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Special Edition

DNB Markets

Beyond the ESG backlash: Recalibrating sustainability in finance

A quarterly newsletter summarising recent trends and developments within sustainable and transition finance, published by the Sustainable Finance team, DNB Markets

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The state of sustainability in financial markets

Why the critical debate on ESG has initiated a healthy recalibration of sustainability

In this special edition of our quarterly Sustainable Finance Market Comment, we wanted to take a holistic view and sum up the current state of sustainability in financial markets. Over the past year, much has been written about the ESG backlash, greenwashing, the politicisation of ESG and the shortcomings of sustainable investments. Some even claim the 'end of ESG', **as the hype of a broadly defined and often misunderstood market trend has come crashing down in face of increased scrutiny as well as new geopolitical and macroeconomic realities**.

Our view is that these critical debates on ESG have initiated a healthy recalibration of sustainability at large, and especially so in the context of financial markets. While the ESG moniker arguably is outdated, sustainability drivers and sustainable business models are more relevant than ever. **We now have an opportunity to refocus on the long-term value creation and real economy impacts of products, services and business models.**

The newsletter first introduces a conceptual discussion of the ESG journey, from hype to recalibration, before we look at several key trends that support our view that **sustainability in financial markets will emerge with renewed force and purpose from the ESG backlash**.

Although our findings give room for optimism, it is important to say that **current efforts to channel capital towards sustainable activities are not nearly enough**. The capital gap to inter alia reach net-zero by 2050 or fulfill the Sustainable Development Goals is still enormous. **Yet, with a more clearly defined focus on real impact and sustainable solutions, the foundation for the reallocation of capital becomes more solid.**

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The journey of ESG – from silver bullet to hard realities

The ESG hype cycle

The ESG concept has in our view followed a typical hype cycle, from hype to disillusionment.

The real breakthrough for ESG in finance came with the establishment of the Taskforce on Climate-related Financial Disclosures (TCFD) following the Paris Agreement in 2015. The ESG concept gained further momentum with the subsequent public awakening on sustainability in general and climate change in particular.

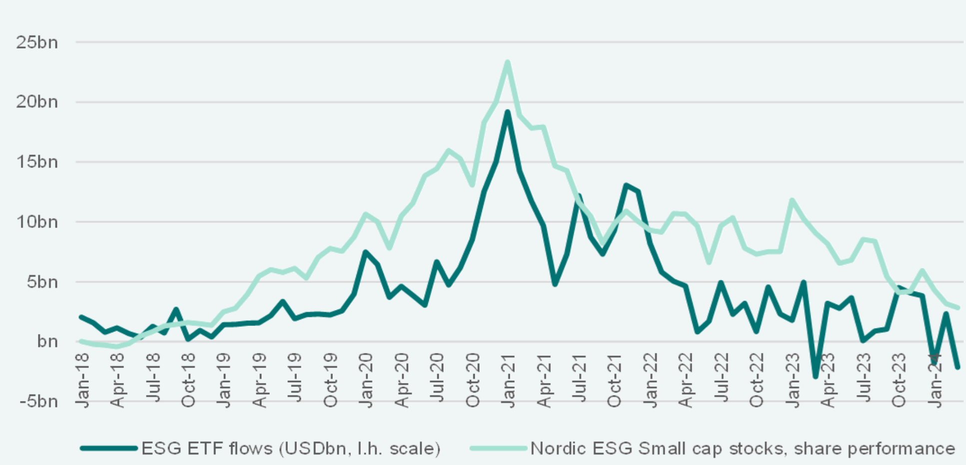
Anchored in the (still very salient) logic of climate risk, much confidence was placed in the ability of market dynamics to drive climate change mitigation and solve other sustainability issues. The expectations to the private sector, and especially the financial sector, were greatly inflated.

What ought to have been a complex story of the interplay between regulations and markets, decarbonisation and economic development, and investments in green solutions vs transition industries, was reduced to a silver bullet narrative where investing in all things ESG would both save the world and earn solid returns.

The ESG stock market bubble

As a result, a tsunami of cash poured into ESG-related investments. ESG-labelled ETFs' monthly inflow grew from USD1bn–2bn in early 2018 to USD20bn–25bn in late 2020.

