NORDSIP
NORDIC SUSTAINABLE INVESTMENTS

Round Table Discussion
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insights

SUSTAINABLE PRIVATE ASSETS

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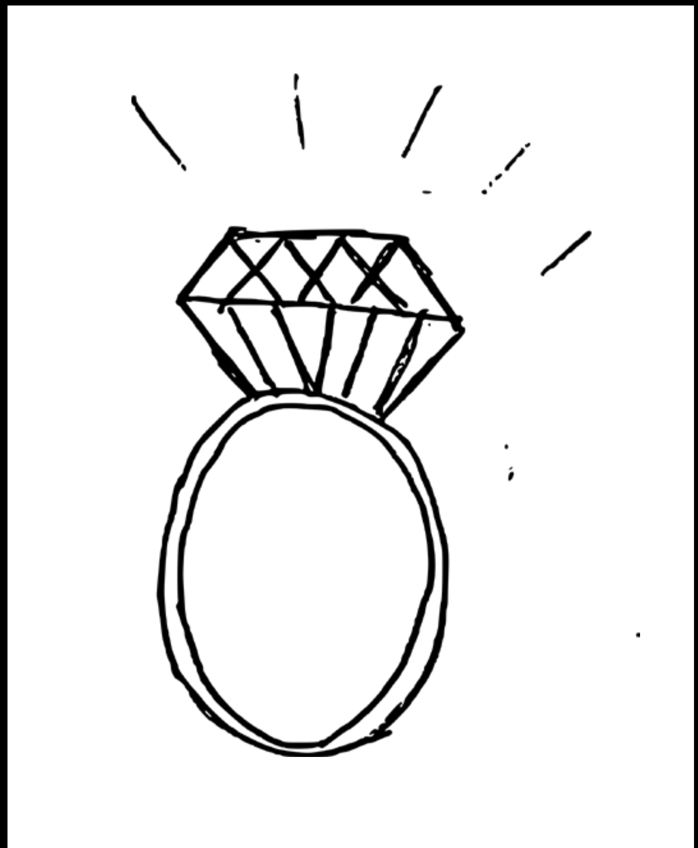


amuse-bouche

it's {not!} complicated

Aline Reichenberg Gustafsson, CFA
Editor-in-Chief
NordSIP

Celebrity weddings are well-known for their prenuptial agreements (or "prenups"), which are intended to help the happy couple negotiate the potentially bumpy road ahead. Similar care is taken when embarking on long-term, locked-in private markets transactions. Asset owners have long been used to conducting deep-dive due diligence of their potential providers and making sure to sign watertight written agreements with them.

Now that environmental, social and governance (ESG) factors are having to be considered throughout the investment value chain, how have private asset investors kept up with the rapid pace of change? As in personal relationships, it seems that the key to long-term success is not so much in writing prenups, but in choosing the right partner. A constantly evolving sustainability environment makes it very hard to predict future needs and incorporate all eventualities into written agreements. Limited Partners (LPs) are therefore learning to scrutinise General Partners (GPs) through new ESG-focused lenses.

NordSIP brought together six hands-on experts in private assets investments to discuss these themes. They were able to share their real-life experiences of this process of adaptation, with perspectives from both sides of the table. Given the challenges of integrating sustainability in illiquid asset classes, they expressed perhaps unexpected appreciation for the help and guidance offered by regulators and called for more dialogue and collaboration among investors.

The discussion also turned towards the need to consider the social implications of private asset investments, either as a factor within a climate-related project or as an investment theme in its own right. Our experts also concluded that unlike public markets, smaller players can have considerable clout in the right circumstances, so big is not always better. It was overall a lively debate highlighting the most up-to-date sustainability-related concerns of these experienced private markets players.

We hope that these insights will make it a little less complicated for you too, in your future relationships with private assets!

who is who?

Niclas Ekestubbe
Investment Manager
Alternative Investments
Länsförsäkringar

Niclas Ekestubbe is Investment Manager for Alternative Investment at Swedish mutual insurance company Länsförsäkringar. Before joining the firm in 2018, Niclas Ekestubbe held the position of CFO at Altor Equity Partners and prior to that as Partner in Cubera Private Equity.

Earlier in his career he was a Senior Manager at Ernst and Young, before moving on to research and portfolio management roles at CA Chevreux and Skandia respectively.

Niclas has a Bsc in Economics and Business Administration and an MBA from Uppsala University.

Mikael Huldt
Head of Alternatives
AFA Försäkring

Mikael Huldt heads the Alternative investments allocation at Swedish labour market insurer AFA Försäkring Before joining AFA in 2015, Mikael was Head of Alternative Investments at Kåpan Pensioner, a role he took on following 9 years as a Senior Portfolio Manager at the Third Swedish National Pension Fund (AP3) where he focused on private equity, timberland, infrastructure, real estate and farmland.

Mikael began his financial career as an Associate with Mannheimer Swartling's private equity law practice.

