PRIME SUSTAINABILITY SERIES

There's No 'EBITDA' for ESG...Yet

When many factors are mistaken for one

How can we make sense of a landscape that, on the one hand, is so varied it includes factors as diverse as water usage or carbon footprints *and* board or workforce diversity - but on the other, is portrayed in headlines as "one" strategy or force?

Such is the challenge of ESG investing in 2021.

With literally **hundreds of factors, dozens of ratings agencies, many more frameworks and a not insignificant number of regulators focused on the topic: ESG investing in 2021 is in a similar position to various accounting standards in its earlier days. Certain – but not all - factors will become standards, and another normal line item for investors to consider as part of their investment process.**

Today, there is agreement, if not consensus that **there are a number of financially material factors not currently captured in traditional accounting metrics.**

- A number of these factors **fall under an "ESG" umbrella**
- These factors **vary by sector, company and region**
- But they matter sufficiently **to warrant inclusion in managers' investment and risk management processes**
- As such, a **meaningful and growing number of alternative managers have dedicated resources and drafted policies** to address this rapidly moving topic

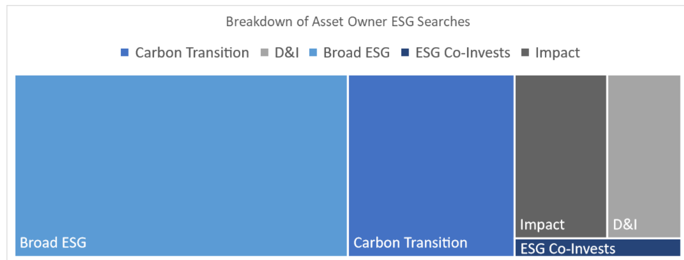
DRIVERS OF INTEREST IN ESG INCLUDE ASSET OWNERS, INVESTORS, REGULATORS AND CORPORATES

What's been behind the growth in interest in ESG? The fact it is coming from many different corners of capital markets. As we have written previously, it is possible – or even likely – that in the coming decade, dominant factors currently falling under an ESG umbrella begin to stand on their own and are regularly reported by companies and incorporated into investment or risk models. Some of the most material include:

1. **Climate risk**. A working group at the CFTC stated bluntly in 2020: "Climate risk is financial risk."[1] While **zero emissions does *not* mean zero oil, at least in the short term, there is a growing consensus that a broad based transition to a lower carbon economy will impact asset and/or enterprise values.**
2. **Confirmation bias/groupthink.** Viewed through a lens of workforce, management team and board diversity, many have reported on the risks posed by overly homogenous groups of decisionmakers.
3. **Data governance**. The SolarWinds hack was only the most recent reminder of the critical nature of protecting our digital infrastructure. As the world moved remote nearly overnight, turning millions of homes into home offices, companies are even more challenged to maintain sovereignty and protect their data.

ASSET OWNERS: WHERE DOES INTEREST LIE?

As of 1H2021, asset owners', CIOs' and Investment Committees' ESG interest is varied. **A survey of ~100 open ESG mandates reveals different factors are in demand**.



Source: Jefferies Prime Services

About 50% of searches are focused on "broad/open ESG" strategies, allowing for many different conversations with managers, 20% on carbon transition factors and strategies, and the remaining 30% across D&I/talent and human capital, impact investing, and a small number on ESG co-investments.[7]

As asset owners work to make sense of what ESG factors are financially material, they are keeping searches fairly broad. The majority of searches are for "open ESG relevant strategies," and even when a search is more targeted from a thematic perspective (i.e. – carbon transition) there are multiple ways in how to approach it.

This makes complete sense if we look at ESG as a suite of factors. Just as factor investing prompted asset owners to reassess "hidden risks" lurking across their books, ESG is prompting a similar investigation.

This allows for more transparency and collaboration between managers and allocators and has resulted in managers crafting broad and agile ESG policies and customized products to address the rapidly shifting landscape and expansive asset owner interests.

HOW ARE MANAGERS RESPONDING?

A notable and growing number of alternative managers are putting pen to paper and are identifying the ESG factors that are material for their strategies. **In fact, some allocators anecdotally report between 60 – 70% of the managers on their platforms have an ESG policy, though these policies are extremely broad and diverse.**[8] It should be noted that these mangers are typically on the more mature end of the spectrum, and in some cases have collaborated with existing LPs to understand their needs and views.

~60% of managers are addressing ESG

With policies, working groups or dedicated resources[9]

WHAT DO THESE POLICIES ADDRESS AND WHAT IS COMMON?

i. What **ESG factors are material to the firm's strategies**, and how do they influence investment and risk management processes?
ii. What **metrics (if any) are incorporated into investment/risk processes**? Why were those selected?
iii. In some cases, **identifying sectors not in the investment portfolio**, or addressing investments therein
iv. In some cases, discussing **what the fund or organization itself is doing** to think about these material factors, as applicable, vis-a-vis their own operation ("If you're going to have it as a product, should you live it as a firm?")

WHAT FRAMEWORKS ARE COMMON?

There are literally dozens at this point – contributing to the confusion or challenge of harnessing standardized metrics.

Of particular note:

- **Task Force on Climate Related Financial Disclosures (TCFD)**
  Known for: Clear proposed guidelines to help identify, measure and disclose climate related risks.[2]
- **Sustainability Accounting Standards Board (SASB)**
  Known for: "Identifying the subset of ESG issues most relevant for 77 industries and… help companies disclose financially-material sustainability information to investors."[3]
- **UN Principles for Responsible Investment (UN PRI)**
  Known for: Global network of signatories and broad reaching goals to build more "prosperous and inclusive societies for future generations."[4]
- **Global Reporting Initiative (GRI)**
  Known for: A broader framework that does not just address those factors with financial materiality, but attempts to address an issuer's social and community impacts as well.[5]

This is to say – there is **no one global reporting standard now**, or even generally accepted common metrics/principles that may slightly vary by jurisdiction (as can occur with more traditional accounting). We anticipate harmonization over time, particularly with regards to climate and human capital issues.