Figure 1. Inflow in ESG EFTs vs Nordic small-cap ESG stocks, USD[1]



Limited availability of listed 'green' and 'solutions' companies, combined with a relative insensitivity to valuations, inflated an ESG bubble in several regions. In the Nordics, small-cap ESG stocks rallied 250% in two years.

Many of the so-called 'ESG stocks' (most commonly 'green' companies offering a climate solution) were capital-intensive companies with most of their growth expected beyond the next 2-3 years, making their valuations sensitive to interest rate movements. As interest rates increased, it became harder for many companies to secure funding for early-phase projects to achieve growth.

As a result, small-cap ESG-related share prices have more than halved since the peak in late 2020.

Figure 2. S&P Clean energy index Nov 2019 – Nov 2024

At the same time, ESG-labelled funds started to underperform versus broader indices, notably because Russia's invasion of Ukraine boosted the oil and gas stocks that ESG funds excluded. Ultimately, it was the perfect storm where the ESG hype was hit hard by new geopolitical and economical realities.

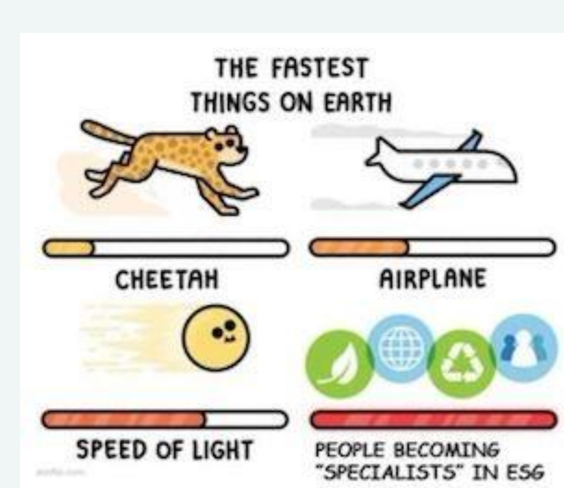
For more context on the ESG stock market bubble, please see '<u>From ESG hype to transition winners</u>' (April 2024) by DNB Markets Equities Research.

Corporate sustainability euphoria – absolution through ambitions

As investors and consumers increased their focus on sustainability, the theme made it into board rooms and climbed up the C-suite agenda. Suddenly all sorts of companies promoted their sustainability efforts, identified relevant UN Sustainable Development Goals and set net-zero targets to attract customers, capital and talent.

By and large, this breakthrough for sustainability and the hype that followed have been overwhelmingly positive. The fact that Boards of Directors and top executives adopted net-zero targets and sustainability strategies should be applauded. **The issue was that we in some ways lost track of the fundamentals along the way.**

Figure 3. Meme: the hype was real



Footnotes: 1) For ESG stocks index 100=2018.

Sources: Figures 1 & 2: Bloomberg (underlying data), DNB Markets (further calculations)

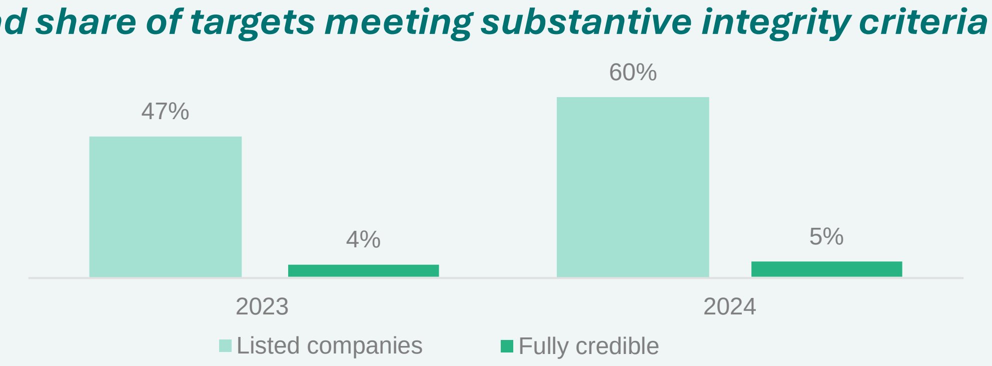
How ESG lost its meaning

Fundamentally, ESG and sustainability has always been about mitigating and capitalising on material impacts, risks and opportunities. But the ESG moniker took on a life of its own, where a wide variety of sustainability issues were lumped together as "ESG".