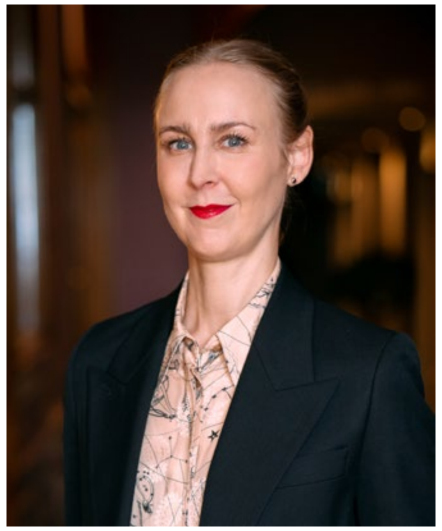
He obtained a Master of Laws in Corporate Law from Stockholm University.

Vanessa Linzander
Investment Manager
AP1

Vanessa Linzander is an Investment Manager responsible for management, sourcing, underwriting and execution in global Real Assets at the First Swedish National Pension Fund (AP1).

Prior to joining AP1 in 2018, Vanessa worked as Analyst and Product Manager for the Property Multi-Manager business at Aberdeen Asset Management. Vanessa began her career as a Financial Accountant at Siemens.

Vanessa obtained an International Master in Business Administration, Finance and German from Lund University.



Anna Olsson
ESG Director
CapMan

Anna Olsson is responsible for the ESG strategy development and implementation across the organization.

Prior to joining CapMan in 2021 she worked at ISS ESG, a finance industry sustainability consultancy, assisting institutional investors globally to develop and integrate ESG strategies and processes.

Most recently she was responsible for the ESG Specialist team in the Netherlands, Nordics, UK & Ireland. Before that, she has held ESG analyst and project management positions for sustainability consultancies and NGOs.

Rens Ramaekers, CFA
Senior Portfolio Manager
Aegon Asset Management

Rens Ramaekers, CFA, is a portfolio manager in the European ABS & mortgages team, where he focuses on mortgages.

Rens joined the industry and the firm in 2015.

He holds an MSc in quantitative finance and actuarial science from Tilburg University and is a CFA Charterholder.

Christoph Schumacher
Global Head of Real Assets, Private Markets
Manulife Investment Management

Christoph Schumacher is responsible for defining the firm's private real assets strategy and managing the operations and development, launch, and growth of investment solutions for clients across the globe.

Prior to joining the firm, Christoph was the global head of real estate at Credit Suisse Asset Management and CEO of Union Investment Institutional Property GmbH. Earlier in his career, he worked at Generali Real Estate and practiced law at Linklaters in Berlin and London.

Christoph holds a B.L. in Law Studies from the University of Freiburg and a J.D., Doctor of Law from the University of Münster–Institute for International Business Law.

From left to right: Niclas Ekestubbe, Rens Ramaekers, Aline Reichenberg Gustafsson, Frank Drukker, Vanessa Lizander, Anna Olsson, Morten Simonsen, Christoph Schumacher, Julia Axelsson, Michael Huldt

Sustainable Private Assets

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Identifying the most pressing issues

Institutional asset owners in the Nordics have been steadily growing their allocations to illiquid alternatives over the last decade, with the 2019 increase of Sweden's AP funds' portfolio cap to 40% providing a further boost to these asset classes. A parallel trend has been the steady pressure from stakeholders and regulators to apply sustainability criteria not only in listed equity, but across the whole portfolio. What are some of the challenges faced by asset owners and their managers as they seek to integrate environmental, social and governance (ESG) criteria and sustainability goals into their private market investments?

For **Rens Ramaekers**, there are three main aspects to the issue of sustainability. "One is the Sustainable Finance Disclosures Regulation (SFDR) and if it is currently really making the market a better or clearer place. Sometimes we find that there is a risk, particularly with Article 8 funds, that form takes over substance. The second aspect is data quality, where the situation is more difficult in private markets than in public markets, which are more regulated. The third aspect is how do we as a firm expand the good work we have done on sustainability in asset-backed securities to our full product range?"

Mikael Huldt, agrees that the regulatory environment needs to improve. "We need to navigate both locally the regulations as interpreted by the local Financial Supervisory Authority (FSA), and at the EU level and it doesn't make our lives easy," he says. "There are still a many grey areas where each of us need to make difficult decisions. We need more clarity. Another challenge is more generally that we are talking about sustainability impact, for example. What becomes clear is that people have varying definitions of what they feel is within that type of remit. What is impact? What is sustainability? How could you measure it? What is good? What side effects are acceptable? And so forth. This lack of standard definitions makes it difficult to navigate the markets because people simply have different views on the most fundamental concepts."

For **Frank Drukker,** Executive Director Business Development Institutional Clients Benelux & Nordics at Aegon Asset Management, sustainability goals are ambitious, and he sees collaboration as a key to success. "Do we need to compete on sustainability, or are the global threats we face so important and ominous that we should decide not to compete on sustainability, but to join forces instead? That is one of the biggest questions I have," he says.

