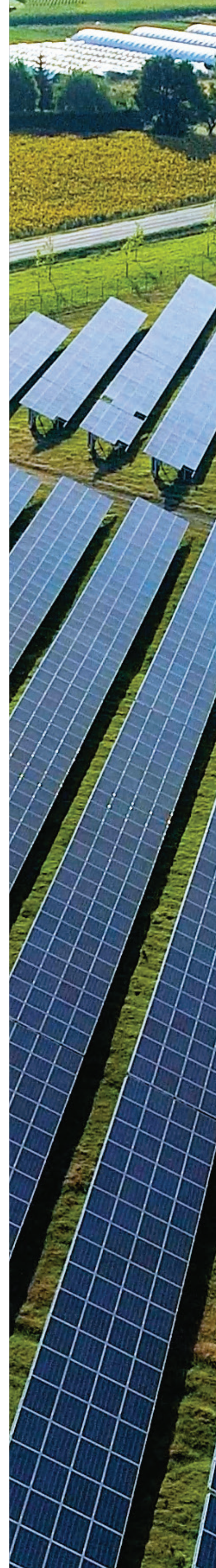
Morgan Stanley

INVESTMENT MANAGEMENT

Push and Pull Factors Drive the Evolution of Sustainable Investing in Private Markets

SUSTAINABILITY | INVESTMENT INSIGHT | JANUARY 2023



Within sustainability themes, climate and the environment originally dominated as the key systematic and idiosyncratic risks to all issuers and corporates in private and public markets. The pandemic we endured and the growing social awareness of critical issues like diversity, equity and inclusion have now come to the forefront of public consciousness.

What we see now in the markets are essentially push and pull factors driving the evolution of sustainability as part of the investment process, with the aim to optimize particular outcomes. The *push factor* is the growing scrutiny from regulators in the US, Europe and Asia. The *pull factor* comes from clients who are increasingly looking for ways to gain greater transparency and influence with their capital.

Identifying four key themes linked to UN Sustainable Development Goals

At Morgan Stanley Investment Management (MSIM), we have adapted our analysis and scrutiny to focus on four key themes linked to the UN's Sustainable Development Goals (SDG)[1] that we think are material from an investment perspective.

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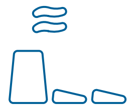
[1] This represents how the portfolio management team generally implements its investment process under normal market conditions. The content has not been approved by the United Nations and does not reflect the views of the United Nations or its officials or Member States. See https://www.un.org/sustainabledevelopment/sustainable-development-goals for more details on the Sustainable Development Goals icons.

DISPLAY 1

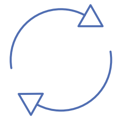
MSIM Sustainability Thematic Focus

Four Key SDG-linked Themes Aligned with MSIM and Firm-level Priorities



DECARBONIZATION & CLIMATE RISK

Supporting the transition to a low carbon economy in line with Paris Agreement goals



CIRCULAR ECONOMY & WASTE REDUCTION

Supporting business models that reduce impact on natural resources and that innovate to reduce waste generation, with a focus on plastic waste

DIVERSE & INCLUSIVE BUSINESS

Supporting business practices that create a more just and inclusive society

DECENT WORK & RESILIENT JOBS

Supporting decent work across the entire value chain and making workforces resilient in the face of innovation and change

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Climate continues to be relevant, as well as pollution prevention, waste control and the circular economy. We would all agree that these themes matter, not just from the *risk* perspective of managing downside—particularly companies' exposure to carbon prices or fossil fuels—but also the potential *opportunity* to help drive the clean energy transition. So both risk and opportunity are related to those themes.

The same is true for the social themes that we added to our priorities: diverse and inclusive business, and decent work and resilient jobs. Both are just as relevant when we consider how to build a sustainable investment thesis.

Thinking first about decent work and resilient jobs, we believe that, as we move into the global economy's phase of recovery and growth, a company's ability to succeed is going to rely on having a productive, healthy and educated workforce. At the same time, the nature of work is evolving, with surveys illustrating that employees have reassessed their goals and priorities it has become even more important for firms to engage with workers to make sure that they are not only safe but also motivated, equipped and skilled in their roles. In our view, those companies that have invested in their people are best placed to benefit as the economy recovers.[2]

Turning to inclusive business practices, academic research has illustrated that a diverse workforce helps to avoid everyone coming from homogenous backgrounds and thinking the same way. Alternative perspectives and insights are invaluable to the investment process, from security research to client communication. That has always been true.