As Professor Alex Edmans from London Business School has written, "the current practice of ESG gives special status to something just because it can be called ESG"[1], even though underlying activities are not really altered.

Much of the sustainability agenda was reduced to ticking different reporting boxes, signing pledges and setting targets, rather than really changing business models and working out how to reach the targets. Phrases like "sustainability is integrated into all we do" became commonplace, and 2050 net-zero ambitions proliferated rapidly. It all culminated with the politicisation of the ESG concept in the US.

Figure 4. Listed companies with net-zero targets globally and share of targets meeting substantive integrity criteria



A return to the fundamentals

In our view, the US ESG backlash misses the point on what sustainability is supposed to be. **But the wider ESG debate it help spark provides an opportunity to get back to basics** and refocus on how to transition business models, make more sustainable products and specific actions to reduce negative impacts.

One such reinterpretation of ESG that resonated widely in 2024 is Edmans' concept of **rational sustainability**. Emphasising long-term value creation of core business, outcomes over labels, and evidence and analysis, rational sustainability **provides a helpful framework to recalibrate the approach to sustainability in financial markets**.

In essence, what we need is a return to materiality and longtermism, two of the foundational concepts of the corporate sustainability movement.

The 'slope of enlightenment'

Even though widespread ESG disillusionment made its mark on 2024, we believe this also marks the beginning of the 'slope of enlightenment', approaching the final stages of the Gartner hype cycle as illustrated below. In our view, we see strong potential for sustainability across financial markets to gain momentum in 2025.

The main reason why we believe sustainability will strike back is quite simply that the **fundamental drivers are as strong as ever**: if unmitigated, climate change, biodiversity loss and respect for human rights will still undermine business as usual, creating a more unstable world with enormous negative economic ramifications.

The world will need solutions to these, and many other pressing issues embodied in the UN SDGs. For the companies that deliver the solutions by way of their products and services, the business opportunities should be substantial. Companies that transition towards more sustainable practices should take market shares from those that do not, provided that politics and regulations favour the former.

Over the next pages, we will highlight three factors that we believe will revitalise sustainability in financial markets': **i) regulations, ii) investor preferences, and iii) corporate agendas.**

