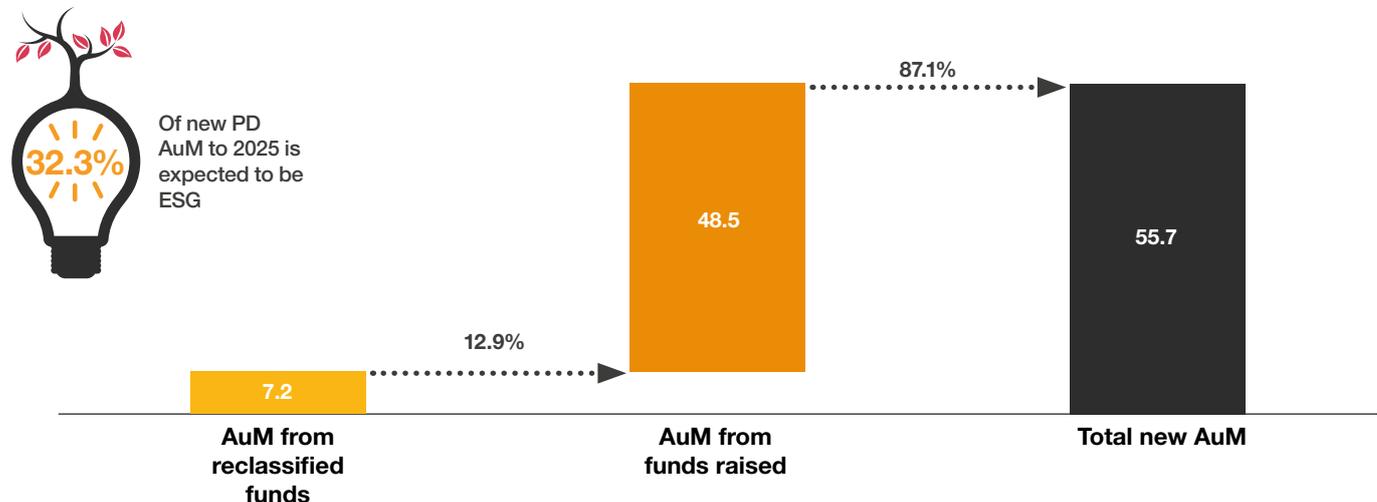
Under a baseline scenario, we forecast PD ESG AuM to reach EUR 78.8bn by 2025 – accounting for as much as 21.3% of European PD AuM by 2025 (cf. exhibit 25). Out of the EUR 55.7bn in total new ESG AuM, 87.1% is expected to stem from new funds raised – representing a EUR 48.5bn opportunity for PD GPs (cf. exhibit 26).

Exhibit 25: European PD ESG AuM: Forecasts to 2025 (EUR bn)



Sources: PwC Global AWM Market Research Centre, Preqin. ‘B’ refers to base-case forecast scenario, while ‘H’ refers to high case forecast scenario.

Exhibit 26: New PD ESG AuM to 2025 (base-case scenario, EUR bn)



Sources: PwC Global AWM Market Research Centre, Preqin

Driving change through lending power

Despite their lack of a ‘hands on’ ownership approach, we believe that PD players possess the tools necessary to drive ESG and to create value for themselves and for broader stakeholders.



Lend dirty, close-out/ refinance clean

- Identify borrowers whose operations generate large negative environmental/societal externalities.
- Use covenants/loan rebates to strengthen/improve ESG KPIs and to reach ESG goals during the holding period, reducing environmental/societal costs and mitigating negative externalities.
- Upon exit, encourage refinancing on further ESG grounds.

Lend clean, mitigate default risk, outperform

- Identify borrowers with ‘clean’ operations and/or with strong ESG credentials.
- Benefit from lower default risks, as ESG-oriented lenders generally present higher repayment (and refinancing) abilities in comparison to their non-ESG-oriented counterparts.
- Use covenants to strengthen/improve ESG KPIs and to reach further ESG goals. Encourage refinancing on further ESG grounds.

Benefit from structural shifts

- Finance businesses with products/services that substantially contribute to sustainability goals as defined in the EU Taxonomy to benefit from structural shifts of capital in the markets.

“ PD players can differentiate themselves by providing creative solutions to ESG issues. They cannot let their lender status hinder their ability and willingness to drive change

Head of CSR/ESG, European Private Debt firm

Asset class spotlight: Key takeaways

Our analysis highlights a strong cross-asset class heterogeneity in terms of current and prospective ESG uptake. We noted a similar heterogeneity across GP size cohorts, with larger GPs often standing at the forefront of ESG adoption. However, small GPs that choose to deeply embed ESG within their portfolios and broader operations – positioning and differentiating themselves as true ESG leads – are set to gain a competitive edge with respect to their counterparts.

Private Equity

- Under a baseline scenario, PE ESG AuM is set to reach EUR 292.0bn by 2025. This will see the percentage of ESG AuM over total AuM increase from the current 10.7% to 20.7%.
- Our survey results attest to PE's considerable lag in terms of current and prospective ESG adherence in comparison to other asset classes. Despite its drawbacks, this 'reluctance' implies that GPs willing to truly embrace ESG are set to enjoy important early adopter benefits within the PE space.
- PE's status as the largest asset class in PM – coupled with its 'hands-on', long-term engagement with portfolio companies and record dry powder levels – gives the asset class considerable power to drive thorough ESG transformations not only within PM and the broader AWM realm, but also in the real economy.
- Those that leverage on these features should be particularly well positioned to unlock the EUR 176.9bn opportunity within the PE realm.



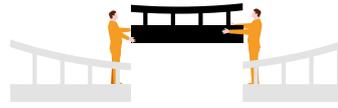
Real Estate

- RE ESG AuM is expected to reach EUR 153.2bn by 2025 under a baseline scenario. The materialisation of this forecast should witness the percentage of ESG AuM over total AuM to increase from the current 23.4% to 33.7%. Our survey attests to RE GPs' proactive approach towards ESG considerations.
- We expect to see RE players assume an even more prominent role in the ESG landscape moving forward as tenant demand for high-quality, sustainable properties surges in the post-pandemic landscape; and as policymakers grow increasingly cognizant of the built environment's protagonism in the transition towards a low-carbon economy.
- The pandemic has further served to highlight the difficulties governments have faced in addressing ever-rising demand for affordable housing, education and healthcare facilities. Real estate's ability to address these shortages provide a strong opportunity for private RE players to reinforce their role as one of the primary proponents of the 'S&G' aspect of ESG.
- The most proactive RE players that step in to fill these demands stand to unlock a more than EUR 81.0bn opportunity.



Infrastructure

- Infrastructure ESG AuM is poised to surge to EUR 251.6bn in the coming five years. Should our forecast materialise, this would see the share of ESG assets in the European Infrastructure asset universe rise from 21.3% to 40.6%. Our survey highlights the extent of current and expected ESG integration within the Infrastructure realm.
- Governmental and societal pushes towards sustainability amid post-COVID recovery programs– coupled with public sectors' hindered abilities to address ever-widening infrastructure gaps – puts private Infrastructure players in a particularly privileged position to push towards a deeper 'ESG-fication' of the Infrastructure environment.
- Those that leverage on these opportunities are particularly well-positioned to unlock the EUR 174.7bn opportunity.



Private Debt

- PD ESG AuM is expected to near EUR 79bn under a baseline scenario – with the share of ESG assets rising from 11.6% to 21.3% in regard to overall assets in the coming five years.
- Although PD has traditionally lagged other asset classes in terms of ESG uptake, our survey results highlight the extent to which PD GPs' have ramped their ESG-related efforts as of late – while simultaneously demonstrating a rising sense of optimism regarding future ESG developments.
- PD's status as an alternative to traditional financing methods – coupled with the increased popularity of ESG-related lending conditions and growing awareness of ESG's power in to serve as a proxy for credit risk – stands to see PD play an increasingly prominent role in driving ESG not only within PM but across the real economy.
- Those that wake up to these opportunities and act accordingly stand to benefit from the almost EUR 48.5bn opportunity to 2025.



Survey results: split by asset class(% of 'Yes')	Private Equity	Real Estate	Infrastructure	Private Debt
Incorporation of ESG considerations into investment processes	89%	87%	92%	83%
Existence of a publicly disclosed ESG policy	60%	80%	69%	69%
Willingness to increase ESG AuM in the upcoming 24 months	75%	78%	81%	78%
Willingness to stop launching non-ESG funds in the coming months/years	33%	44%	53%	47%
Belief on an eventual convergence between ESG and non-ESG funds	52%	69%	81%	75%
New ESG AuM to 2025 (as % of total AuM)	35.9%	46.9%	56.3%	32.3%