In the meantime, managers, asset owners and corporates are all working to identify the financially material factors for their own firms and sectors, and many anticipate building in any global standards to a **"new balance sheet" in the years to come.**

WHERE DOES REGULATION STAND

Depends on the jurisdiction. The U.S. and the E.U. (and, potentially, the U.K.) have taken different approaches to regulating sustainable investing. While the **E.U. passed the Taxonomy Regulation** to minimize "greenwashing" by establishing mandatory EU-wide criteria for designating which economic activities *are* sustainable in 2020, the U.S. only just designated an ESG lead at the Securities and Exchange Commission in February.[6] Europe has also passed the SFDR – the Regulation on Sustainability Related Disclosures for Financial Services. No comparable regulation exists to date in the U.S.

"ESG: Doing well by doing good" has been replaced by ESG: financial materiality.

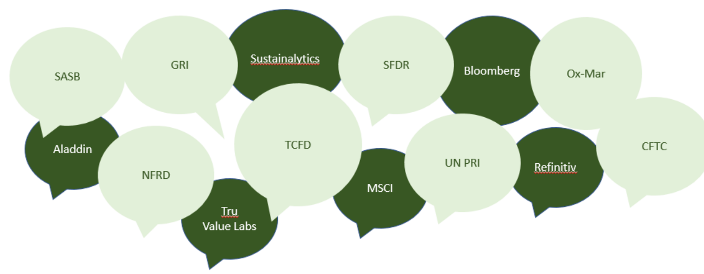
In the U.S., the focus is on transparency and reporting – both at the company level and at the manager level.

On the one hand, there is general consensus that climate issues and a transition to a lower carbon economy will have material impact on enterprise value, asset valuation and capital allocation. But on the other, there will be a desire to minimize any potential 'greenwashing' of investments in this space.

Companies, investors and asset owners want to have more data to properly identify and plan for these changes.

Today – **frameworks are fragmented and have yet to be harmonized. Regulation is fragmented and has yet to be harmonized. And the ESG ratings agencies (of which there are more than 100) are fragmented and have yet to be harmonized.**

Snapshot of Frameworks, Regulation and Ratings Agencies



Source: Jefferies

GIVEN THIS DIVERSITY, HOW ARE MANAGERS MEASURING ESG AND HOW ARE ALLOCATORS RESPONDING

As with any other financially material factor – there is no one size fits all approach. **ESG is an orchestra, not a single driver.**

Managers are proactively researching what may be critical for their current strategies and investment processes and are ensuring these factors (some of which may have long been measured, like governance), are front and center when considering initiating positions and the sizing thereof.

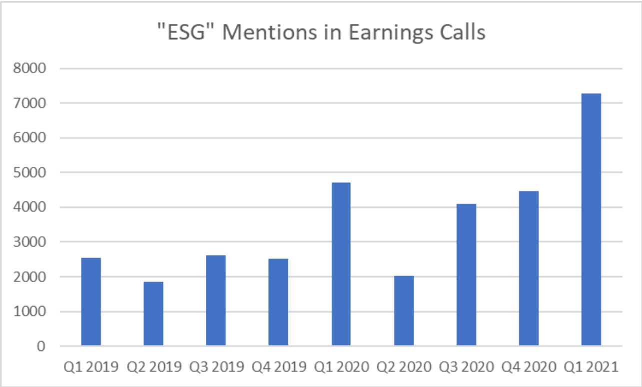
What they are not doing is attempting to be all things to all ESG investors. Those who *do* are seen, often rightly, as using ESG as an enhanced marketing tool rather than an investment or risk factor. Rather, different sectors require different factors – with managers acknowledging standards around many will change in the coming years, necessitating updates of investment processes.

WHAT DO COMPANIES THINK

Companies have been early in identifying some of the material factors impacting their businesses that fall under an ESG umbrella: confirmation biases and groupthink that may arise from homogenous decisionmaking groups, climate transition and carbon footprints all top the list.

And we are increasingly seeing remarks around these issues making their way into earnings calls and other public statements.

GROWTH IN ESG/SUSTAINABILITY MENTIONS IN GLOBAL EARNINGS CALLS 2019 - PRESENT



Source: Bloomberg. Note: this chart reflects mentions of "ESG," sustainability, carbon neutrality, climate change or diversity & inclusion.

HOW JEFFERIES CAN HELP

We have fielded a considerable number of new inquiries from managers, allocators and companies wishing to explore many of the opportunities and challenges posed by the growth in sustainable investing. Although much is changing on the ground on a regular basis, there is a considerable sense that greater transparency and measurement will create better outcomes for all three sets of actors.

In any era, there are new and emerging drivers that shape company profitability and long term success. This generation's may largely fall under the ESG umbrella. While there are hundreds of different considerations to consider – some may emerge as new 'factors' that shape hidden opportunities and risks in portfolios.

We look forward to helping you understand the shifting and maturing landscape as these drivers become more clear.

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[1] "Managing Climate Risk in the U.S. Financial System." A report by the Climate-Related Market Risk Subcommittee, Market Risk Advisory Committee of the U.S. Commodity Futures Trading Commission. September 2020.

[2] www.fsb-tcfd.org

[3] www.sasb.org

[4] www.unpri.org

[5] www.globalreporting.org

[6] www.sec.gov/news/press-release/2021-42

[7] Jefferies Prime Services

[8] Jefferies Prime Services

[9] Jefferies Prime Services