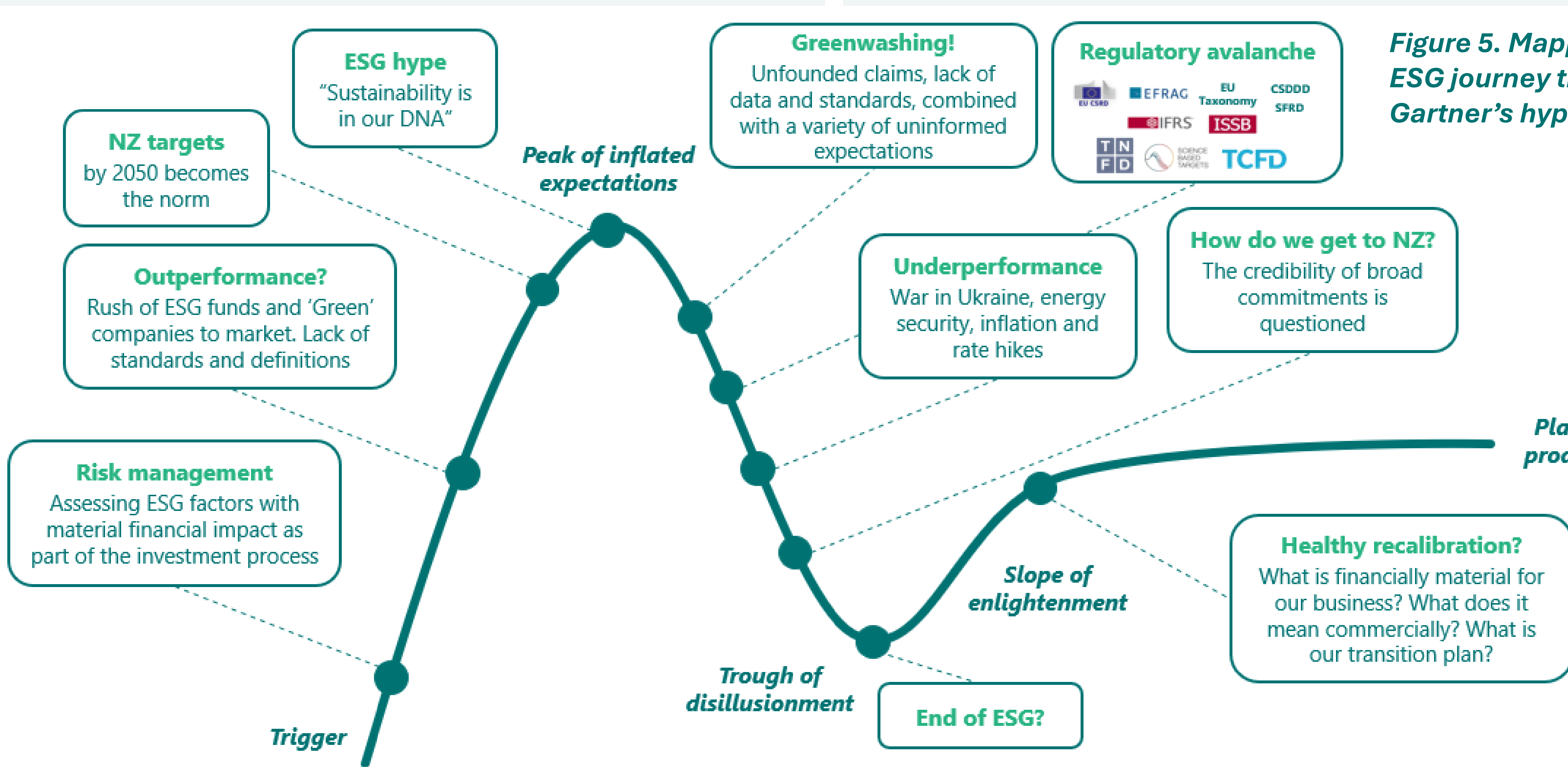


Figure 5. Mapping the ESG journey through Gartner's hype cycle

Footnotes: 1) Edmans, A. (2024), 'Rational Sustainability, Journal of Applied Corporate Finance, p. 6

Sources: Figure 4: Net-zero tracker, 'Net-zero stocktake 2024'

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Factor 1: Regulations

Regulations will continue to stimulate sustainable business opportunities

Despite increasing global GHG emissions and the fact that the 1.5-degree ambition of the Paris Agreement seems to hang by a very thin thread, leaps have been made on the regulatory front over the past few years.

The EU and the US have approached transition policies differently: one with sticks, the other with carrots. The EU's approach has been risk and cost-based, with policies focused on increasing the cost of carbon-intensive production and products. The US' approach has been to boost low-carbon solutions in renewables and clean tech with subsidies that should eventually bring costs down and facilitate production. Meanwhile, **China** has initiated extensive green public spending programs on renewables and clean tech. Looking ahead, we **believe regulations will remain a key driver for sustainability** – both as sticks and as carrots – **with five broad policy trends to follow closely:**