Vanessa Linzander's approach to sustainability focuses on resource efficiency in AP1's real estate and infrastructure investments. "The priority for us, especially on the real estate side, is trying to build and refurbish with minimal impact and uniquely high standards, by trying to use as much of the existing stock there is, to minimise any possible negative impact," she explains. "Real estate is the biggest part of our real asset portfolio. We have a high focus on circularity. Sometimes it can be difficult to get tenants to recognise the benefits of refurbished space vs a new built one."

Anna Olsson, agrees that making better use of resources is key. "I believe that we need to focus more on circularity. We do not invest in the worst of the worst. When we talk about impact, we often mean the companies that help drive environmental or social change, but we also need to address the bulk of the rest. We must make sure that we can transition those companies and make them more circular," she says.

Olsson is also concerned by data quality but believes it should not hold us back. "We sometimes struggle because we can't find perfect data and we might never do. We strive to gather and collect data as well as set improvement targets, but we can't wait for perfection because, if we wait, it may take 10 years, and we don't have that time. So, we need to move forward in a world that is not perfect. That is what I'm struggling with, every day."

Data and uncertainties are also main concerns for **Niclas Ekestubbe**. His organisation weeds out managers with weaker ESG credentials quite early in the process. "The problem that we often run into, at least recently, is to get managers to do all the ESG reporting that we require," he says. "Our fund offerings are classified as an SFDR 8. It complicates things slightly, because what we need to report to our stakeholders isn't yet entirely defined and that means that we are trying to get managers to supply us with data in the future when they don't yet know what it will be. Most managers don't like that part of the equation, the lack of clarity about what to report and how. That is the main task that we are struggling with at the moment."

Morten Simonsen, Head of Distribution Northern Europe at Manulife Investment Management commented "Due to the lack of accepted global principles and standards that differ tremendously around the world, my challenge is to ensure that as a global firm, we meet the Environmental, Social and Governance (ESG) requirements of European investors and their clients.

Christoph Schumacher concurred but is broadly optimistic and believes Europe is leading the way towards better sustainability reporting standards: "The challenge we face is how to effectively measure and move the global industry towards improved and standardised reporting."

Schumacher believes that the European regulators' efforts are not perfect, but they have been necessary to move things forwards. "I've been in the real estate and infrastructure business for many years, serving on the boards of different industry associations, and as an industry we were just too slow. I don't therefore blame regulators and governments for stepping in, because the business community isn't making the necessary progress quickly enough. While there are downsides to enforcing heavy restrictions, they do help accelerate momentum.

"For example, I believe that real estate faces the challenge of impending devaluations on existing portfolios due to stranded assets," Schumacher warns. "Because if assets are not green, they're subject to reputational and transition risks. And it's also vital to standardize measurements and models for valuing carbon credits in a sustainable way. The market shows so much potential, and we want to ensure good-faith participants are taking the lead in developing it. So, as an industry, we need to be careful about finding the right platforms for carbon credits. We should, in my view, also be developing a credit model that provides a financial value for nature biodiversity and makes it tradeable. If we can achieve that, it would represent a tremendous opportunity and a different model for investing in the future. It could be a true game changer."

Locking Sustainability into Private Market Transactions

Given the long-term nature and subsequent inflexibility of private markets investments, how do investors and managers deal with the constantly evolving regulatory environment? Working with the right partners and figuring out a suitable framework and modus operandi from the very outset are two crucial pillars of sustainability in private markets.

Huldt builds on Ekestubbe's point regarding the reporting requests he puts on external managers. "In most private markets, we are investing for the long term, beyond a 10-year time horizon, and this dynamic changes the nature of the investment process compared to other markets. I think Niclas puts it well: how can we ask our managers to provide us reporting over the next 10 years when we don't know what we're going to be requiring? It is impossible," he laments. It needs to be a dialogue, with mutual flexibility, Huldt argues. "We need to work together. Let us solve the equation together. We cannot formalise the question and present it in terms of bullet points. We cannot make it mandatory to report specific data because in three or five years, this data may be obsolete. Then we might need different data points and those won't have been included in the initial agreement. Instead, we should be setting the tone initially, and having a consensus around the direction we want to pursue together. This is the level of transparency and the level of communication that is important to us. Being too formalistic and trying to box it down, that doesn't work."

Finding the right partners

Finding like-minded managers is a big part of the solution for Linzander. "ESG is a crucial topic on everybody's agenda. Naturally, these are questions that we ask external managers at quite an early stage: What is your view and how do you work with ESG and how is it integrated in your business? Perhaps the answer isn't perfectly defined, but it is most often enough to provide us with the manager's intention. From there, we try and work together. As Mikael said, it is hard to navigate, and hard to know today what the reporting needs will be in the future. We already have some defined requirements to report on carbon for example, and those are quite easy to formalise. For us it is important that our intentions are aligned and we conduct an open dialogue already from the beginning. Even if not all the standards are currently in place, does the manager understand the importance of ESG and the effect it has on long term returns?" she asks.