Also relevant for us is reflecting on movements like Black Lives Matter, which are raising our awareness that the effects of events like pandemics are falling disproportionally on the most vulnerable and marginalized elements of the population. When we evaluate companies to invest in, we need to consider whether they have done their part to make products and services more accessible to those less privileged, and to help their brands resonate with a more diverse community. That can be powerful for fostering customer loyalty and keeping the brand profile aligned with the current state of public consciousness.

Building sustainability factors into our investment practice

We live with competing and critical challenges. Private equity investors are looking for good long-term premium returns associated with private investing. The question of whether climate investing can generate returns has been answered affirmatively. What we now need to ask is how can we afford to avoid climate investing or climate loans if we are investing for the long term? We know the size of the problem: to cut our carbon

[2] The statements above reflect the opinions and views of MSIM as of the date hereof and not as of any future date and will not be updated or supplemented. All forecasts are speculative, subject to change at any time and may not come to pass due to economic and market conditions.

emissions by 40 gigatons each year from now until 2050 to reach the goal of carbon neutrality.

Investing for climate impact is intrinsic to compelling private equity outcomes across four dimensions. First, company managements recognize that efficiently using raw materials and other inputs in the production process directly impacts the bottom line. We could say that improving EBITDA margins is private equity 101, so aligning with environmental objectives can be quite intuitive.

Second, sustainability is a growth area. Consumers are willing to pay more to eat sustainable food, wear sustainable clothes, drive sustainable vehicles and live in sustainable housing. These are all exciting markets and revenue streams for older traditional companies to pivot towards for future growth—often by acquiring newer companies focused on sustainability.

Third, building climate resilience into business models becomes imperative as frequent extreme weather events pose threats to supply chains. Infrastructure needs to last for the 8- to 10-year investment periods of most private funds. Managing operational risk through secure locations and backup plans can improve cash flow predictability.

Tying together the dimensions of margins, growth and resilience, we find the answer to our question in the markets. In our experience, private companies with concrete sustainability stories tend to capture the so-called gradient when they list in the public equity markets. Or traditional companies acquire them for the same reason.

Leveling the playing field in early-stage funding

Through the lens of our clients at Morgan Stanley—that pull factor—we see a real desire to be part of the solution around the funding inequity in private markets—especially for early-stage companies. According to Crunchbase, the dollar amount of funding to Black founders is up, but still represents just 1.2 percent of venture capital invested in U.S. startups through the first half of 2021 perpetuating the inequality that pushes into middle-market private equity and ultimately the companies that file IPOs and exit the market.[3]

Our surveys reveal that 75% of our VCs (venture capitalists) strongly agree that an investment strategy can intentionally invest in women and founders of color, while still maximizing returns.[4] So investors are coming to understand that they are not required to sacrifice returns for diversity in their portfolios. Diversity really plays into the ability to fund direct investments that can actually outpace the benchmarks, even in early-stage companies.

We observe the push and pull where LPs (limited partners) push for more diverse founders in VC portfolios and greater capital into emerging managers and funds of color, then VCs pull to find diverse founders and go to their sources to open their own networks to those founders. The objective is to tackle social issues while investing in companies that are inherently more sustainable, because they find solutions to problems affecting their communities.

Bottom line

Across the spectrum of private investing—from early-stage funding to deal sourcing to public offering—we see the role of sustainability as ever-increasing. Governmental supervision and legislation push us to factor ESG metrics into our investment analysis, while our clients pull us forward to take their preferences and objectives into account. Relative to the public markets, private markets give investors the ability to require these outcomes and let them track the impact their money is creating. After all, this is just good private markets investing, and we are headed in that direction.

[3] Crunchbase, *Black Women Still Receive Just A Tiny Fraction Of VC Funding Despite 5-Year High*, July 2021.
[4] Morgan Stanley, *Asset Owners and Investing in Diversity: Intention versus Action*, October 2021.

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