Relative position with respect to other asset classes

1st

2nd

3rd

4th

2

How to create value through ESG

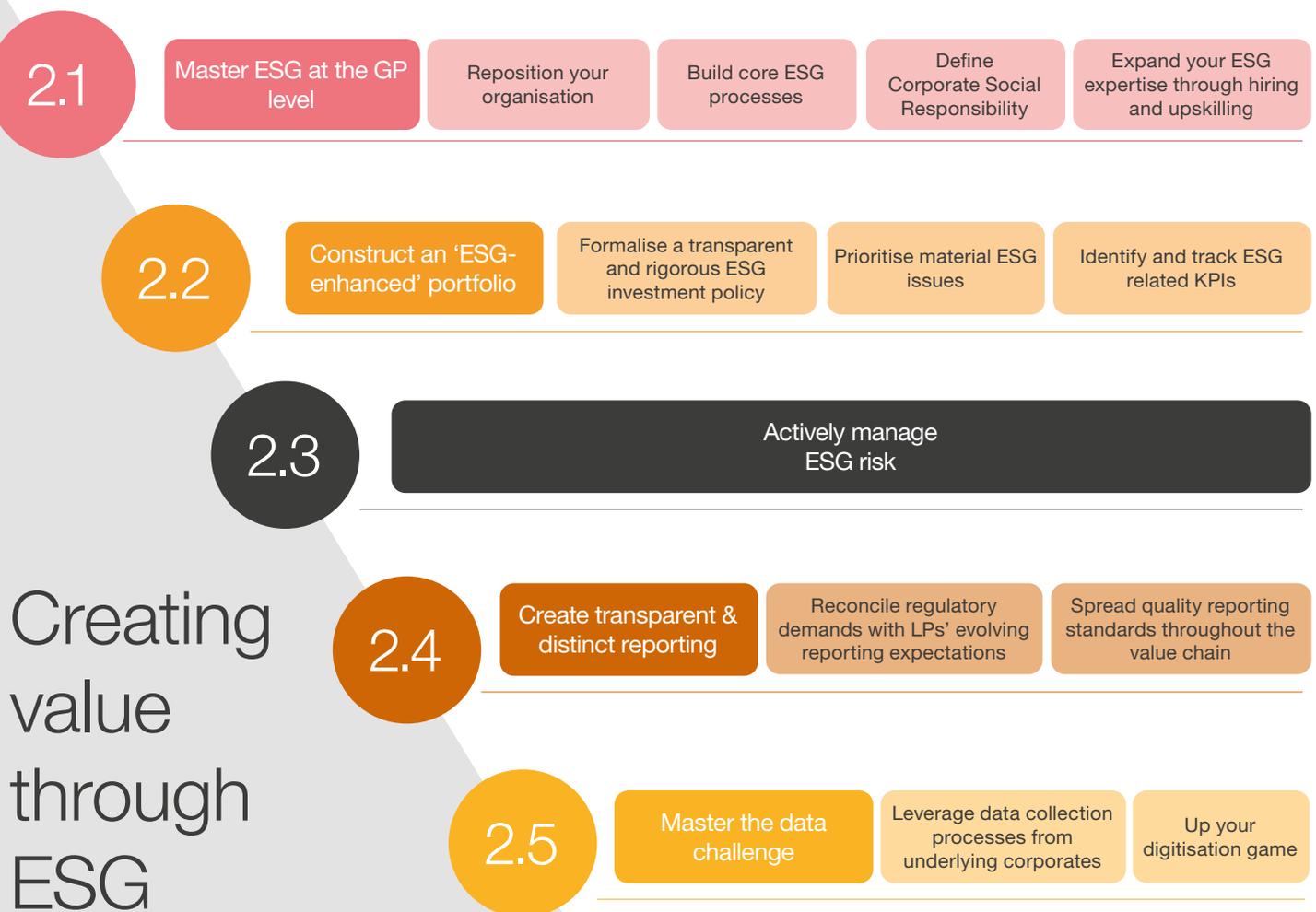
The European Private Markets landscape is at a turning point – where all societal stakeholders are increasingly valuing ESG considerations and regulators are becoming progressively more convicted in their push towards ESG. In this new landscape, the GPs that stand against the winds of change risk falling by the wayside, finding it increasingly difficult to gain traction with LPs and defend their current market positioning.

These external drivers notwithstanding, the industry's own growing realisation of ESG as a truly material matter – both in terms of protecting and creating value – represents an additional current pushing the ESG wave to the shore.

However, in order to reap all the benefits associated with thorough ESG integration, GPs will need to reassess their value proposition and core processes and rethink how ESG informs their decision-making processes at various levels.

The value that stands to be unlocked by GPs' effective integration of ESG will not only benefit themselves and their LPs but will ultimately spill over to the broader stakeholder base. In this context, we outline a five-pronged approach for GPs to undergo in order for this value creation to materialise (cf. F).

Figure 6: Five-way approach towards value creation through ESG





2.1

Master ESG at the GP level

2.1.1 Reposition your organisation

Before embarking on their ESG journey, GPs should first assess the role they wish to play in the new paradigm, reconciling their current order of operations with that called for by LPs and regulators. Based on the conclusion of this assessment, they should then make a strategic decision as to how their organisation defines ESG, and the extent to which they wish to anchor it within their business operations. We have identified three strategic options that GPs can pursue in order of increasing disruption: “business as usual”, “selective approach – not being a laggard”, or “sustainable GP – innovate and lead”:

“Business as usual”: GPs that opt for this approach will adjust their governance and operational structures in accordance with minimum regulatory requirements, attaining compliance but largely sticking to the status quo. Their primary focus will be on the immediate impact of ESG risks on financial performance, with sustainability risk-oriented measures mainly focused on internal organisational aspects and stakeholders. GPs that decide to stick to “business as usual” will promote a very limited ESG fund offering that, although compliant with regulatory provisions, will not meet the sophisticated expectations of more sustainability-oriented LPs in terms of ESG transition, ESG themes or ESG investment management. This approach will mainly be adopted by more ESG-agnostic and ESG-sceptic GPs, who likely underestimate the true extent of the ESG value creation opportunity. That being said, we believe that these GPs may find themselves losing their competitive edge over the medium term – both in terms of reputation and in terms of concrete financial performance.

“Selective approach – not being a laggard”: GPs that opt for this approach will go beyond regulatory requirements in terms of the adjustment of their governance and operational structures but will not promote an all-encompassing shift towards sustainability. Fund ranges will be composed of both ESG and non-ESG funds, with these selective GPs aiming to meet a fair share of varying demands across the entire LP spectrum. The investment focus will integrate minimum exclusions as well as ESG criteria for investment target selection, although it will most likely not factor sustainable investment management and sustainability transition management. While this strategy may well represent an effective first step towards full ESG reinvention, these GPs run the risk of undermining their

conviction and credibility in the eyes of an increasingly sustainability-oriented LP base. Besides, the parallel operation of both ESG and non-ESG investment processes could prove highly costly and complex and may see these GPs be less flexible to sudden demand and market shocks. Furthermore, the absence of sustainability transition management in this strategy will likely see those that opt for it facing restricted value creation opportunities.

“Sustainable GP – innovate and lead”: This strategy would see GPs completely revamp their value chains and investment philosophies, writing ESG and sustainability into their operational DNA. This will witness ESG/sustainable values and principles impacting every facet of the organisation, ranging from the ‘internal’ impacts of their own organisational activities on ESG factors – such as the inclusion and diversity of staff, and the impact of business and social concerns of society – to their ‘external’ fund and investment target engagement strategy. Sustainable GPs’ investment strategies will encompass minimum exclusions and ESG investment criteria, as well as sustainable investments and sustainability transition management in accordance with the EU Taxonomy. While this approach may initially prove cost-intensive and complex in its implementation, this will be far outweighed by the long-term benefits that stand to be unlocked from the range of opportunities, the innovation potential of the investment strategy, corporate value creation and heightened traction with LPs. The successful implementation of this strategy will also significantly enhance and strengthen GPs’ competitive positioning over the medium to long term given the rate and scale of regulatory and societal shifts in favour of ESG/sustainability.

That being said, we believe that the extent of and need for ESG implementation at the GP level is directly correlated with the requirements being set and the scale of value creation that stands to be unlocked. As the EU Taxonomy is implemented from January 2022 to January 2023, and the broader Asset Management industry becomes increasingly ESG-focused, we believe that this correlation will strengthen exponentially – to the point where the degree of ESG entrenchment will not only determine success, but survival. As such, the true permeation of ESG values will prove increasingly instrumental for GPs to unlock their full potential and ensure long-term success.

2.1.2 Build core ESG processes

Once a GP makes the strategic decision as to which extent they wish to entrench ESG within their corporate ethos, they should adjust their operations to reflect their new organisational philosophy. GPs that opt for embedding ESG in the very core of their operations should consider

constructing a coherent and holistic ESG-oriented corporate strategy that informs every facet of their operations, ranging all the way from their investment strategy to their marketing & disclosure approach (cf. figure 7).

Figure 7: Organisational ESG strategy



Source: PwC Global AWM Market Research Centre

“ A detailed, overarching ESG framework is essential to ensuring ESG success. Each line of business must come up with their own methodologies to meet these standards.

Global Head of Product, Global Asset Management firm

Investment Strategy: GPs' investment strategies should outline guidelines for 1) the expansion of Article 8 and Article 9 fund offerings; 2) the development of fundraising strategies, targeted towards existing/potential clients; and 3) the formalisation of ESG investment policies/processes that clearly elucidate how sustainability risks and opportunities are incorporated. In order to ensure consistency and avoid investor confusion, multi-asset GPs should ensure the alignment of their ESG objectives and ESG policies/processes across their entire fund universe. Further, these policies and processes should be reviewed on a regular basis.

Risk Management Strategy: GPs should consider developing risk management processes both at the organisational and portfolio levels that actively identify and mitigate/manage material ESG-related risks and impacts – whether they be reputational, financial or operational in nature. While these ESG risk requirements are subject to a far-reaching regulatory minimum standard in the EU, the active approach to ESG from an investment and risk angle is the key to minimising risk and unlocking the value creation opportunity, i.e. accept risk at the investment stage, manage/mitigate/transition during the holding phase and exit at an ESG premium.

Marketing & Disclosure Strategy: In this new investment landscape, it does not suffice for GPs to solely 'walk the talk', they should also 'talk the walk'. GPs should actively elucidate their ESG 'mission' in their internal and external communications, disclosures and reports. In this context, the GPs that stand to thrive long term are those that go beyond regulatory disclosure requirements, instead writing their own 'ESG story' and actively showcasing it to their LPs and the broader stakeholder base.

Engagement strategy: In order to ensure ongoing alignment with LP and regulator demands, GPs should consider developing a transparent ESG engagement strategy with their portfolio companies. This will, in turn, provide a solid basis for the implementation of action and transition plans; ensuring that these are being adequately followed through. Not only will this prove instrumental in monitoring these companies' ESG performance on an ongoing basis and ensuring that their current and planned ESG efforts mirror the GPs' own ESG philosophy, but also in helping the GPs themselves communicate to corporates and LPs how they currently/plan to tackle ESG issues during the holding and monitoring phases of the investment. Furthermore, a close and continuing GP-corporate relationship puts the latter in a particularly privileged position to conduct successful engagement

strategies and reap all the associated benefits therein – especially when compared to their public counterparts. The early development of a consistent, successful engagement strategy could also serve as an important differentiating factor; especially at the early stages of PM's ESG 'revolution'.

Data Strategy: GPs should consider bolstering their in-house data capabilities through heightened investment in data collection and data storage facilities. GPs should aim to develop consistent methodologies and approaches for the assessment of ESG KPIs both at the portfolio and organisational level; as well as to invest in technology (either internal or external) to gather ESG- and sustainability-related data across various sources at the deal and holding phases.

Core ESG Team: In order to ensure the timely and adequate implementation and execution of the abovementioned strategies, it is critical that GPs compose a core 'ESG team' within their organisation structure. These teams' role is largely that of a Subject Matter Expert (i) 'translating' corporate the ESG strategy into individual, binding investment criteria and targets as well as (ii) managing the data consistency and assessment, supporting the core investment and risk teams. While these skills can be created and obtained through staff upskilling and a clearly articulated corporate structure, a core ESG team is absolutely pivotal in a landscape in which the ever-expanding volume of ESG matters that GPs are expected to manage (at the portfolio and entity level), paired with the introduction of investment targets disclosures and newly defined regulatory standards, have seen ESG and sustainability requirements grow exponentially more sophisticated and complex. Given this ever-increasing complexity, success is largely dependent on an exhaustive, consistent and effective management of ESG and sustainability related goals, criteria and targets/limits/exclusions.