Linzander adds to Schumacher's point about stranded assets: "In the long-term if sustainability isn't embedded in the investments, they will become obsolete. Especially as a long-term investor, at AP1, we have been prioritising these sustainability questions in our deal processes for a long time."

Switching from a real asset perspective to the private credit space, **Ramaekers** already sees concrete steps being taken. "Changes are already occurring in the documentation and in the relationships between the private debt parties. Some reporting requirements are indeed embedded in the documentation. Even if not all the requirements are set in stone, the parties agree that they will at least work together and make sure that future reporting requirements will be delivered to the extent possible. ESG risks are also embedded in the contracts. If certain events happen, for instance bad press coverage during a strike, investors can impose specific obligations on the borrower."

Ramaekers has seen a good overall response from managers. "We have been calling the CLO managers in our ABS strategy over the past two years, and we have noticed a huge change. Roughly 80% of the managers are making important changes in their investment process and how they work with sustainability related reporting. Of course, there are differences between US and European managers, but the trend is definitely going the right way."

US managers delivering ESG by stealth

Some US managers are already meeting sustainability requirements within their existing processes, according to **Ekestubbe**. "Europe is probably a year or two ahead of the US market, but US managers very often do a lot of what we classify as ESG, but they simply view it as commercial. I had a discussion with a California-based manager. They have a one-page ESG policy, and that's it! We also wondered why they are not a member of the UN global compact. 'How do you deal with union problems or child labour?' we asked. For them, it is part of the legal due diligence. They check every claim the companies have against them, and that includes child labour. It is something they pick up on the commercial side. We call that ESG, but they don't. Our head of ESG and I met with the two founders of a firm, and they ticked off almost every item that he had on his agenda. They called it either commercial, financial, or legal and they said, 'that's what you call ESG? Well, sure. That's not a problem!' When it came to the reporting, they understood what he wanted. They understood the distinction between what is nice to have, what we need to have. Even if they don't classify themselves along the SFDR classification because they are a US firm, they were doing the right things and they had the intention of doing the right things, in general, when it came to reporting as well. In the end, our Head of ESG had an easy time ticking them off, even though, on the surface, with a one-page ESG policy, it looked challenging to accept. The most important finding was that they were walking down the right path anyway."

Linking fiduciary duty to sustainability

Highlighting the link between the financial materiality of ESG factors and fiduciary duty will help spread the word into the U.S., according to **Schumacher**. "We're all travelling on this journey together. As investment managers bound by a fiduciary duty to our clients, embedding ESG into our financial outlook means being able to measure its financial impact, which is the right way to begin. We expect the price of carbon sequestration to increase in the coming years as the market begins to grasp the necessity of that function, so there's a strong financial incentive for long-term investors. Commercial potential is critical for the U.S. market, so it's key to attribute a credible financial value. In this business culture, fiduciary obligation is undoubtedly linked to financial value and without this link, change is very hard to implement.

The Power of Direct Ownership

For **Olsson**, majority ownership in direct investments unlocks enormous potential to imbed sustainability at an early stage. “In many ways our work is made easy because we are an active owner. We are often a significant owner, so when we conduct a due diligence process with investment companies, we can be very clear about what we will need from them. For example, many of the companies we acquire now will have to set science-based targets. Of course, owning 5% doesn’t give you the same power as owning 55%. We have different strategies managed by different teams, but we are working towards having a common approach across all of our investments, and to bring that into the due diligence process in a systematic way.”

This process can be a time-consuming, but it is important to get it right from the beginning, emphasises Olsson. “Sometimes we only have two weeks and sometimes six weeks for due diligence, which makes quite a difference. However, if we can do it right in the due diligence process, before making the investment, then we have a good understanding of ESG risks and opportunities, and a better understanding of how we can create value. So, once we have acquired the company, we know where to start. What we are working on right now is implementing this way of thinking across the board. That approach goes for LP (Limited Partners), GP (General Partners) and for GP companies. If you know where you stand before you enter an investment, then it is so much easier. It is more difficult for us now to go to a company that we have owned for four years and own 10% and say, ‘let us get your ESG up to speed.’”

“I started at CapMan last year. Going through the Due Diligence documents that we have received from LPs for the past four years, I could notice that over the last year there has been a complete change in tone and in sophistication. For the first time there are questions on climate risks: detailed questions on physical and transition risks, and they are just much more sophisticated. Instead of one page, we get 50 pages. I think LPs are stepping up as well and forcing GPs to look at the reporting and what to measure. It can be quite hard, but, as everyone has said, the relationship is the most important thing. It is key that you trust who you invest in and understand that they are on the right track. They might not necessarily be doing exactly what you would do, but they live up to your policy, and you believe in them moving forward.”

