CLIFFORD CHANCE

ESG TRENDS THAT COULD IMPACT FINANCIAL INVESTORS IN 2022

– THOUGHT LEADERSHIP

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ESG investment is booming – according to research from Bloomberg, ESG assets are forecast to hit US$53 trillion by 2025 (a third of global assets under management) and the $2.2 trillion ESG debt market is forecast to hit $11 trillion in the same year. This presents huge opportunities for financial investors including dedicated asset managers, fund management arms of diversified banking groups and institutional investors, including sovereign wealth funds and insurance companies. This briefing explores some of the ESG trends and challenges that may be relevant to financial investors in 2022.

- **Supply chains:** As financial investors sign up to net zero emissions targets, they will need to put pressure on their suppliers to do the same in order to achieve those targets. This may result in short term disruption as a result of the recalibration of supply chains (for example some suppliers may be cheaper, but may not meet the ESG standards imposed upon them). However, it also presents opportunities for M&A activity in businesses that provide supply chain management and transparency solutions.
- **Decarbonisation:** Decarbonisation will continue to gather pace, but the big question in the run up to COP27 in Egypt, is how to decarbonise developing and emerging economies and the role the developed world has to play. This presents opportunities for financial investors in facilitating M&A investments in emissions reduction, energy efficiency technologies, carbon offsetting and trading markets (accelerated by the agreement on a global carbon market mechanism largely completing the 'Paris Agreement Article 6 Rulebook' coming out of COP26). They could also potentially rethink their strategies around carbon-intensive fossil fuel assets (for example, instead of divesting those assets, they could consider investing or holding onto those investments in order to drive change from within, including by winding down the operations of these assets earlier than the expiry of their design life and incorporating cleaner energy solutions in parallel). This also presents opportunities for the private sector to partner with the public sector in developing and implementing decarbonisation solutions.
- **Infratech:** The resilience of critical infrastructure is a priority for governments across the world as they look to 'build back better' from the global pandemic and prepare strategies to achieve their climate targets. The integration of technologies like blockchain, distributed ledger technologies (DLTs) and the metaverse, is likely to be key to facilitating these outcomes. This presents opportunities for financial investors to invest in businesses related to asset tokenisation and smart infrastructure as well as data centres and technologies including 5G and the Cloud which have become integral to IT systems worldwide. In parallel we expect there will be increased focus on the associated ESG implications including:
  - "E" – a focus on the environmental implications of blockchain validation processes due to excessive energy consumption and electronic hazardous waste.
  - "S" – a focus on the use of sensitive data and personal information that can be a target for repression, espionage, sabotage and foreign interference activity, leading to increased scrutiny by governments of foreign investments in relation to these transactions.
  - "G" – a focus on the governance arrangements associated with the decentralisation of infrastructure systems as a result of the integration of these technologies. The collective responsibility of participants in a decentralised system aligns with the increasing awareness of sustainability and social inclusion – both culturally and politically.

- **Greenwashing:** We expect that stakeholders will continue to ramp up pressure on government and companies to 'walk the talk' when it comes to ESG. This risk will get personal in 2022 with an increasing focus on directors' duties to consider the ESG implications of their decisions (in addition to the fiduciary duties of funds to do the same). It will be important that financial investors roll out regular training for their staff and develop crisis management plans to mitigate the risks associated with climate-related litigation and stakeholder activism. In addition, as the green financing landscape continues to evolve from its early stage and voluntary requirements, financial investors will need to balance the opportunities associated with promoting sustainable finance to their stakeholders – including access to additional capital and pricing advantages – with potential added verification and reporting costs, and the reputational risks associated with greenwashing.
- **Increased regulation:** We are unlikely to see a global convergence of ESG regulation in 2022. Rather, we expect to see increased regulatory change particularly in APAC and the US, as governments seek to align themselves with market trends coming out of Europe. Financial investors will need to keep track of these developments (including reporting and disclosure) in order to develop strategies to navigate the increasingly complex regulatory landscape on the entry to investments, during their lifecycles and upon exit. Playing to the highest or lowest common denominator with respect to compliance may not be the right strategy and so finding the right balance will be essential.
- **Whole of life approach:** Whilst ESG is increasingly being embedded along the value chain for financial investors, we expect that in 2022 the focus will be on adopting a more 'whole of life' approach – from fund formation through to the investment process (i.e., due diligence, acquisition, ownership and exit). Having a strong ESG commitment from the top, and clear ESG objectives established from the outset which are focused on value creation, may assist with implementing ESG initiatives in portfolio companies – particularly in regions where companies are still getting to grips with understanding ESG and its impacts (for example, Asia Pacific and Africa as compared with Europe, North America and Oceania).
- **People and wellbeing:** A portfolio company's ability to secure a sustainable talent pipeline (and therefore maintain value/share) will be interlinked with employee wellbeing initiatives, upskilling the existing workforce (including for green jobs or to be environmentally compliant), and diverse recruitment. Firms or funds with a strong narrative in these areas may present a positive opportunity, and a failure to navigate social requirements may undermine value or market share due to reputational (and financial) impact and talent flight risk. This will see investors needing to carry out social due diligence (including human rights due diligence) on their own business and those in which they invest (in addition to their supply chains), to avoid allegations of social washing. Stock exchange and regulator developments plus employee expectations will increasingly impose requirements for a breadth of diversity credentials, at board level, and below, and investors will want appropriate access to metrics on diversity performance (to display a positive picture on this on exits or disposals). This will also see an increased need to update data privacy governance frameworks to manage access to broader DE&I data. Firms will also increasingly explore AI for recruitment and need to navigate ethical and bias issues and seek to put in place appropriate frameworks to manage this. Board and workplace culture and ethics (as well as composition) will be subject to greater scrutiny, with pressure to ensure that the voice of the employee is increasingly present and appropriate actions are taken: whether through enhanced whistleblowing channels, increased unionisation, ESG-outcome based remuneration and employment practices, or the undertaking of ESG investigations. Employee action is likely not just to be about employees' own social rights (for example, freedom from harassment), but on their employer's position and actions on climate and sustainability.

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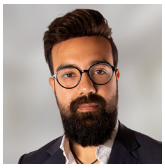

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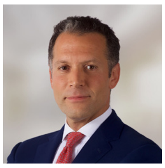

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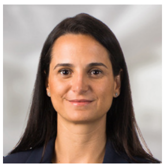

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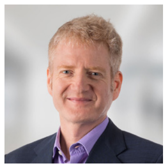

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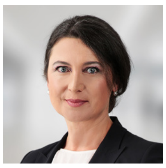

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