“ ESG departments should not be treated as 'add-ons' to investment teams. ESG should be integrated in any and all investment decisions.

Head of CSR/ESG, European Private Debt firm

Data Strategy: ESG Reputation Monitoring & Target Due Diligence

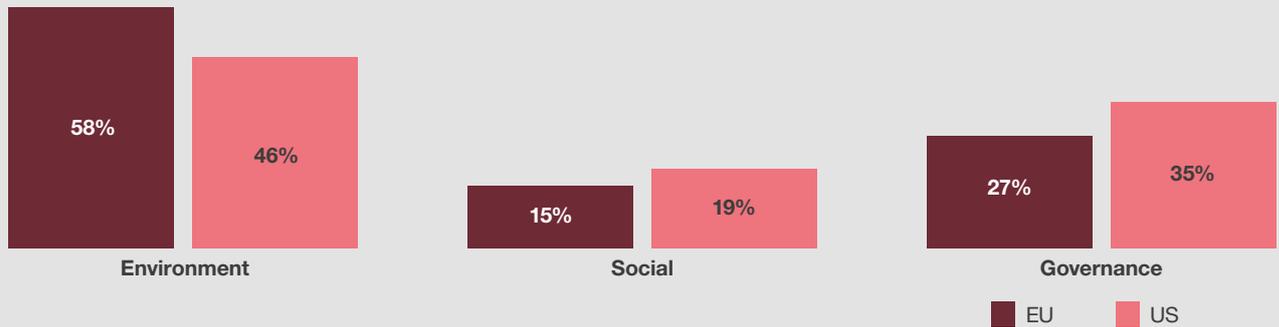
In this data-driven world, it is becoming increasingly imperative for GPs to hold an accurate and ongoing view of how consumers and the broader market perceive them with respect to ESG and sustainability-related matters. Having access to real-time, accurate market and consumer sentiment data can prove instrumental in: i) obtaining valuable and actionable consumer/market insights, ii) assessing brand valuation, iii) understanding and benchmarking GPs' sustainability and ESG reputation, as well as that of their competitors and underlying corporates; and iv) constructing custom-built indices to support in performance assessments. Together, these features can ensure GPs' ongoing alignment with societal expectations and demands; facilitating the construction of a successful digital strategy and the process of taking a new product to market.

The ESG Public Perception study, conducted by PwC's Digital Intelligence Services, illustrates the valuable insights that can be gained from the analysis and synthetisation of such information. The study analyses consumer sentiment regarding EU and US Private Equity firms' ESG performance – encompassing aspects such share of voice, ESG sentiment and ESG subtopics' relevance. Besides shedding much needed light onto evolving consumer perceptions, sentiment studies can also help GPs in assessing investment targets and performing transaction due diligences by obtaining additional information to verify company data/disclosures as well as enhance the value creation or value risk prospects of a target.

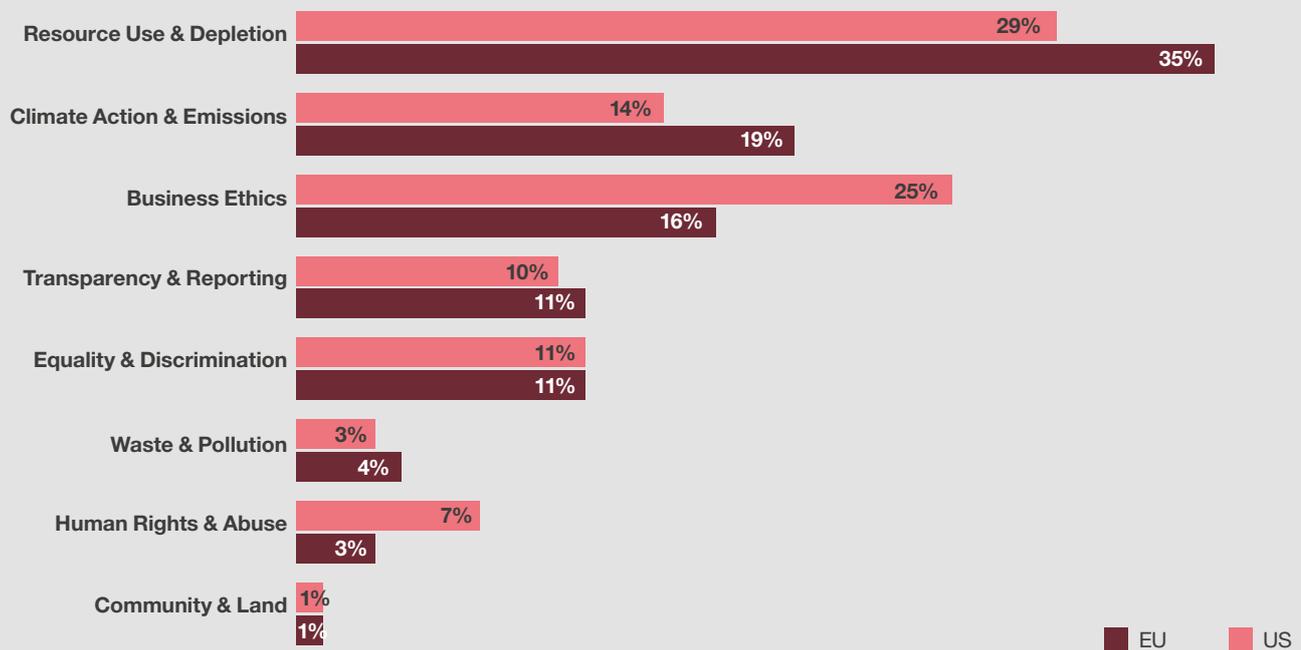


ESG Reputation Monitoring study: comparison between the EU & US PE firms

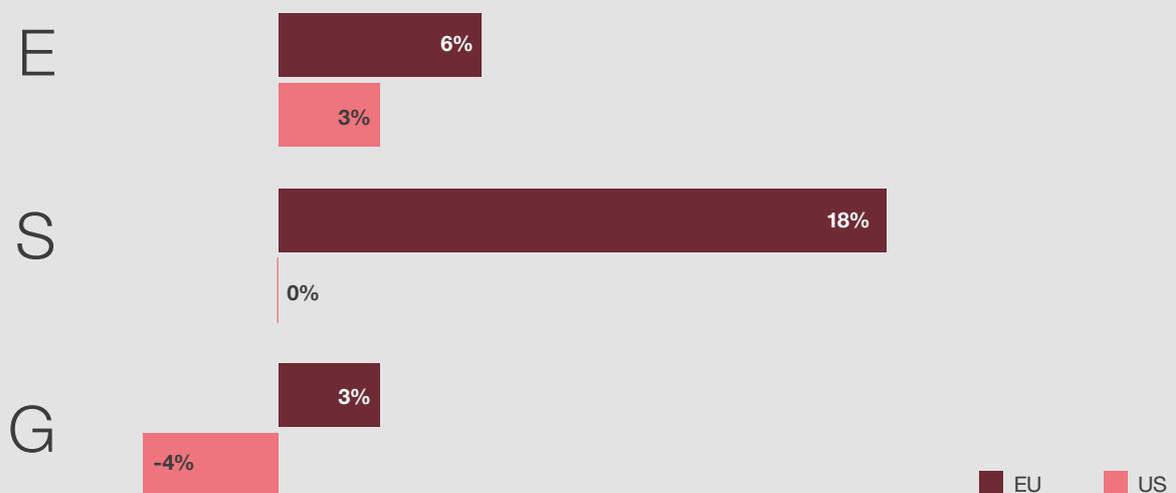
ESG share of voice⁹



Most discussed ESG Sub-topics



ESG Net Sentiment¹⁰ Split: EU vs. US



Source: PwC's Digital Intelligence Services: Global online public data (News, Forums, Twitter, etc. in English) retrieved from August 2020 - August 2021

⁹ *Note: ESG Share of Voice is the proportion of results mentioning each pillar of ESG (Environment, Social, Governance) compared to the total ESG results.

¹⁰ Net Sentiment is the difference between the percentage of total positive results and percentage of total negative results

2.1.3 Define Corporate Social Responsibility

While the promotion of a holistic ESG strategy is an essential tenet in unlocking the full extent of the value creation opportunity, it is of equally paramount importance that GPs effectively define and communicate the extent and scope of this corporate ESG strategy to the investment community. GPs should consider implementing internal Corporate Social Responsibility (CSR) policies to hold themselves to account, actively self-assessing and monitoring their internal operations to ensure the incorporation of ESG at every level. The effective elucidation of these ESG-related commitments, however, inherently implies the reconciliation of their definitions of ESG with those of regulators, LPs and the broader stakeholder base.

While regional regulatory developments have catalysed a historic shift towards the harmonisation and unification of ESG taxonomies and reporting standards (with the EU Taxonomy and SFDR potentially emerging as the global standard), their impacts are still largely region-specific. In response to this, recent years have witnessed the emergence of a set of international frameworks aimed at aiding entities in the assessment and elucidation of their ESG-related efforts; as well as the incorporation of relevant metrics into their organisational structures. Initiatives such as the World Economic Forum - International Business Council (WEF-IBC) and the United Nations Principles for Responsible Investment (UN PRI) have been particularly useful in this regard.

WEF-IBC & CSRD

The WEF-IBC initiative has established a comprehensive set of recommended metrics in an attempt to provide a clear pathway for companies to embed ESG information into their reporting and integrate these metrics into their governance, business strategy and performance management.

Organised into four pillars which are in alignment with the UN's Sustainable Development Goals, these metrics draw largely from existing standards such as the Global Reporting Initiative (GRI), Sustainability Accounting Standards Board (SASB), Task Force on Climate-related Financial Disclosures (TCFD), among others.