Leave it to the experts

Huldt understands the importance of integrating ESG factors early on, but believes one still needs to be flexible. “I completely agree that ESG needs to be integrated. It needs to be part of the overall business case and investment strategy. But we should be mindful, especially when working with LP and GP relations that LPs shouldn’t try to second guess the GP's expertise in their particular field. Even though I sympathise with those who attempt to find a one-size-fits-all methodology across the board, they risk missing the big picture. In some companies, environmental issues are the most pressing, and we should focus on those. In other companies, it might be diversity or social issues. While we need data and we want the GPs to provide comprehensive reporting of good quality, we should also allow the managers to know best which are the most relevant ESG and sustainability metrics for their individual investments. We should not try to push a round plug through a square hole,” Huldt says.

Olsson agrees with him and highlights the need for GPs to have a systematic approach. “CapMan needs to have ESG targets on an asset manager level, of course, but these are aggregate targets. At the same time, it is important to have asset specific targets within our portfolio companies and within our properties, because that is where it happens.”

“We need to trust that the manager is on the same journey as the LPs, and that they will focus on the most relevant issue within their specific portfolio and highlight those to their investor. We should not force them to be everything for everyone, and to produce massive reports that no one will read,” Huldt adds.

Asset owners driving the agenda

Sector exclusions are often a first step when setting up the documentation underpinning private market transactions. However, especially in the realm of private assets which are often long-term illiquid investments, exclusion requirements may change over time. “Sentiment changes,” Huldt points out. “Let's just take investments in the defence industry in Europe. Investors’ policies about those investments used to be quite straight forward. Now a couple of months into this year, many of them have changed their mind. We cannot know how sentiment will change and how we will have to navigate those unknown future issues. Working with someone we trust, who has the core principles aligned with ours is essential. Because we cannot predict the future, we need to trust that a manager who believes in our core values will follow a path that is similar to the one we will choose.”

Should weapons always be excluded?

For **Ekestubbe** the defence sector is also problematic. “The exclusion of weapons is a continuously moving target,” he says. “We don’t like controversial weapons, but we are okay with investing into weapons, at least to a certain extent. We have turned down investment proposals because there were too many weapons in them. These investments had historically generated great returns, but they were really borderline to what we could invest in under our mandate. There were no controversial weapons, and they were mainly producing so-called ‘life preserving products’ linked to battlefield visibility or communications. These are war-instruments meant to protect American soldiers, but they were nonetheless too hairy for us.”

Exclusion lists work in tandem with broader guidelines in terms of sustainability risk, according to **Linzander**, describing how AP1’s process has changed over time. “Just like Niclas at Länsförsäkringar, we do have exclusion lists and they continuously evolve.”

“We have been working a lot on the due diligence process,” Lizander continues. “From the beginning, we

have always looked at the process as an in-depth conversation. We do have a checklist in place now, but it isn't a tick-the-box exercise where we merely verify if a certain number of policies are in place. I have come across many such lists. In our case, we look for a broader understanding of the manager's view and understanding of ESG, especially about risks. For example, one question can be: 'what are the main risks that you see within your sector and how do you mitigate them?'"

"We are an active owner," Linzander says. "We get involved in the board nomination process to ensure the quality of the board composition. For the investments that I work with, we try to secure board or advisory board seats to ensure we can have an impact and control of certain decisions that are important for us. We work with ESG issues as well as the UN SDGs. ESG is such a big topic and it's transitioning very fast, and it is sometimes difficult to decide what to focus on, and then how to report on what we have achieved. That is why discussions like these are beneficial. It helps to find common ground with other organisations who find it as hard as we do. We want to make an impact, be active and drive change in any way we can. Therefore, we often collaborate with other large LPs, because even though we can be strong as a large single investor, we are stronger together."

An ESG non-compete agreement between asset owners?

Olsson picks up on Drukkers earlier suggestion of not competing on sustainability. "Coming back to what you said, do we really need to compete on this? Within ESG, I find it quite useful that you do share, and you do not compete between professionals. You can learn a lot from each other and help each other because there is, as you said, no one-size-fits-all. Of course, even if a solution works for my company, it might not work for yours. It is not about competing, but about challenging each other. If you have done something great, then I will take notice. There is a lot of good cooperation in ESG."

The useful Sustainable Development Goals

Olsson believes that to address the social aspects of ESG, organisations need to expand their overall sustainability resources and capabilities. "To make ESG more manageable, many institutions have had to narrow down the scope a little and focus on what is most material, which means that climate often wins. ESG is young, of course. I think 10, 15 or 20 years from now, it will be completely differently resourced in companies. And maybe the competition between E, S and G is already slowing down."

Some types of project do incorporate multiple social aspects more readily, according to **Ramaekers**. "If you look at hospital financing in developing countries, you are not only addressing health coverage but also creating jobs and helping to implement labour agreements. The two aspects don't have to compete." Nevertheless, as Olsson points out specialisation will need to increase. "There has to be a profound understanding and you have to be really good at what you do. There are so many different components that you have to understand," she adds.

