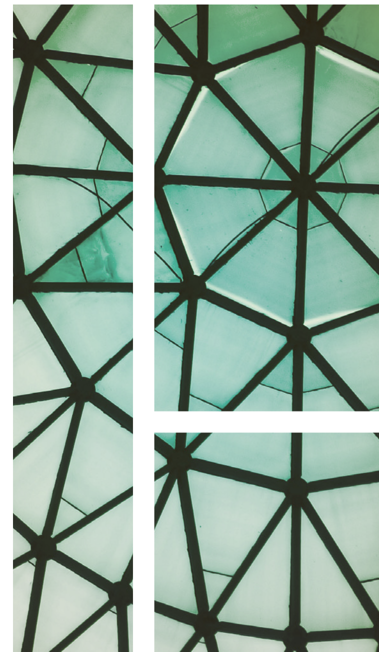
Looking to Europe for Insight on the Increasing Criticality of ESG in Investing

As enthusiasm for Environmental, Social and Governance (ESG) investment continues to rise, businesses and institutional investors are shifting focus to maximize the impact of purpose-driven investments and take advantage of high volumes of capital dedicated to sustainable investing. Today, the most sophisticated businesses and corporate leaders recognize the importance of evaluating and quantifying ESG efforts to a much broader group of stakeholders beyond internal shareholders. Historically, European companies have been at the forefront of ESG adoption. Now, companies beyond Europe should look to the region for several key insights in areas such as reporting, capturing investor interest, due diligence and talent retention.



European countries have noticeably taken a leadership role in establishing and executing sustainable finance and ESG disclosure policies, namely the green taxonomy and the Sustainable Finance Disclosure Regulation. While many global markets already require standardized ESG reports, the U.S. disclosure landscape has historically been comparatively more fragmented in terms of reporting standards and frameworks. Recently, the U.S. Securities and Exchange Commission (SEC) has proposed new climate disclosure rules for public companies and is expected to introduce a human capital disclosure rule in the next several months. While these disclosures are directed at public companies and have not yet passed as law, companies public and private operating ahead of the curve should look to European standards as an example of where the regulatory landscape is trending and as a best practice example.

The SEC's actions aligned with increasing interest from investors and other stakeholders in providing more detailed, measurable information from companies about their ESG commitments, progress and evaluation against competitors. In 2021, BloombergNEF assessed G-20 countries' mandatory ESG disclosure policies, assigning each country a regulatory landscapes score out of 10. The surveyed countries were assessed on how much their policies cover, how ambitious and guided the policy is and the level of international coalition influencing them. The average score across all countries fell at a 6.57 out of 10. Countries with higher scores were unsurprisingly those with more strategic and comprehensive ESG policies as well as standardized processes for reporting against those efforts. Ultimately, companies that can communicate how they deliver both financially and environmentally have become endlessly valuable to regulators and investors alike.

Investing trends in Europe also demonstrate that ESG considerations are a critical factor in transaction decisions for many market participants around the globe, and the pressure to invest sustainably will only continue to grow. If companies fail to understand and communicate the diversity or environmental impact of their organization, they could miss out on significant investor interest and capital. In order for private equity funds to maximize interest, general partners must demonstrate the ESG-related impacts and benefits of the fund to limited partners (LPs), or risk losing out on funding.

Further, institutional investors, sponsors and lenders increasingly view due diligence of ESG initiatives as equally important to traditional financial due diligence processes. As these stakeholders aim to better understand the risks, long-term profitability and reputational considerations of the companies to which they deploy capital, sustainable due diligence is a critical step. They are particularly wary of "greenwashing" and lessons from European successes indicate proper measurement and reporting can help demonstrate meaningful progress against ESG commitments.

Finally, as social pressures from younger demographics continue to increase, ESG prioritization will not only become table stakes in due diligence and reporting processes globally, but also a key factor in attracting and retaining talent. As such, boards will see increased pressure to remove socially and environmentally sedentary leadership teams. With the value and importance of ESG in investing becoming exceedingly pervasive, now more than ever investment managers will be held accountable for how they choose to standardize, report metrics and deploy capital.

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United States

While the European Union has previously enjoyed a head start on ESG implementation, U.S. companies are quickly making the topic a priority focus and accelerating adoption of ESG principles to catch up with global markets. There is now widespread recognition in the U.S. that sustainable investments and corporate practices are both the right thing to do and the key to generating higher returns long term. As a result, there has been pressure from corporate boards, employees and shareholders to address ESG and incorporate it into business planning.

Given the complex political and social environment in the U.S., expects that social pressure will continue to drive increased interest in ESG before regulatory and corporate policies, such as the SEC's recent proposals, are formalized over the long term. Further, as companies continue to adopt new ESG standards, those that are viewed as more sophisticated, impactful or comprehensive will over time become the "best practice" example that could influence future regulatory mandates.

Ultimately, the reality today is that companies that are not already thinking about and addressing ESG are already behind by both U.S. and European standards. Within private equity, specifically, companies should have a basic framework for how they will evaluate investments and invest with purpose, create long-term, sustainable value for LPs and attract capital from investors with an ESG focus. As the ESG conversation in the U.S. becomes more advanced and given recent trends focused on measurement, we expect the next area of focus will shift beyond simply communicating ESG policies to measuring and reporting their impact.

Europe

Recent shifts in mindset have caused internal shareholders to begin allocating capital for ESG investment—especially in Europe. While capital dedicated to sustainable investment has historically been focused on the businesses known for "doing well" against ESG benchmarks, there are now more investors considering the long-term value of investing in corporates actively transitioning towards sustainability as part of their remit. This prioritization of the ESG journey over current ESF performance arises as an attractive opportunity for our clients in more traditional sectors.

As investment in corporate ESG prioritization and implementation gains pace, many players begin to evaluate what the valuation premium, if any, is for being recognized as an ESG-focused organization. While Lincoln has seen increasing incorporation of ESG considerations in diligence processes, there are currently limited metrics to measure this, other than margin reductions in sustainability-linked loans. However, it is important to note that organizations not executing against a clear ESG strategy will attract reduced investor appetite over time, resulting in less competitive tension and lower valuations.

Based on these factors, Lincoln expects that ESG will become a key due diligence component in sale processes in the coming years. For example, a recent European mergers and acquisitions (M&A) deal in the industrial sector saw substantial investor scrutiny on ESG due diligence, even more than on tax due diligence. Further, Lincoln has also seen the scope of diligence required by investors expand – direct environmental impact continues to be important, but investors are equally considering the sustainability of the supply chain across all pillars, with E, S and G in mind.

However, sustainable investment does not come without challenges. While there are clear benefits from a long-term perspective, in the short-to mid-term, sustainability initiatives may result in cost inflation and impact global growth. Lincoln is seeing corporates and investors increasingly focus on sectors benefitting from megatrends, including cybersecurity and energy transition, to provide investment protection during the transition period. Ultimately, despite near-term challenges, it is clear ESG is here to stay and will continue to significantly impact investing priorities.

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