WEF-IBC's 4 pillars: Sub-themes, Core Metrics and Disclosures

Principles of Governance

- Setting purpose
- Board composition
- Impact of material issues on stakeholders
- Anti-corruption
- Protected ethics advice and reporting mechanisms
- Integrating risk and opportunity into business processes

Planet

- Greenhouse Gas (GHG) emissions
- TCFD-aligned reporting on material climate risks and opportunities
- Land use and ecological sensitivity
- Fresh water consumption in water stressed areas

People

- Gender pay equality
- Diversity and inclusion
- Wage level
- Risk for incidents of child, forced or compulsory labor
- Health and safety
- Training provided

Prosperity

- Net number of jobs created
- Net Economic Contribution
- Net investment
- R&D spend ratio
- Community investment
- Country by country tax reporting

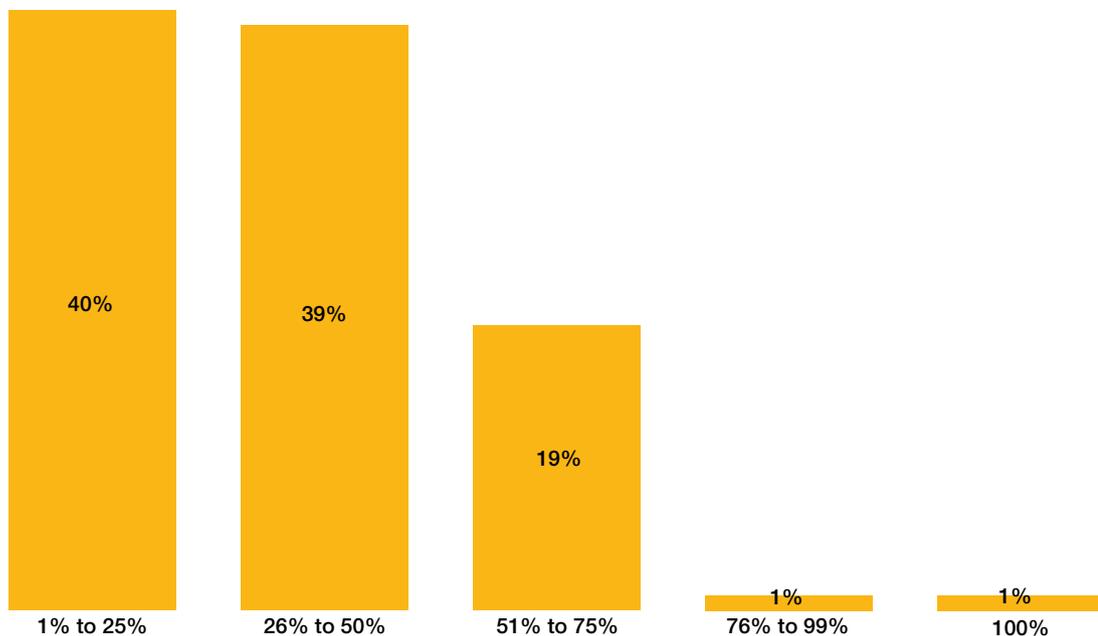
Unveiled in April 2021 and set for release in 2023, the proposed EU Corporate Sustainability Reporting Directive (CSRD) represents another regulatory effort to codify and legislate sustainability disclosure requirements. Introduced as an amendment of the existing Non-Financial Reporting Directive, the CSRD the aim of the Directive is to ensure that investors are provided with sufficient sustainability information prior to making an investment decision. Not only does this amendment significantly widens the scope of the NFRD (from 11,000 companies to over 49,000), it also represents the first attempt to introduce the concept of 'double materiality' into the EU's regulatory landscape – providing that businesses not only disclose how sustainability issues affect their company, but also how the company impacts society and the environment.

2.1.4 Expand your ESG expertise through hiring and upskilling

As ESG becomes increasingly integral to GPs' operations and fund offerings, a broader range of skills and knowledge will be required. It is therefore pivotal that GPs strive to build a talent pool skilled in various ESG-related areas – ranging all the way from ESG data analytics to ESG risk and policy monitoring.

Despite this pivotality, our survey results suggest that the current PM landscape does not yet boast a sufficiently ESG-ready workforce to keep pace with the rate and scale with which ESG is redefining the industry. In fact, as much as 42% of our respondents cited lack of ESG expertise or the absence of a dedicated department/team as their primary hindrance in the ESG integration process. Besides, over 80% of GPs boast investment teams in which less than 1 in 2 employees is formally trained on ESG (cf. exhibit 27).

Exhibit 27: What percentage of your investment team is formally trained on ESG? (GPs)



Source: PwC Global AWM Market Research Centre

These skill shortages can be addressed either through targeting ESG-skilled individuals in hiring processes, creating a core ESG team, or by upskilling existing staff. While hiring ESG-skilled employees may represent an appealing (and fast) solution, competition for individuals with both financial and ESG know-how is fierce - meaning that the construction of a future proof and ESG-ready workforce entails upskilling existing staff across the entire organisation.

Amidst a rapidly changing market and regulatory environment, the frequency of this upskilling is as instrumental as the quality of the upskilling itself. Our survey, however, suggests that annual training sessions remain the industry norm – with fewer than 15% of respondents training their investment staff on an ‘as-needed’ basis.

Besides, GPs should strive to reflect the diversity which they expect from their portfolio companies. Thus, the workforce of tomorrow will not only have to be broadly skilled, but also broadly diverse – reflecting the demographic makeup of the society in which it operates as well as the true ESG values embedded in GPs' organisational philosophy.

“ Our Millennial or Gen Z employees and new joiners are increasingly asking about our efforts in terms of Diversity and Inclusion – these are questions that we never received in the past.

Head of CSR/ESG, European Private Debt firm

2.2

Construct an 'ESG-enhanced' portfolio

If the implementation of ESG values at the organisational level represents the steering wheel towards more sustainable aims, its successful integration at the portfolio level is the engine that promises to propel GPs towards the full realisation of ESG's value creation potential. In this context, GPs that wish to remain at the forefront of the ESG revolution – and to unlock the full extent of the ESG opportunity therein – should consider going back to the drawing board and placing ESG at the heart of their portfolios. They can do so by (i) developing new, holistically ESG-oriented portfolios and/or (ii) repurposing existing portfolios in accordance with ESG values/principles.

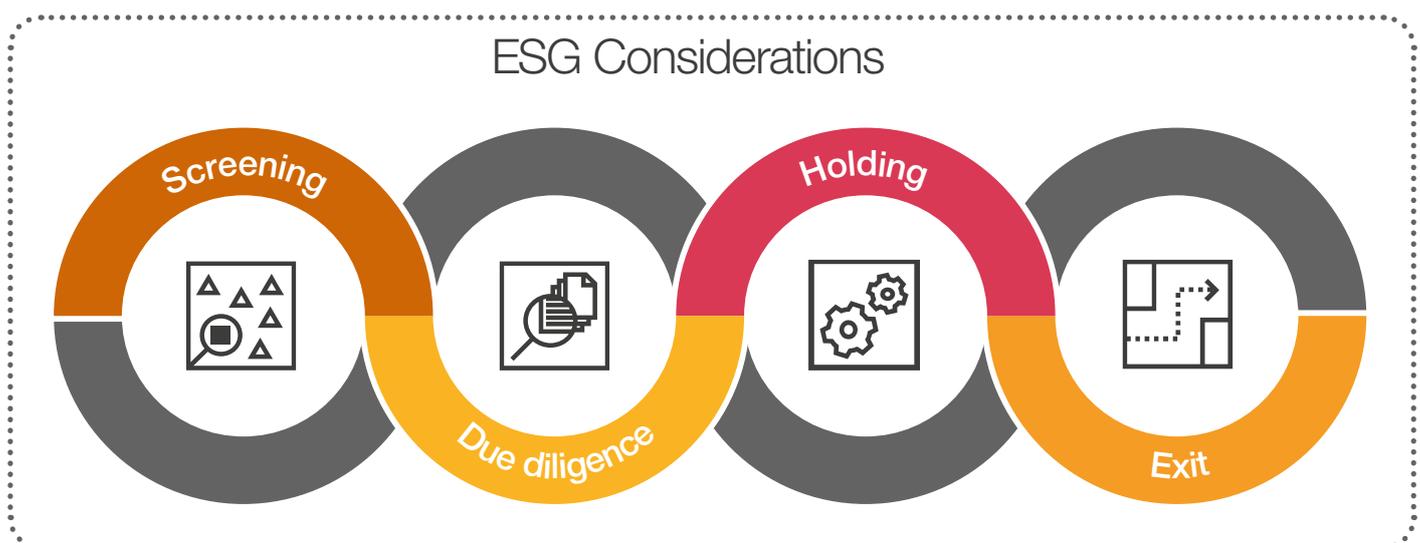
Starting 'from scratch'

The development of new ESG-oriented portfolios provides GPs with the unique opportunity to ensure ESG considerations are holistically and consistently incorporated throughout the entire investment life cycle; viewing screening, due diligence, holding and exit processes through an all-encompassing ESG lens:

“ Deeply embedding ESG into the investment methodology - to the point where ESG considerations and investment decisions are entirely inter-related – is absolutely key

Head of CSR/ESG, European Private Debt firm

Figure 8: ESG considerations throughout the investment life cycle



Screening



Screening the market through an 'ESG lens' in the pre-investment period is an effective tool when it comes to performing an upfront assessment of potential material ESG risks and opportunities. For example, GPs could formulate screening processes that effectively assess companies and sectors through a materiality lens, which will allow them to consider companies with non-sustainable activities or in traditionally less or non-ESG sectors (e.g mining, steel, construction) and develop important value creation strategies by actively supporting them in their transition and improvement.

Due diligence



The incorporation of ESG factors in due diligence is pivotal in identifying any material downsides that can affect the investments' success, as well as mitigating any potential ESG-related risks and legacy issues. Assessing ESG factors/KPIs in this investment phase also provides further insights regarding potential value creation during the holding period and is a starting point for setting action plans aimed at enhancing ESG performance. Although due diligence practices are largely asset-class and sector-specific, recent years have witnessed the emergence of a set of best practices and frameworks for the incorporation of ESG considerations in due diligence processes – which generally entail tailored questionnaires and checklists aimed at screening ESG risks.

Holding



An effective holding period is instrumental in appropriately managing the ESG risks identified during due diligence and capitalising on ESG-related opportunities and improvements; ultimately boosting underlying corporate's ESG KPIs and performance and paving the road for ESG's value creation potential to materialise upon exit. Effective and regular monitoring is also a paramount part of the holding process, ensuring that ESG factors and risks are being appropriately handled with. Regular ESG KPI tracking and reporting, periodic reviews of previously established action/transition plans and on-site visits (when applicable) can be powerful monitoring tools.