Increased cost of carbon

Energy efficiency

Resource efficiency

Push for renewables

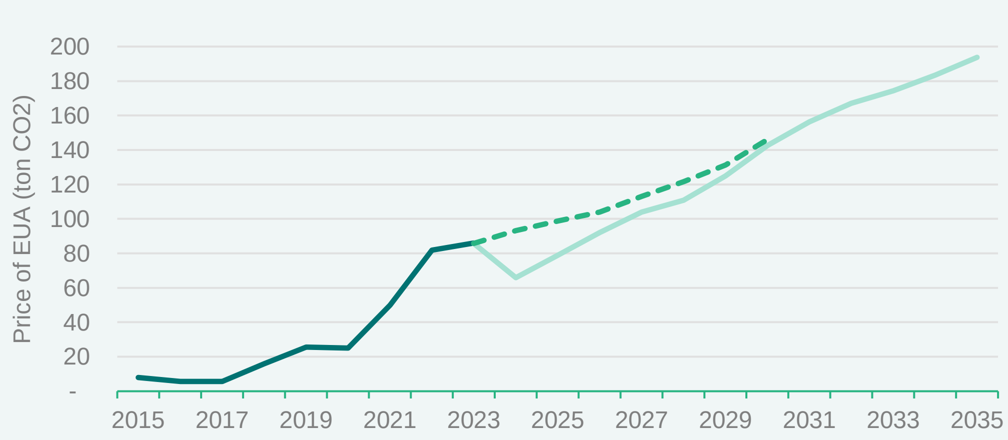
Push for clean tech

The EU – consolidation and implementation will impact gradually

The 2019-2024 'sustainability laws boom' has supported emissions cuts[1] and wide ESG-integration. We expect a more pragmatic, action-oriented sustainability focus for the coming strategic period, where the European Commission must balance competitiveness with climate goals. The Fit for 55 package of laws and regulations under the Green Deal has so far been mostly about **costs and requirements**. 'Sticks' such as the **EU Emissions Trading Scheme reform** and **Carbon Border Adjustment Mechanism** aim to lower emissions by increasing cost (Figure 7). The **Energy Performance in Buildings Directive** is an example of requirements on minimum energy efficiency standards and related upgrades. Moreover, new regulatory areas are becoming increasingly specific, notably the continued roll-out of policies under the **EU Circular Economy Action Plan**.

'Carrots' may take a more central place on the EU agenda with the upcoming **Clean Industrial Deal**. As current EU subsidy schemes are regarded as fragmented and complex, a more streamlined and forceful framework to support risk-sharing and mobilize private investments may sail up to counter Europe's dwindling competitiveness.

Figure 7. EU ETS carbon price could reach EUR 200/t by 2035



US – effective incentives, albeit Trump uncertainty

The landmark **US Inflation Reduction Act** from 2022 addresses the US' key emitting industrial sectors and includes nearly USD400bn of direct subsidies and tax credits to clean energy technologies and solutions. However, the coming Trump presidency poses considerable uncertainty for ESG-related policy areas, such as global climate diplomacy, the investment appetite for renewables, and US climate risk disclosure requirements. Given the notable economic benefits (Figure 8), it is possible that the key ongoing climate initiatives under the IRA could prevail even under Trump. In any event, **the role that the IRA has played in stimulating green investment underlines the importance of policy in creating the right incentives**.

Figure 8. Benefits from the launch of the IRA

- **USD 500bn** of planned investment
- **USD 265bn** of announced company investment across US, with 75% occurred in underserved communities
- **330k+** new clean energy project jobs
- **40+** new manufacturing facilities online and operating
- **300+ GW** clean power capacity in development
- **250k+** Americans have claimed IRA EV tax credit

China – national growth and international position set to continue

China's political focus on green industry and decarbonization is set to continue, backed by stable local EV demand and strong governmental push for renewable energy (e.g. 2030 clean electricity capacity expected at ~3000GW compared to the EU's ~600GW[2]). In addition, **China's exporter role of the necessary 'new three' – solar cells, lithium batteries and EVs** illustrates the global, and especially EU's, dependency on China, despite the upcoming threat of increasing tariffs (e.g. 98% of EU's solar cells imports are from China[3]) .

Footnotes: 1) The European Commission 2024 Carbon Market Report, Nov. 2024, 2) IEA Renewables, 2024, 3) European Commission, October 2024.

Sources: Figure 7 – Bloomberg New Energy Finance (underlying data), DNB Markets (further calculations); Figure 8 – The White House Fact Sheet on Inflation Reduction Act (August 2024), Clean Energy Investing in America report (August 2024)

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Factor 2: Investor preferences

With newfound maturity and sophistication, sustainable investing is set for a comeback

The end of the beginning

During the ESG hype, funds marketed as sustainable experienced significant inflows, especially in Europe. Since the heydays in 2020-2021, global sustainable fund inflows have declined substantially according to Morningstar data.[1] Several financial market net-zero alliances have similarly seen a rapid rise followed by an equally rapid collapse.