Agriculture or forestry investments are an area where social responsibilities cannot be ignored, as **Schumacher**

explains: "We work closely with local communities and smaller landowners, including private owners, and our engagement differs in each country. We're concentrating our efforts on climate change adaptation, or access to water or recreation, in line with other Sustainable Development Goals. Since we're vertically integrated, we're always engaging with local forestry and farming communities, and we need to continue to support their interests. We do have an important responsibility and the social aspects of these relationships are not always easy to quantify or to solve."

For Schumacher, there is a strong need for regulatory consistency from country to country. "We must be careful with regulations and guidelines that are too local. For example, if we investigate a new fund for the European market, we must ensure that the strategy is aligned and meets the regulations with all the regions, not just some of them. I believe that it is important that European regulators find common ground with each other. In Europe, we tend to be more focused on regional needs while the United States has a more global approach."

Leave no one behind

Good social ESG practice should examine not only the staff of portfolio companies but also how they interact with external stakeholders, **Ramaekers** points out, explaining

that in the context of his private credit strategy, "we try to understand how companies treat their clients. In consumer loans, for example, how do they deal with situations where clients come into hardship? Aegon has a long history of implementing humane practices in the Netherlands, for instance by providing budgeting and job search coaching. Whenever we go into ABS (Asset Backed Securities) with consumer loans, we look for similar standards of practice. We do find quite a dispersion even in Europe, including some rather aggressive ways of getting money back from clients. We think it is better for both the investor and the borrower to support them in finding a new job or better budgeting."

Choose a few key SDGs to run with

The SDGs cover such a broad range of issues that Ramaekers believes the only solution is to narrow things down. "We try to focus on a couple of them such as social housing and affordable cities, which are relevant across the globe. There are some quite good opportunities in these areas, both in the Netherlands as well as overseas. We just funded a transaction in social housing in Ecuador, for example, with clear reporting requirements in terms of overall coverage improvements and the income bracket being addressed. Local banks are also becoming more aware of the SDGs and how addressing them can improve investment inflows, which I think is a good trend."

AP1 also uses the SDGs and refers to them in the annual report, explains **Linzander**. "We focus on all of the goals. However, I do believe that some of the SDGs may be more relevant for some companies or sectors than for others," she says. The SDGs still lack comparability when they are used to evaluate a company's impact, Linzander believes. "While it may be more straightforward to use the goals for reporting purposes, we struggle to use them when evaluating different investments. How do we compare companies with different SDG outcomes? Who is better than the other? Under which conditions? We have definitely been struggling with these questions," she admits.

Olsson agrees that the SDGs have become quite a good communication tool between LPs, GPs, and portfolio companies. "You can speak the same language and you can understand it, too."

The SDGs can be quite vague and therefore might support attempts at greenwashing. Olsson still believes they can be useful. "Still, I am very careful with SDGs, because you can use them in whichever way, unlike the taxonomy."

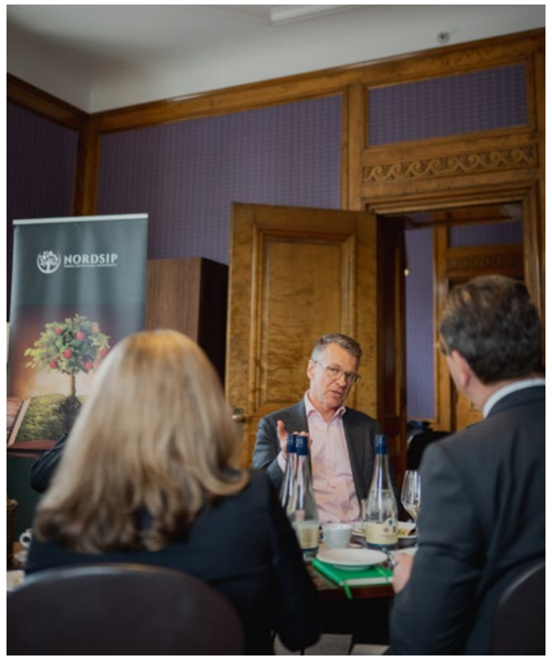
Zooming in on EU regulation

Three cheers for the regulators

Olsson has a positive word for the regulators. "Look at where sophisticated sustainable investors were four or five years ago. Now, it is mainstream for investors to aim higher, to be classified as an article 8 fund for instance, because they need to. So, regulation has been brilliant. The investment industry was quite shocked, to start with, as they thought they had come further than they have. Regulation is complex, too, you get a headache trying to understand it, but it is lifting the entire industry and there is at least an attempt to establish a baseline now. In a few years, when we have gone through this painful period, it will be a lot better."

Difficulties capturing the transition

One key drawback of the taxonomy is that it fails to properly capture the concept of transitioning companies, **Huldt** believes. "With the Sustainable Finance Regulation and the taxonomy, the regulator has been so focused on the light green Article 8 and the dark green Article 9, which albeit useful are also very restrictive. There is a risk of missing out on the whole notion of investing companies that are okay and making them better. It is important that these also are able to capture any transition, where investors take a yellow or red investment and though active dialogue drive these into becoming light green and then into a dark green. Capital needs to flow that way as well, in order to make changes. Regulation doesn't fully capture this opportunity and the SDGs are too broad to really catch that either."