Exit



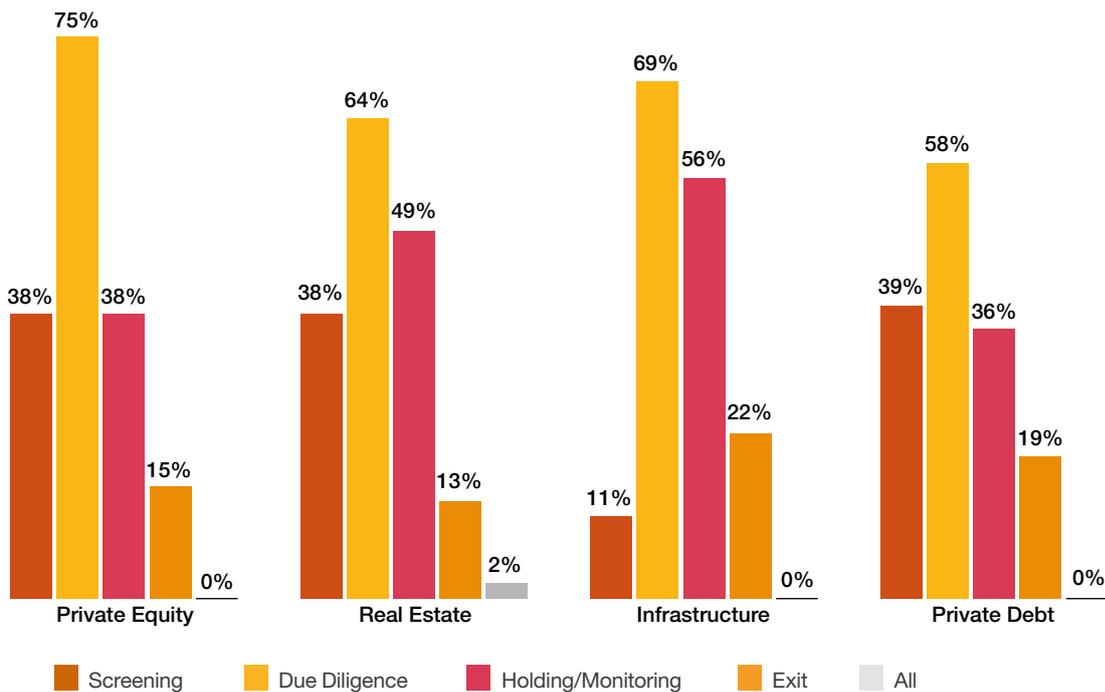
The provision and assessment of accurate, quantifiable ESG-related KPI improvements achieved during the holding period can translate into a more objective assessment of exit valuations (as well as providing a stronger case for valuation enhancement) and increase the number of potential bidders/buyers. Adequate proof of these ESG-related improvements and potential risks not only streamlines the exit process, but also helps providing an ESG roadmap for the subsequent owner – supporting them in the continuous improvement of ESG performance.

A deeper and holistic incorporation of ESG within the investment life cycle not only stands as the golden ticket to ESG's value creation/protection opportunity, but also facilitates alignment with evolving regulatory demands and with LP expectations. This incorporation should consist of both 'structural' changes (i.e. considering ESG-factors in the investment cycle), as well as thematic changes (i.e. covering ESG topics and relevance/materiality).

Despite these aforementioned benefits, our survey results suggest that GPs generally boast a less-than-holistic investment philosophy, with such an all-encompassing

approach being far more of an exception than a rule. In fact, while only 2% of RE GPs integrated ESG during the entire investment cycle, none of their surveyed PE, Infrastructure and PD counterparts did so (cf. exhibit 28). This confinement of ESG considerations to certain stages of the investment life cycle not only risks limiting ESG-related gains but may also undermine GPs' credibility in the eyes of their existing and prospective LPs.

Exhibit 28: In which phases of the investment process are ESG considerations taken into account? (GPs)



Source: PwC Global AWM Market Research Centre

In light of this, we have outlined three key action points that GPs should consider embracing when deciding to integrate ESG within their investment life cycle:

2.2.1 Formalise a transparent & rigorous ESG investment policy:

- The development of an ESG investment policy stating and detailing the GP's commitment to ESG not only works as an important signalling mechanism for LPs and stakeholders but also helps in the development of consistent and replicable screening, due diligence, holding/monitoring, exit and reporting processes. Drawing on pre-existing frameworks and initiatives can be a particularly useful first step when outlining such policies.
- Frequent revision and updating of ESG investment policies is also recommended in order to ensure alignment with ever-evolving LPs' demands and needs.

2.2.2 Prioritise material ESG issues:

- Focusing on ESG factors that are material throughout the investment life cycle is of the utmost importance for treating ESG beyond a mere box-ticking exercise.
- Materiality is important as it enables GPs to identify and prioritise areas for improvement throughout the investment duration in accordance with their impact on the portfolio company and their importance to stakeholders and LPs, providing a strong basis for assessing value creation potential.

- Using pre-existing frameworks and guidelines could represent a particularly useful starting point to spot which ESG considerations are the most material across different industries and sectors.

2.2.3 Identify & track ESG related KPIs:

- By making ESG-related improvements 'tangible', KPIs allow for the verification and quantification of ESG-related progress and risk throughout the investment life cycle.
- Identifying (and agreeing upon) measurable indicators at an early investment stage is essential for monitoring and tracking future ESG-related improvements, as well as spotting challenges and potential opportunities at subsequent investment stages.
- Well-defined and clear KPIs also allow for a more precise quantification of ESG performance improvements, providing a stronger basis for enhanced exit valuations.
- The lack of binding and harmonised approaches for KPI assessment has given rise to a series of frameworks and guidelines aimed at supporting GPs and LPs in the identification of relevant and material ESG KPIs across different sectors.
- However, the advent of the EU Taxonomy – and its provisions requiring non-financial companies to disclose their 'environmental performance into financial variables' – brings a degree of objectivity and harmonisation that will facilitate PM players' assessment of their investment decisions.

EU Taxonomy: Disclosure standards

The EU Taxonomy provides that non-financial companies disclose the share of their environmentally sustainable economic activities that are in alignment with its criteria. EU corporates will be required to disclose in accordance to EU Taxonomy standards based on three main types of disclosures:

- **Turnover:** proportion of net turnover stemming from products/services that align with the EU Taxonomy. These, in turn, provides a snapshot of the company's contribution to environmental goals.
- **Capital Expenditure:** proportion of capital allocated towards current or upcoming 'transition' towards Taxonomy-aligned activities. These will provide a view on companies' transformational ambitions.
- **Operational Expenditure:** proportion of operational expenditure allocated towards current or upcoming transition Taxonomy-aligned activities. These include direct non-capitalised R&D costs, renovation, leases and other everyday operational activities.



Transitioning your existing portfolio

While the closed-ended nature of Private Markets and GPs' rigid capital commitments may hinder the formal reclassification of non-ESG funds; certain GPs may choose to act now, repurposing/restructuring their existing portfolios on ESG criteria. Despite the burdensome nature of this strategy, those that opt for it stand to reap the benefits of complying with evolving regulator and LP demands while simultaneously reaping ESG's value creation and risk mitigation benefits. Furthermore, the repurposing/restructuring of existing portfolios can prove instrumental in retaining increasingly ESG-demanding LPs (especially those willing to divest away from GPs that continue to promote non-ESG-oriented funds alongside ESG ones) and to meet ever-pressing societal demands.

GPs looking to 'ESG-ify' their existing product shelves find themselves with two main options: i) divesting from non-ESG portfolio companies/sectors and re-investing the proceeds in ESG/sustainability-aligned businesses, and ii) rethinking holding and monitoring processes. While divestment may prove burdensome and displease or inconvenience certain LPs, ramping up ESG efforts during holding and monitoring can help streamline existing portfolio companies' processes and operations – increasing resilience and building a basis for valuation enhancement upon exit.

Overall, a given GP's ability to restructure portfolios could prove pivotal in ensuring that PM's long holding periods and close-ended nature do not constrain PM players – particularly those with a high number of legacy products – to play an active role in the ESG revolution. Even if repurposing/restructuring does not result in formal fund reclassifications, doing so (while actively demonstrating your repurposing efforts) can be an important step in the early transition towards a veritably sustainable portfolio.



2.3

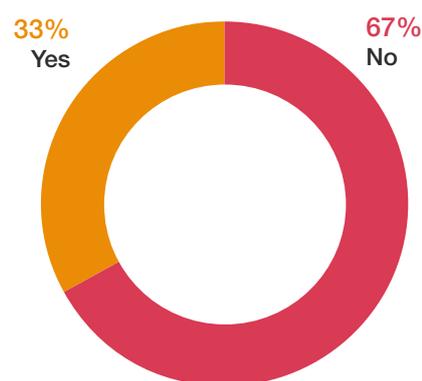
Actively manage ESG risk

As ESG becomes an increasingly central facet of Europe's regulatory landscape, GPs are being urged to reassess their risk management processes in order to incorporate non-financial risk alongside financial risk; no longer prioritising the latter at the expense of the former. The SFDR strongly catalysed the regulatory rally behind the institutionalisation of ESG risk management processes, requiring the assessment and monitoring of potential ESG risks even among products/funds that do not promote ESG as an investment criterion or objective.

Regulation aside, the active management of ESG risk is absolutely instrumental in reaping all the benefits inherent to ESG's value protection potential. Given that the materialisation of ESG risks can translate into material reputational and financial losses for GPs and underlying corporates alike, the strengthening of internal risk management and processes at every level is becoming increasingly imperative.

Although the holistic assessment of ESG risks at the portfolio level is paramount throughout entire investment lifecycle, the length of the holding phase – and therefore its high susceptibility to changing environmental and social conditions – renders the consideration of ESG risks therein of particular importance. As failure to conduct appropriate monitoring can not only translate into important financial losses but also into foregone value creation potential, it is in GPs best interest to strengthen their ESG risk monitoring capabilities. In spite of this, only 33% of our surveyed PE GPs had dedicated teams to monitor ESG risks during the holding period (cf. exhibit 29).

Exhibit 29: Does your organisation have a dedicated team for monitoring ESG risk during the holding period of an investment? (PE GPs)



Source: PwC Global AWM Market Research Centre

This notwithstanding, we believe that GPs' deeper engagement with underlying corporates renders them particularly well-positioned to support these corporates in the active mitigation of ESG-related risks. The implementation of effective ESG risk-management processes, in turn, can translate into portfolio companies' enhanced resilience to ESG-related risks and, ultimately, into enhanced exit valuations.