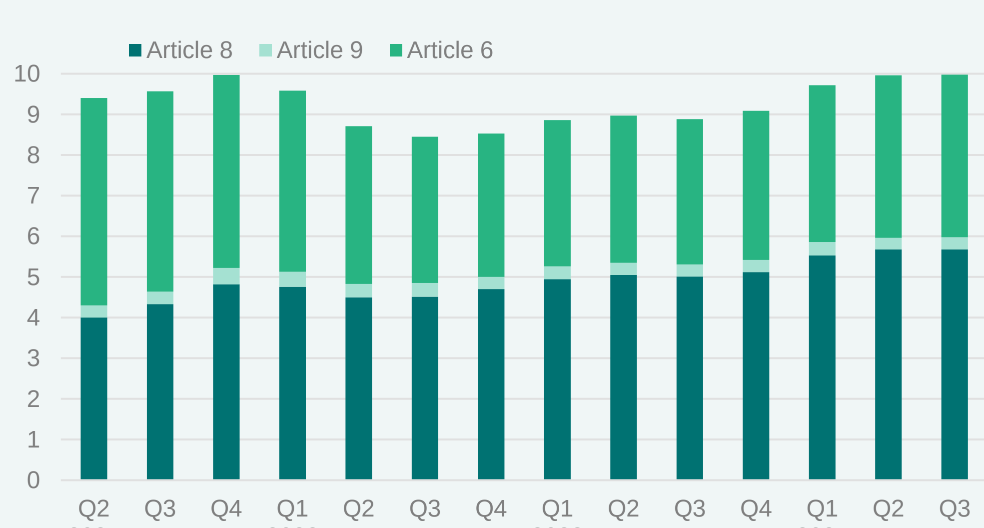
It might look like investors are done with ESG, but the picture is in fact not all that bad. In Europe – where 84% of global sustainable fund assets are held – conventional funds fared even worse and saw outflows during the same period. More importantly, the **ESG investment hype took place when there was no common definition of what constituted a sustainable investment**. The boom may have petered out, but sustainable investments are getting more sophisticated. And the alliance exodus by US banks due to ESG politisation is not necessarily the same as giving up on climate risk.

Sustainable investments are evolving, not outdated

In the EU, regulators were quick to identify the problem of greenwashing in the financial sector. The introduction of the Sustainable Finance Disclosure Regulation (SFDR), has successfully contributed to weeding out ESG-labelled funds that were little more than conventional funds with a label.

A closer look at the European fund landscape shows that ESG is by no means dead to investors. 57% of European fund assets are held by 'light green' Article 8 funds that integrate sustainability. Around half of these hold at least 30% sustainable assets, although the definition of sustainable assets vary. A further 3% of fund assets are held by 'dark green' Article 9 funds that pursue sustainability objectives. In other words, **60% of European fund assets are held by funds that consider sustainability in some way or another**.[2]

Figure 9. Asset breakdown by SFDR classification (EUR tn)



While the momentum for sustainable investments may appear lost, we believe the segment will **benefit from a recalibrated, better informed and more rational approach**. Investors are still interested in sustainability because they recognise that transition risks and opportunities are real.

In a 2024 survey of institutional investors by the Morgan Stanley Institute for Sustainable Investing, 78% of global asset managers and 80% of asset owners expect sustainable AUM to increase in the next two years. Among the top reasons cited for the expected increase were precisely that sustainable themes offer exposure to growth opportunities, and the fact that sustainable investments is becoming a more mature strategy with an established track record.[3]

In other words, **the long-term sustainability themed opportunities are still attractive.** Maybe even more so now that valuations have fallen as the ESG hype subsided.

Investing with impact

Another sign that sustainable investments are developing is the steady growth of impact investments, which can be defined as investments made with the intention to generate positive environmental or social impact alongside financial return. As such, they are at the opposite side of the spectrum from the first generation of ESG funds that primarily made small changes to common indices.