International consolidation and consistency needed

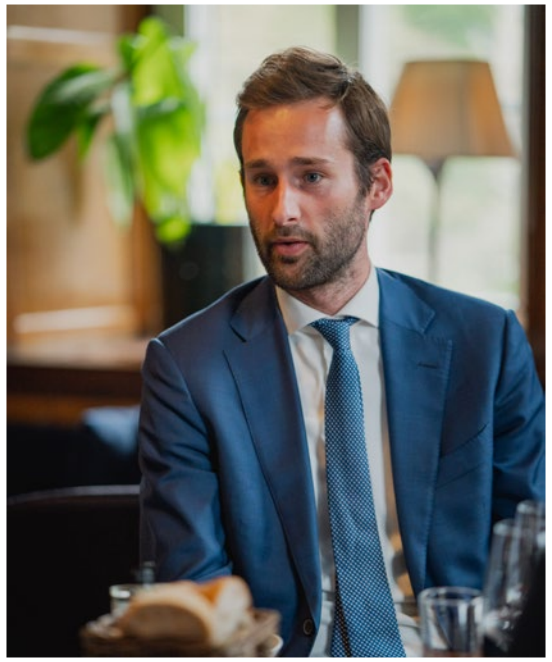
In the Europeans' defence, **Ramaekers** says "one thing good about the new regulations is the introduction of the Principal Adverse Impacts (PAI), especially regarding the SDG washing that we mentioned before. It is too easy to claim job creation impacts in relation to portfolio companies. But when you must actually report in detail on those impacts, it suddenly becomes much harder to trade as an impact fund." **Olsson** agrees. "There is a lot of different guidance to investors, but now that we have the PAIs, there is a framework, you know what you need to look at. It is just what investors have been asking for, and it can possibly help in the relationship between LPs and GPs, as well."

SFDR Article 8 or 9, not a slam dunk

The classification a fund manager targets can affect the investment targets as a result, but they are given some time to adapt. "The funds we invest in, do not have to be article 8," says **Ekestubbe**. "As long as the firm has the right intentions and a reasonable level of maturity in terms of sustainability, and as long as the fund manager has an intention of giving us the reporting that we think we will need in the future, we are happy to work with them. We do want to see some progression year over year, that they are becoming more mature and taking more initiatives. If they do, we are happy to work with them even if they aren't at that level on the day we invest with them. The progression is key for us."

Keeping that progress ongoing is difficult, Ekestubbe says. "We have to move in the right direction year over year, which is positive, but it complicates things too, of course. It means that wherever we are today, we have to keep tightening our criteria all the time. As a result, there are a lot of investments that we must filter away although they might have a very positive impact on the environment, provided we could invest, but we can't because the way that model works."

"In the private debt scene," explains **Ramaekers**, "we do also see difficulties with some investments. The contracts are long-term, but you can include specific environmental or social criteria that could trigger a mandatory repayment if breached. It is certainly very painful to prepay a large part of your debt, so these can be strong inentives for borrowers to make the right business decisions."



A sustainability J-curve

Private markets investors should embrace sustainability as an integral part of their long-term efforts to increase the value of their portfolio companies, **Huldt** believes. "Private capital should have a place given its long-term nature. Private asset investors should be able to bear the investment J-curve, sustainability or otherwise, just because there should be a clear opportunity to make these long-term changes compared to the listed investment space where the focus is much shorter term, quarter over quarter. Regulation and often its interpretation do not allow for the gradual improvements that are needed at different levels, and that is a hindrance. This is where private capital can play a substantial role due to its long-term and illiquid nature," he says.

Offering up another example of transition efforts, **Olsson** relates the case of Norled. "In 2019, we acquired Norled, which is one of the biggest ferry operators in Norway. We are helping them transition to electric ferries and green hydrogen. The transition is going fast, and they are ahead [of the competitors]. The thinking of our team is that we don't necessarily need to buy something that is already sustainable, but we want to make it so. That is where we add value."

Sustainability value creation is a must for managers

Sustainability skills are no longer a nice-to-have for managers, **Huldt** explains. "When we speak to managers, they're not relevant if they don't have a sustainability value creation lever in their playbook," he says. "A sustainable company is worth so much more than its peers. Improving profitability and revenue and growing the company needs to go hand in hand with making it more sustainable. That is how you create value."

Size is usually an asset when promoting sustainability in listed markets, as evidenced by collaborative engagement initiative like the Climate Action 100+. What role does investor size play in private markets, where ownership stakes can be much greater?

For **Ramaekers**, "size definitely comes into play. The very biggest asset managers like BlackRock are not really competing in the private debt markets, so even though you might be relatively smaller you can still be a big player in that market. For the direct loans we do to SMEs, we are one of their biggest funders and they will definitely listen to us.' Nevertheless, in other circumstances, smaller players may need to club together to have sufficient influence. Ramaekers explains: "in other markets where we are smaller, we will club together with other lenders. For example, if new reporting requirements come up, companies might not comply if they only hear it from us."