2.4

Create distinct & transparent reporting

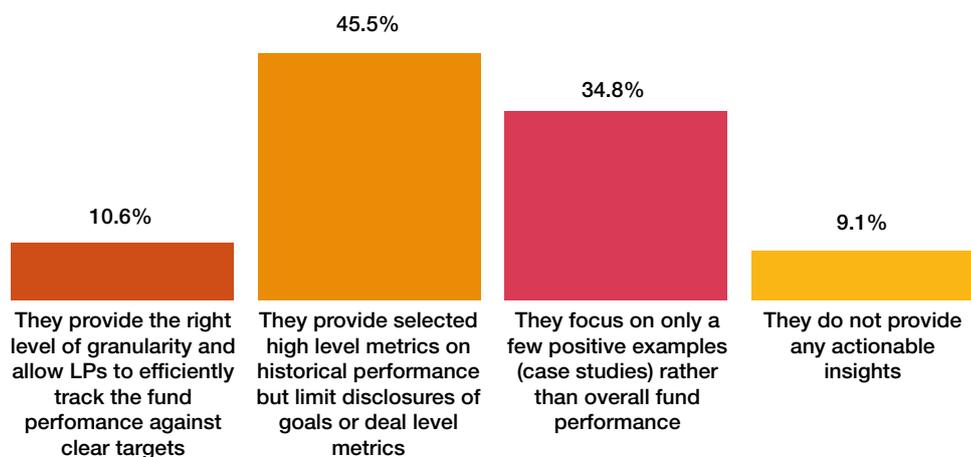
Accelerating regulatory momentum, coupled with mounting LP demands for transparency, are increasing the instrumentality of genuine and transparent reporting in the traditionally opaque Private Markets. Besides addressing regulator and LP needs, the provision of transparent, detailed and straightforward reporting also represents a valuable opportunity for GPs to demonstrate their ESG values to their employees and broader stakeholders. This revisiting of reporting practices can in turn generate significant reputational benefits, demonstrating GPs' deepening commitment to ESG and helping to strengthen the historically tentative link between Private Markets and ESG.

2.4.1 Reconcile regulatory demands with LPs' evolving reporting expectations

Although reporting content is largely dictated by regulatory developments, many LPs are going above and beyond – with reporting requirements often being as diverse as the LPs themselves. In this context, GPs should ensure that their reporting practices are designed not only to meet their LPs' content expectations but also to adapt to the evolving nature of their preferences. The Covid-19 pandemic, for instance, shifted investors' attention to the 'S' facet of ESG; which may imply heightened reporting requirements in social-related aspects and metrics.

Besides content-related issues, the level of granularity provided by GPs in their reporting efforts often does not accurately meet LPs' expectations. The findings from an INSEAD survey further highlight the extent of PE LP dissatisfaction with the level of sophistication provided by their GPs, with only 10.6% of respondents believing that they are provided with 'the right level of granularity' – i.e., one that allows them to adequately track the fund performance against clear targets (cf. exhibit 30).

Exhibit 30: What is your view on the number of ESG metrics reported by GPs post-investment? (PE-investing LPs)



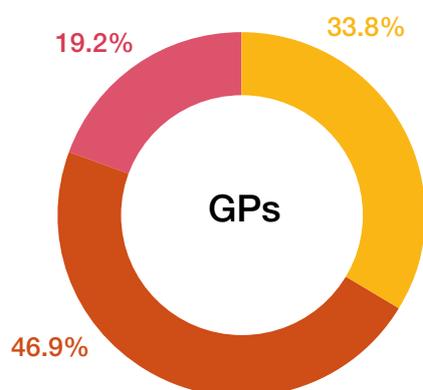
Our survey results also highlight a considerable misalignment between GPs' perception of their LPs' satisfaction with the overall quality of their reporting practices and LPs' actual levels of satisfaction. While virtually all of surveyed GPs agreed or somehow agreed that their LPs were content with the quality of their firm's ESG/sustainability reporting, the figure stood at just over a half when the analogous question was asked to LPs (cf. exhibit 31).

In summation, amidst an increasingly competitive environment and increasingly demanding LPs, simply attaining regulatory compliance is no longer sufficient to stand out from the crowd and meet LP requirements in terms of content, granularity and quality. This urges for an ongoing engagement with LPs to ensure their needs are being met; as well as the development of a flexible reporting policy that is able to promptly accommodate fast-changing and heterogeneous investor needs.

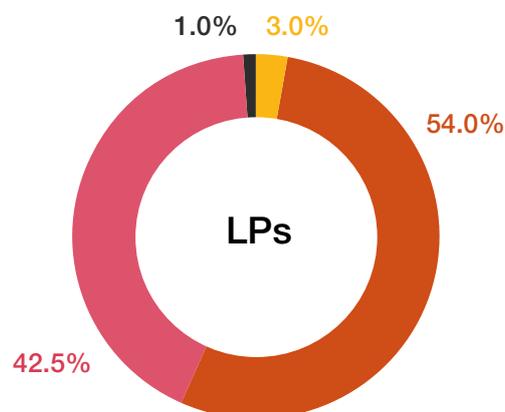
Exhibit 31

To what extent do you **agree with the following statement:**

My LPs are satisfied with the quality of my firm's ESG/
Sustainability reporting (GPs)



I am satisfied with the quality of ESG/Sustainability
reporting provided by my GPs (LPs)



■ Strongly agree
 ■ Somewhat agree
 ■ Neither agree nor disagree
 ■ Somehow disagree

2.4.2 Spread quality reporting standards throughout the value chain

The quality and precision of reporting from GPs to LPs (and to broader stakeholders) is intrinsically linked with the effectiveness of reporting practices from underlying portfolio companies to GPs. Adequate reporting from portfolio companies to GPs is also key to ensure an efficient and streamlined holding and monitoring period, as well as to ensure that eventual ESG-related action/transition plans agreed upon during due diligence are being followed through.

However, GPs have historically faced significant headwinds in this regard – with certain players fearing that stringent ESG reporting requirements would increase the burdensomeness of the reporting process, adding on to the already lengthy list of required financial KPIs. Other GPs often stressed difficulties that underlying companies experienced when tracking and measuring relevant ESG data, as well as reluctance from those in developing their own ESG data collection processes.

Recent and upcoming regulatory developments will help in minimising these headwinds, bringing much needed clarity and standardisation with respect to ESG-related information. Effective as of 2023, the aforementioned CSRD will require that all large European companies (whether private or public) and listed SMEs disclose the impacts of their operations on people and the environment. This, together with related regulatory developments, will significantly decrease the burdensomeness of GPs' assessment and collection of ESG KPIs from portfolio companies, ultimately helping to streamline reporting practices at various levels.

In summation, reporting is becoming increasingly instrumental for GPs to demonstrate to regulators, LPs and stakeholders that the right steps are being taken towards achieving a truly sustainable corporate philosophy and elucidate that they are holding themselves to the same standards to which they are holding their portfolio companies.



2.5

Master the data challenge

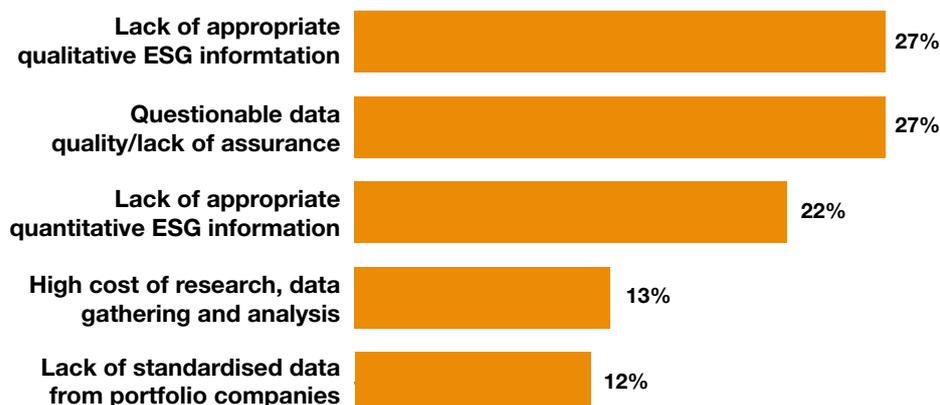
If an ambitious organisational and portfolio-level ESG strategy represent the steering wheel and engine that promise to drive Private Markets towards more sustainable aims, timely and accurate data is the fuel needed for the rubber to hit the road. In other words, mastering the data challenge is the ‘sine qua non’ condition for successful materialisation of the abovementioned action points. Timely, accurate, and relevant data is not only central to achieve regulatory compliance but is also a central tenet of an effective quantification of ESG-related risks and improvements – ultimately providing a quantifiable base for the assessment of ESG’s value creation potential.

That being said, data is as challenging as it is crucial. The historical lack of data harmonisation, coupled with Private Markets’ inherent opacity, has largely complicated the data collection, synthetisation and dissemination processes at several levels. In fact, data challenges ranked as the second most dissuasive challenge in the ESG integration among our surveyed GPs. Among these, a lack of appropriate

qualitative and quantitative data, as well as the questionable quality of the data itself, stood as the primary drawbacks (cf. exhibit 32). Besides dissuading GPs from doubling down on their ESG efforts, the data challenge has ultimately translated into in a growing asymmetry between LPs’ data requirements and GPs’ satisfaction thereof.

The resolution of Private Markets’ characteristic data challenge lies in the streamlining of in-house data collection and analysis procedures at the organisational and portfolio company level; as well as the development of processes in order to evaluate and disseminate ESG-related data to regulators and investors. We strongly believe that digitisation represents a compelling solution to this hurdle. In this context, GPs that opt to ‘top up’ their digitisation game by leveraging a range of disruptive cutting-edge technologies to streamline data processes and maximise efficiency are the most likely to gain a competitive edge with respect to their less technologically advanced counterparts.

Exhibit 32: Within the data challenge, which of the following do you consider to be the biggest barrier to ESG adoption? (GPs)



2.5.1 Leverage data collection processes from underlying corporates

The quality and precision of the data that GPs receive from portfolio companies will largely determine the accuracy and relevance of the information they provide to LPs, regulators and broader stakeholders. Furthermore, data quality is equally pivotal in the effective assessment of risk, the tracking of ESG-related progress and the objective quantification of corporates' ESG impact.