According to the Global Impact Investing Network (GIIN), **impact investing assets have grown at 14% CAGR over the past five years**. There are also signs that impact investing is becoming more mainstream, as the percentage of assets allocated by investors who also do conventional investments increased by a CAGR of 34% in the same period.[4]

A longer-term perspective in private markets?

Private market investors may also become increasingly important for providing capital towards the energy transition. With their typically longer dated focus, they may at times be better **positioned to reap business opportunities compared to some of their public market counterparts**, who tend to be more driven by quarterly earnings and shorter-term trends.[5]

Transition finance – the next 'green'?

With an increasing level of sophistication and maturity in sustainable investing strategies, "transition finance" is also receiving more attention. If the ESG hype was all about defining 'green', the 'slope of enlightenment' brings a broader perspective on decarbonization. Folksam's chief economist, Marcus Svedberg, makes a compelling case for pursuing climate delta to achieve what he refers to as beige alpha – investing in companies that will increase their competitiveness by way of transitioning their businesses.[6]

Over the years, capital markets have been fairly good at spotting the truly green and truly brown assets. However, **identifying the relative transition winners among the vast majority of assets that are somewhere in between, may be where the real investment opportunities are.**

Footnotes: 1) Morningstar, Global Sustainable Fund Flows, Q3 2024 in Review, 2) Morningstar, SFDR Article 8 and Article 9 Funds: Q3 2024 in Review, 3) Morgan Stanley Institute for Sustainable Investing, Sustainable Signals, December 2024, 4) Global Impact Investing Network, State of the Market 2024:Trends, Performance & Allocation, September 2024, 5) Bloomberg, article citing KKR and MSCI, July 2024, 6) Responsible Investor, interview, July 2024

Factor 3: Corporate agendas

Less marketing, more strategy

Corporate sustainability efforts are becoming more detailed, material and credible

Companies have not given up on their sustainability efforts, even though the ESG backlash and fear of greenwashing accusations seem to have made them more quiet. A study of the Fortune Global 500 companies, reveals that the world's largest companies increasingly are setting climate-related targets.[1] Similarly, a 2024 analysis of hundreds of thousands of companies find their financial disclosures are mentioning sustainability as much as ever.[2] **What is gone, are the big marketing campaigns and unfounded claims about going climate positive.**

We can thank EU disclosure regulations for much of this clean-up. Yet, the evolution also reflects a maturing of corporate sustainability efforts; what we refer to as a 'healthy recalibration'. **After everyone established net-zero targets, the next question naturally was: how do we reach them?** Companies now focus on near-term targets, concrete actions to reach them, the investment needs required, and long-term viability of their business model. And CSRD will make sure that companies cannot drop the ball on sustainability disclosures, strategy and governance.

In our experience, **companies recognise that investing in sustainable products and business models is important for long-term value creation.** Activity in the sustainable finance debt market shows that companies increasingly tie funding to their transition journeys, with continued support from investors.

Another strong year for the sustainable debt market

Total issuance of sustainable bonds in 2024 was just shy of the record year of 2021, with green bond issuance reaching an all time high. Sustainable bond issuance as a share of total bond issuance increased globally to a new record of 7.4%. In the Nordics, the share holds steady at around 20%, but if we look at the Nordic corporate bond market in isolation, more than 40% of capital raised had a sustainable label.

As the great majority of sustainable bonds are use-of-proceeds instruments, where funds are earmarked for mainly green investments, **it is safe to say that companies are still investing in their sustainability journeys**.