One example of such a collaboration is Polhem Infra, which was jointly set up by Sweden's

AP funds. As **Linzander** explains, this joint investment structure allowed for increased investment power, especially because the infrastructure investments targeted tend to be very large. Collaboration opportunities, however, go well beyond this initiative. "We have other ways to collaborate with the other AP funds, such as The Council on Ethics of the Swedish AP Funds. We are completely separate entities but have the same framework. We also work together with other peers on listed assets, to drive change in the listed companies where we have a say on board composition for instance. We have also set up some funds together with managers where we were able to dictate terms to meet our needs. In a way, given the type of investor we are, we can also be like a role model for others. Size matters but finding the right partner will allow an investor to make a difference even when they are small."

Smaller investors can also have a big influence in direct investments, as illustrated by Olsson. "We are mainly majority investors. In many cases we own 100%, like in our real estate businesses. We own all of it, so we can just decide what to do. In Infrastructure, we have some collaborations which have been working really well, because we also choose who to collaborate with. We are rarely so small that we don't have a say. It is rather the case that the companies ask us for guidance. We are also helping them prepare for the upcoming CSRD (Corporate Sustainability Reporting Directive)."

Linzander agrees that bringing value can sometimes be more important than size. "We don't always have to be the biggest investors in size, but because we have a lot of expertise and influence, many value having us on the board, even when we're a smaller investor."

Olsson concurs. "Companies can choose who to cooperate with, and it is about more than money. They choose us as a partner in this because we always bring more to the table thank just capital."

Some commentators believe that private investors may play a negative role in the market by taking on divested carbon-heavy assets. "I agree," responds Olsson. "If everyone who cares about sustainability just divests, there would be a lot of owners that do not care left in those companies. However, what you need there is activist investors or investors that have very, very clear sustainability targets. And that is not really what we are talking about here."

"The concept of value creation through sustainability transition is on top of the mind of most managers," Huldt adds. "I am sure there will be certain investment themes – whether it is oil and gas or others – might entice some investors who think there are gains to be made despite question marks on the companies' sustainability. I do think that these investors will be a minority. Everyone is very much aligned on the broader stance. I don't think it is right to define some owners as good versus others who are bad. The world isn't black and white. It is made of shades of grey."

Ekestubbe highlights the positive power wielded by private investors: "On the private side, it is possible for investors to own a significant proportion of a company's capital. Therefore, if you want to, you can force through change. In the listed space, the main owner might have 3% or 4% and the CEO and the senior leadership might not own anything at all. As such the C-Suite managers are really just agents happy to collect their annual cash. Interests are not aligned in the same way as in the private space. In a private equity owned company where managers have a serious stake, interests are much better aligned," he says.

ESG-linked corporate incentives

Incentive structures can be a powerful tool, **Huldt** points out. "We haven't talked about this yet, but ESG-linked compensation needs to become even more in focus, as far as sustainable investment is concerned." Olsson agrees. "We have integrated [ESG-linked compensation] at CapMan and we are integrating it in all of our new majority owned companies, because that is key."

A search for clarity

Overall, there is a consensus that clarity is needed at all stages of private investments. In **Ekestubbe**'s words: "It is not enough to say that you have a good intention or that you are moving in the right direction, because it has to be measured one way or the other. Once the EU decides what we are going to measure under the SFDR, life will be much, much easier, because it is very relevant, but right now it is still a moving target. When there is a lack of clarity, it is very hard to get someone else to agree to walk in the same direction when they don't know which direction that will to be."

Good regulation will help achieve clarity, **Linzander** believes. "Regulation is a real positive," she says. "All these organisations need to try and make sure that we speak the same language. It makes things much easier and driving change requires that we talk the same language. We all know that impact is a big word, but we still aren't sure about its definition. Impact has a different meaning depending on who I talk to. Everyone says, 'we want to make an impact.' Does that mean that we should buy coal mines and refurbish them? Indeed, we could have a great impact by doing so, but then on the other hand, an impact investor would probably not want to own coal mines to start with."

All market players should drive positive change

Ramaekers is keen for investors to drive change: "we should not simply wait for the regulators to change things. I believe that especially in private markets, they are also looking at us for guidance. It therefore really helps if we have come together, with everybody aligned towards the same targets. It is also up to us to put the right requirements on our portfolio companies ahead of expected legislation. There will not be enough change if we sit back and relax."

Olsson reiterates that the global economy is changing, driven by sustainability concerns. "The entire economy is shifting. It is revolutionary, even if it is happening by taking small steps. I think it will all be different 10 years from now. We need to value natural assets in a different way than we have done previously. Climate is one thing, but we need to add circularity to whatever business we are in. The entire world is shifting in this direction. We need to figure out how to do that, measure it in the best way possible, and communicate it the best way possible as well. This is our main challenge."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