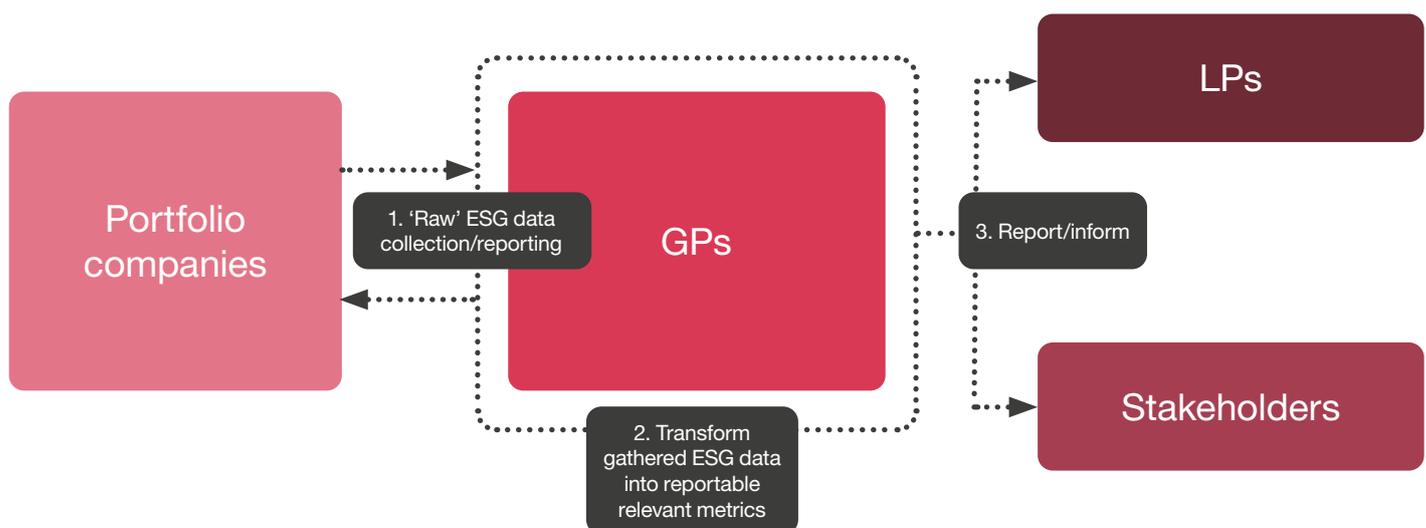
A series of structural hindrances have historically complexified GPs' corporate data synthetisation processes. The primary roadblock has traditionally stemmed from the disjointed and heterogeneous nature of non-financial reporting, which has left GPs struggling to reconcile a wide range of differing terminologies and methodologies. This is further ambiguated by lacklustre corporate reporting standards and the strong degree of sectoral heterogeneity between portfolio companies. Not only this, but the inherent opacity of Private Markets – and unlisted nature of the

corporates therein – have resulted in an ESG data market largely skewed in favour of public markets; leaving the ESG data collection process largely up to the GPs themselves.

This notwithstanding, GPs' direct access to corporate data – as well as their ability to support companies that are unwilling or unable to streamline their ESG data-related processes – represents an important advantage with respect to their public counterparts. These features, coupled with recent and upcoming disclosure-related regulatory developments, are set to partly alleviate the magnitude of the data challenge within PM; especially with respect to standardisation.

However, while the quality-enhancing benefits of these developments cannot be understated, the adequate synthesis of ESG-related information and its subsequent dispersion to regulatory entities and LPs will remain a significant challenge. GPs that wish to meet LPs' content, quality, and granularity expectations should go above and beyond regulatory provisions and refine their data collection processes accordingly.

Figure 9: ESG data collection/reporting processes in Private Markets



2.5.2 Up your digitisation game

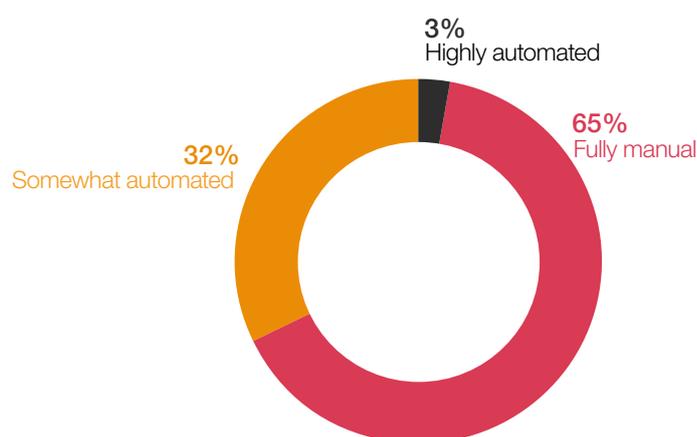
Digitisation represents a compelling solution for GPs looking to circumvent the abovementioned ESG data hurdles. Emerging tools, such as ‘next-gen’ data analytics, machine learning and artificial intelligence, can help these GPs refine the data collection process from underlying companies, effectively track ESG-related improvements and performance, and streamline the reporting of relevant metrics to LPs and regulators.

Although the benefits of technologically-enhanced data gathering processes cannot be overstated, their implementation is still far from widespread. According to the 2021 Private Funds CFO survey, as much as 65% of GPs still collect ESG data manually; with as few as 3% of respondents characterising this process as ‘highly automated’ (cf. exhibit 33). These figures are directly related to the ‘spread-sheet based’ data collection culture deeply

entrenched in the PM realm, as well as an over-reliance on legacy data systems that often prevent GPs from fully digitising.

As we emerge into an increasingly ‘data-driven’ AWM industry, GPs that remain hesitant to modernise their data-collection processes will find themselves unable to keep up with the pace and dynamism that this new reality requires. Although the inherent costs and operational interruptions associated with upgrading or implementing cost-cutting technologies may dissuade GPs, the inherent benefits that stand to be unlocked will offset these drawbacks in the medium to long term – as these technologies will not only allow to extend the scope of available data, but also to assess the quality, reliability and plausibility of collected data. Moving forward, we strongly believe that technological capabilities will increasingly separate who will merely survive from those that will actually thrive.

Exhibit 33: How automated is your ESG data gathering process (from portfolio companies)? (GPs)



Source: PwC Global AWM Market Research Centre, 2021 Private Funds CFO Leaders Survey