Figure 9. Global issuance of sustainable bonds and loans (EUR bn)

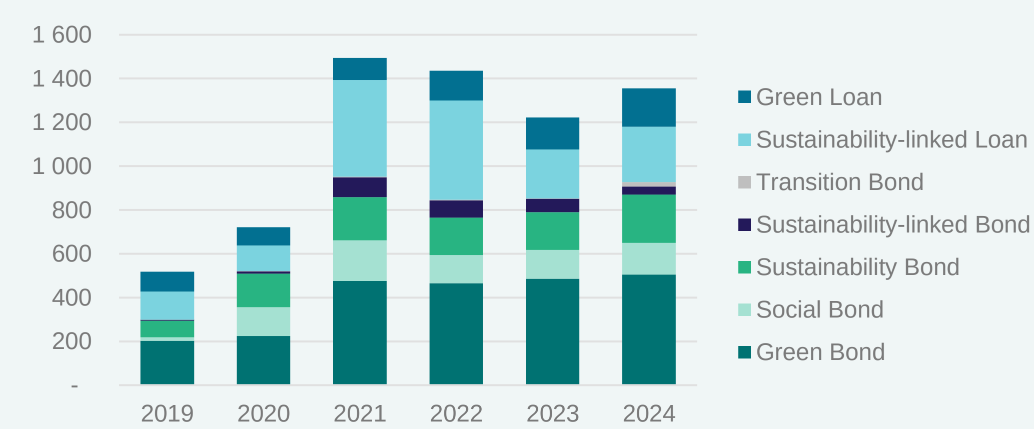
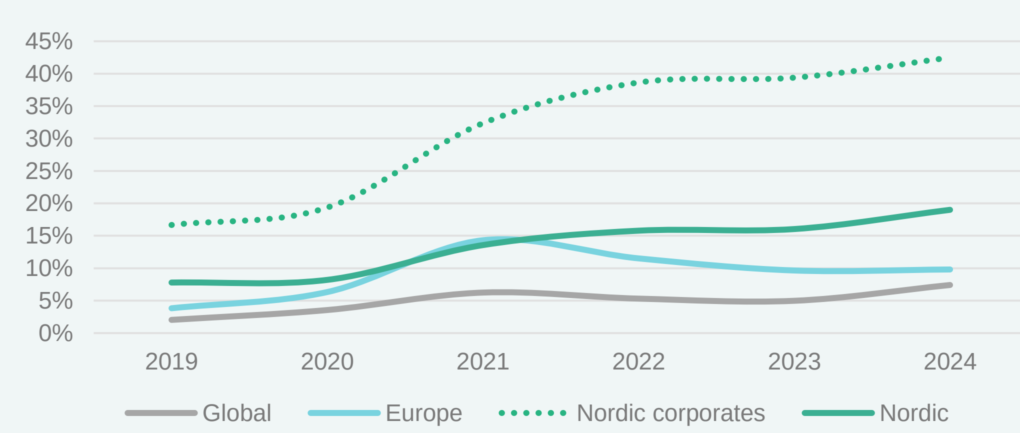


Figure 10. Share of bond market with sustainable label



Momentum has also returned to the much-berated sustainability-linked loan (SLL) market. The market recorded a dramatic drop in 2023, and a weak start to 2024, amidst greenwashing and credibility concerns related to weak KPIs and targets. **We believe the SLL market's recovery is a prime example of healthy recalibration, where the bar for qualifying for the SLL label has risen markedly** compared to where it was in 2021-22. Banks' assessments are more sophisticated and expectations higher. Meanwhile, the companies' sustainability strategies, targets and reporting have improved, making it easier to establish robust and ambitious structures.

Concluding remarks

We argue that the fundamental long-term drivers for why sustainability matters, including climate change, biodiversity loss, and respect for human rights, remain as strong as ever, with potential to significantly impact both risk and returns. With the ongoing healthy recalibration of sustainability in financial markets, we believe sustainable investments are better suited to help mitigate transition risks and make use of sustainable opportunities going forward. Timing is however a key uncertainty, notably with regards to politics and regulations. Short-term political sentiment and regulations can alter projected cashflows and profitability of future projects, thereby impacting investor willingness to allocate capital, or even corporation's willingness to make such strategic investments in the first place. 2025 may become a pivotal year in this respect.

Footnotes: 1) ESG Today, Study Finds Largest Global Companies are Accelerating Climate Commitments, Sept. 18th 2024; 2) Wall Street Journal, Companies Haven't Abandoned Sustainability. They're Just Talking About It Less, Aug. 19th 2024

Sources Figures 9 & 10: Bloomberg, DNB Markets

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