3

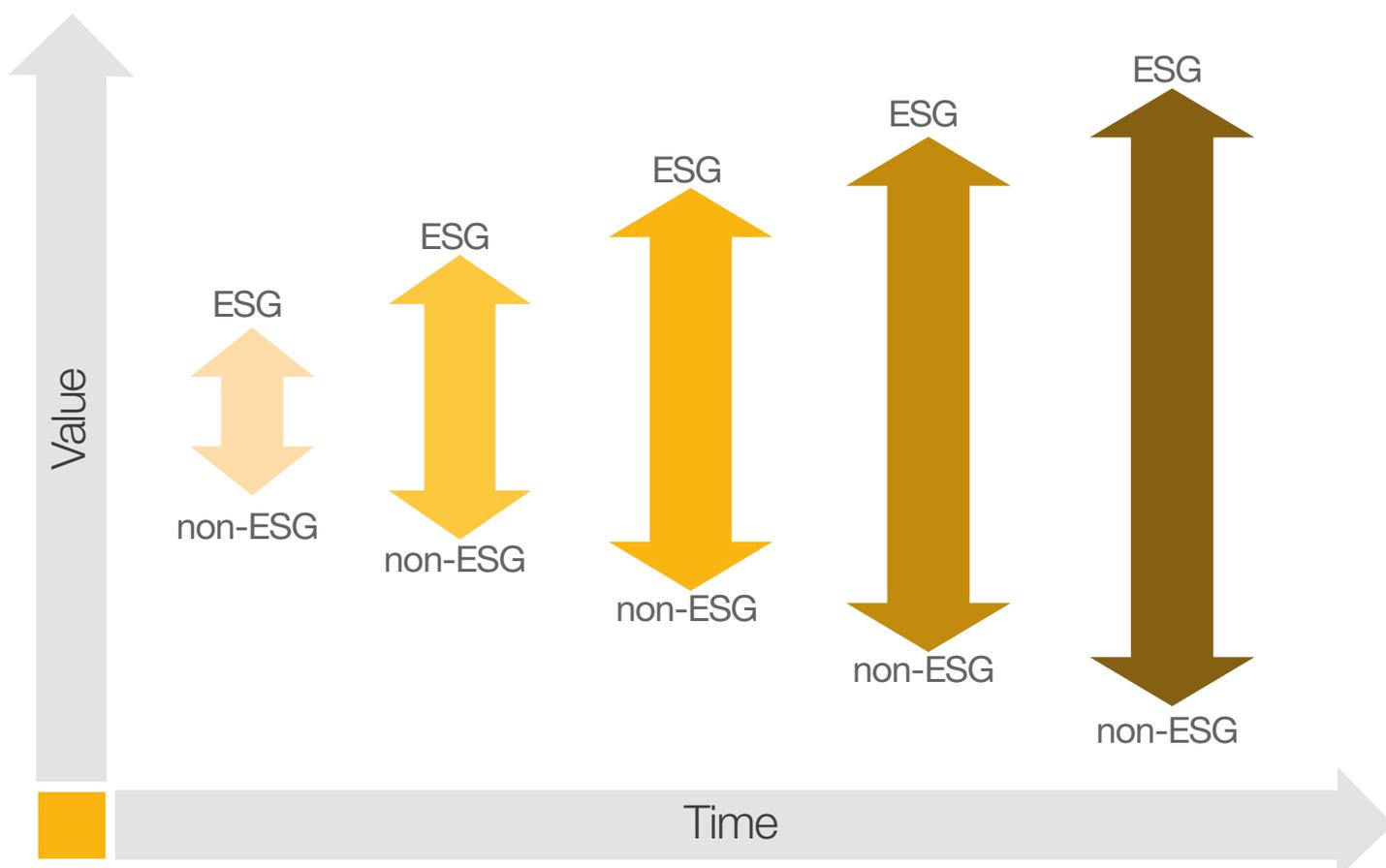
Conclusion

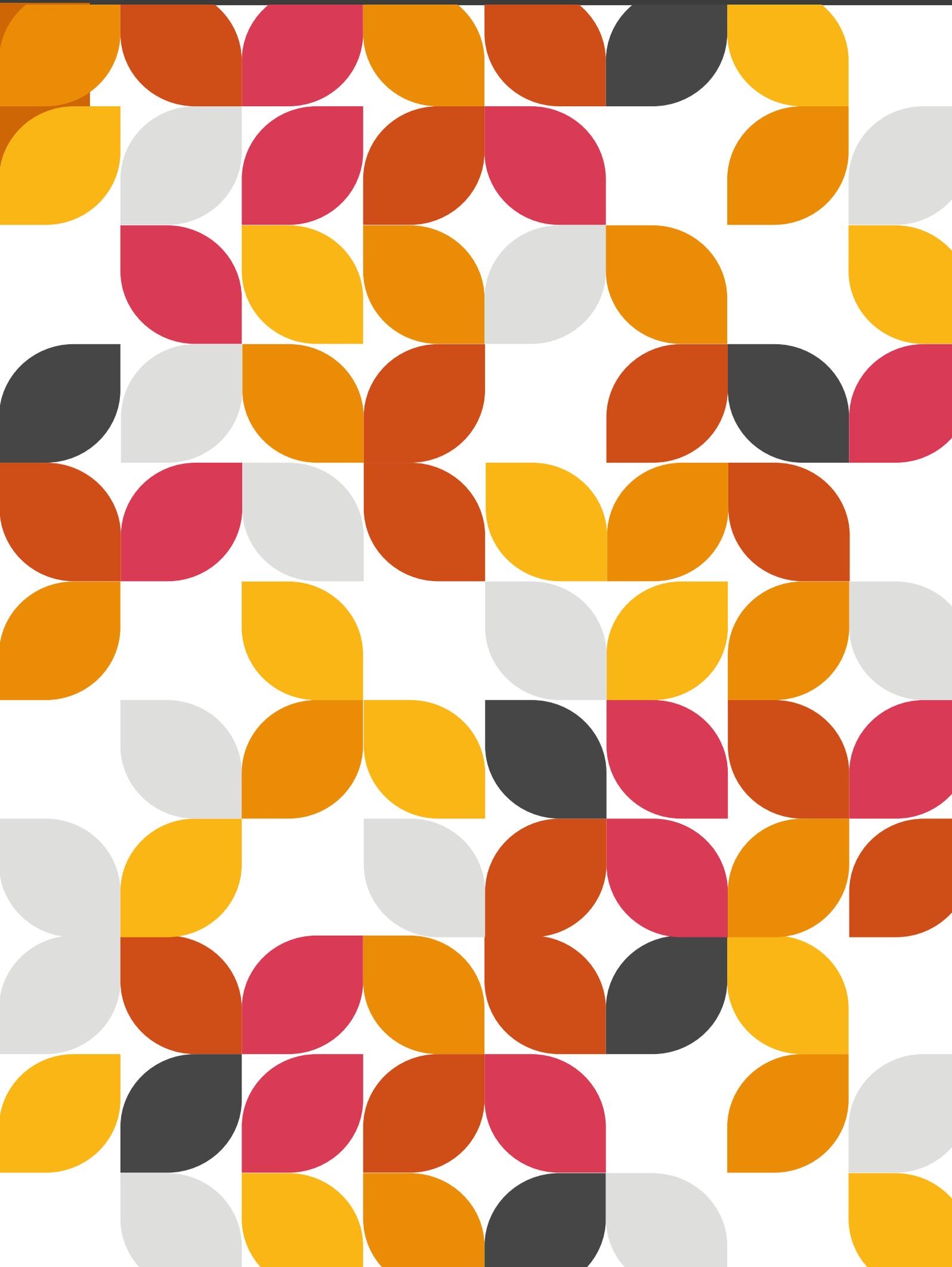
A combination of external and internal drivers has been propagating a veritable ESG shift in the European Private Markets landscape. While the former has long been driving this shift, it is the growing recognition of ESG's value protection and creation potential that is set to take it to unprecedented heights. In particular, GPs are waking up to the fact that ESG's reputational enhancement, revenue-boosting and cost-cutting potential ultimately provide a strong case for valuation enhancement. This is illustrated by the fact that GPs, on average, benefited from a premium of between 6% and 10% following ESG implementation within their investment methodologies.

While this premium is by no means negligible, we strongly believe that this is just the tip of value creation iceberg; and that the full benefits that stand to be unlocked by grabbing the ESG opportunity with both hands are yet to materialise. The actual magnitude of the value creation opportunity is currently hindered by the adaptation phase of the ESG journey in which the industry finds itself; with players swiftly adjusting their investment methodologies and corporate ethos' in order to adapt to this evolving landscape and to the growing ESG needs of LPs. This process is anything

but linear, however, with the evolving state of the future regulatory landscape – combined with the heterogenous nature of LP expectations and difficulty in dealing with legacy assets – adding on to the vast list of hurdles that GPs have to overcome.

However, we expect these concerns to start alleviating considerably by 2022. As regulations start to settle in and players increasingly wake up to the sheer magnitude of the ESG value creation opportunity, we expect ESG to quickly become a 'natural reflex' for both GPs and LPs – to the point that its incorporation into investment decisions and portfolios becomes the status quo. This will see an increased discount across the non-ESG realm, leading to a continuous widening of the value spread between ESG and non-ESG assets. Even if the premium on the former increases only moderately, the discount on the latter stands to be such that the discrepancy between both will be anyway magnified. As this materialises, and ESG emerges as the new standard for investment, we strongly expect the premium yielded by ESG assets to jump to 100% by 2025.





4

Methodology

Forecast

We use econometric modelling to obtain our estimates. The AuM is used as the target variable and various macroeconomic indicators from the IMF and IHS Markit are used as explanatory variables.

We have mainly utilised Private Markets data from Preqin. The models are based on several economic factors. The most prevalent economic indicators across our models were the GDP in PPP (Purchasing Power Parity) and interest rates.

We use statistical software to search among hundreds of different possible (linear) models. We test the models in levels, in differences, in logs, and with and without lags, and have shortlisted those statistically significant models. Our Senior Economists finally choose among the plausible models selected by the algorithm.

Our forecasts are based on the IMF WEO and IHS scenarios which included substantial uncertainty across financial and real economy markets. We have subsequently utilised the scenarios provided by the OECD and the World Bank. The most optimistic scenario was used to build our 'High' scenario whereas the 'Baseline' scenario is considered as the scenario that is most likely to materialise through until 2025.

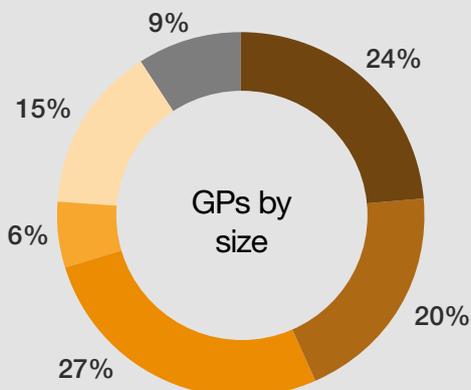
Survey

In addition to our econometric analysis, we carried out a survey of predominantly European-based GPs and LPs in order to paint an accurate picture of how the PM landscape

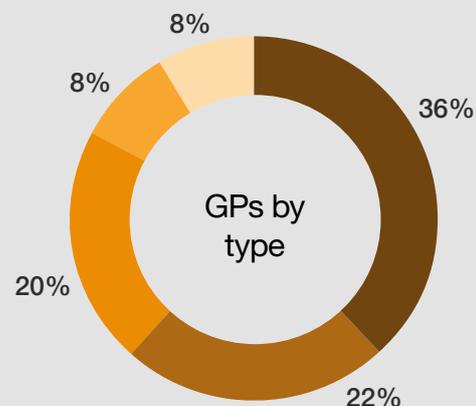
views the current ESG shift, and the direction in which this shift is likely to take the industry in the coming years.

GP survey

Our GP survey sample includes 200 respondents accounting for a total global AuM of EUR 16.7tn – with our respondent base being largely cross-sectional in terms of size/tranche. These GPs covered the entire PM investment strategy spectrum, with our respondents primarily being active in Private Equity (36%), Real Estate (22%) and Infrastructure funds (20%).



■ <=500m ■ 501mn-1bn ■ 1.1bn-5bn ■ 5.1bn-10bn
 ■ 10.1bn-100bn ■ 100bn+

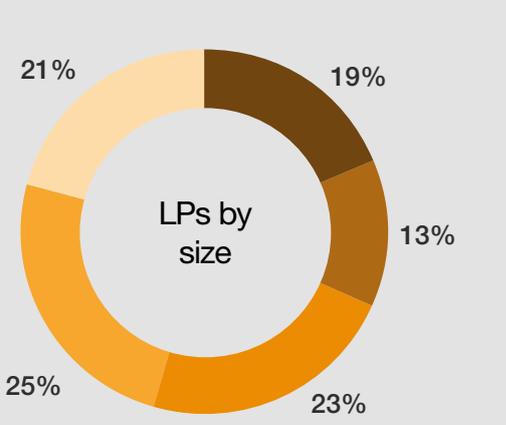


■ Private Equity Funds ■ Real Estate Funds
 ■ Infrastructure Funds ■ Private Debt Funds
 ■ Multi Assets

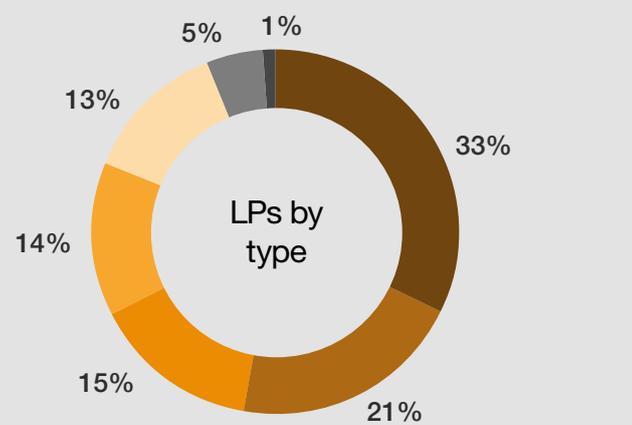


LP survey

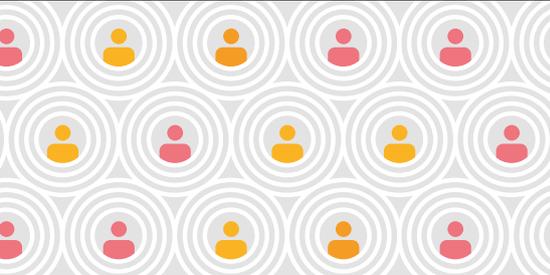
Our LP survey consists of 200 respondents, with combined global assets of EUR 29.4tn. Our respondents covered a wide AuM spectrum in terms of size, with almost half boasting assets of over EUR 10.1bn. In terms of LP type, Public and Private pension funds together accounted for over half of our LP respondent base.



■ <=500m
 ■ 501mn-5bn
 ■ 5.1bn-10bn
 ■ 10.1bn-100bn
 ■ 100bn+



■ Public Pension Funds
 ■ Private Pension Funds
 ■ Endowments/Foundations
 ■ Family Offices
 ■ Insurance Companies
 ■ Sovereign Wealth Funds
 ■ Other



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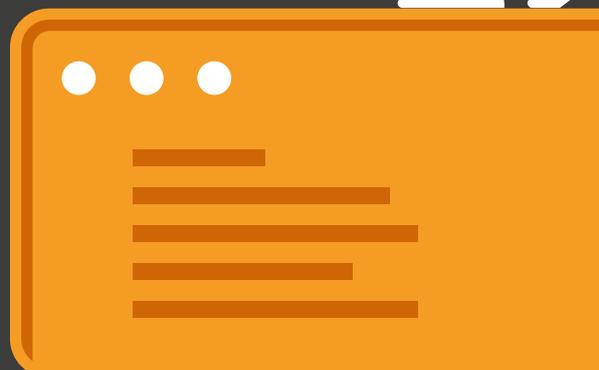
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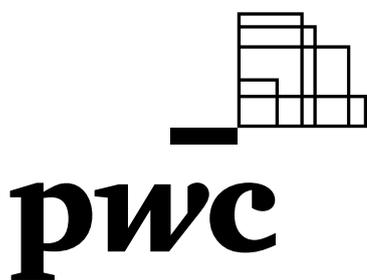
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