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2023 ESG Review and Outlook for 2024

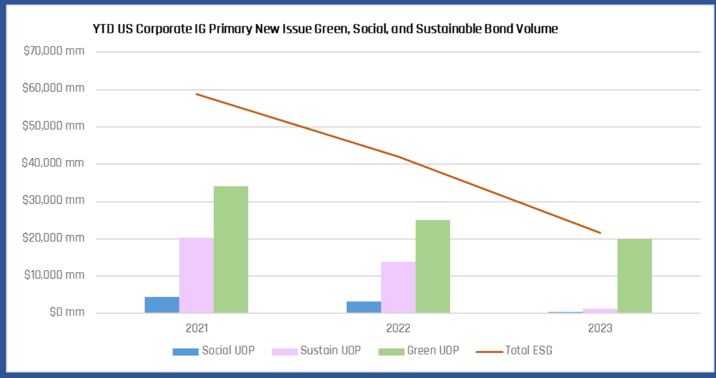
In this month's report, we review some of the key developments that we've seen this year with a specific focus on the United States and what could be on the table for next year. More specifically, we examine 2023 ESG-themed fund flow, new-labeled debt issuance, and VC/PE activity. We also touch on what U.S. policymakers are considering and the areas for possible alignment going forward. Lastly, we highlight how geopolitical and security concerns (specifically cyber and maritime security) are increasingly becoming top of mind ESG issues.

2023 Issuance, Fund Flows, and VC

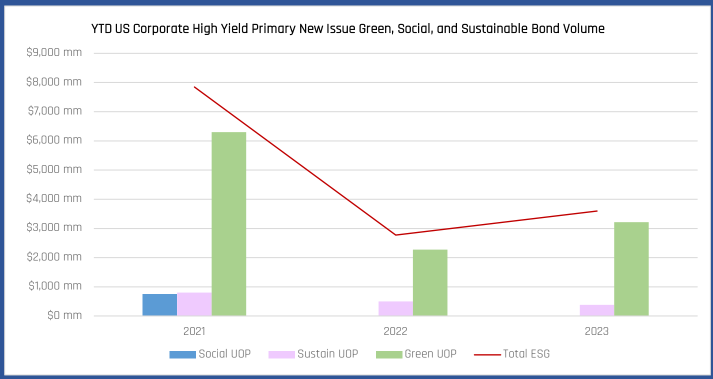
While global issuance of new green, social, and sustainability bonds remains resilient (especially by European governments and supranationals), issuance of these instruments in the U.S. by corporates has dropped precipitously from the volumes seen in 2021. This year, only $21bn in IG GSS bonds and $3.5bn in HY GSS bonds were printed by U.S. companies, for a notional value of $21bn (the majority for green purposes). 2023 was down almost 66% versus 2021. Utilities and financials continued to dominate the space from an issuer perspective, but we see opportunities for materials, industrials, and non-traditional "green" companies looking to print use of proceeds instruments. Earlier this year, LyondellBasell and Eastman Chemical both issued $500mm 10YR inaugural green bonds. In addition to LYB and EMN, Comcast also came to market with an inaugural $1bn green bond, making it this year's newest U.S. green bond entrant among communication services companies.

It was a challenging year for many U.S. Sustainable Funds. Both passive and actively managed sustainable equity funds saw outflows throughout most of the year. Meanwhile, sustainable bond funds saw modest inflows as investors aimed to get in on more optimal yields. Driving a lot of these outflows have been macroeconomic concerns regarding recession, rising interest rates, and geopolitics, leaving total U.S. Sustainable Fund assets under management of $300bn, a 14% reduction from Q4 2022's highs.

2023 U.S. Green, Social, and Sustainable Debt Volume



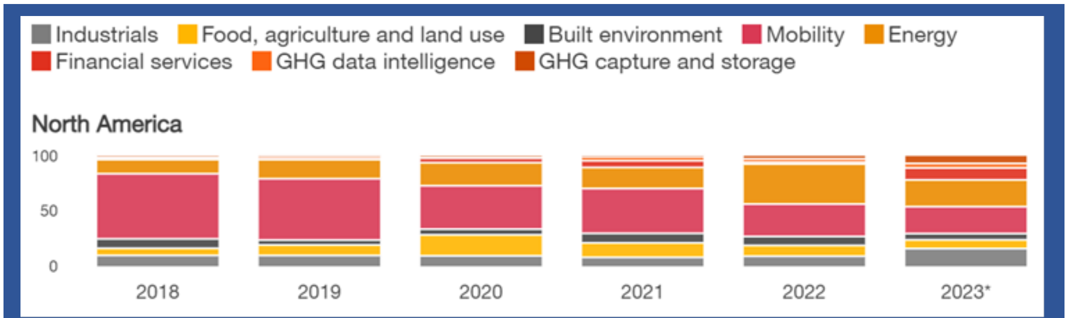
Investment Grade: No change in U.S. IG new issue green, social, and sustainable labeled bonds since November. Volume down for the year.



High Yield: One last issuer came to market for $550mm in December 2023. HY Green Bond volume is up for the year. Source: Bloomberg.

Morningstar Global Sustainable Fund Assets: Q3 2023

Like U.S. sustainable funds, 2023 climate tech venture investment in the U.S. saw a drop of over half to $18.6bn from last year's ~$40bn. Interest rate risk, inflation, geopolitical tensions, energy, and supply chain concerns are some of the primary reasons why investors are on the sidelines or looking elsewhere.



PWC: State of Climate Tech 2023

However, while the volume of investment has dropped, the diversity of available investments has increased. For instance, in 2018, 59% of VC and PE climate tech investments were in mobility. This year, only 24% of investment was in mobility, while the rest was distributed among energy, industrials, and financial services.

U.S. Policymakers and ESG: Friction & Alignment

When reading the headlines, bipartisanship is probably not the first thing that comes to mind when discussing ESG and policymaking here in the U.S. However, we do see opportunity for alignment among legislatures over the long-term on ESG & climate, including in areas such as adaptive and resilience measures needed to manage flood risks and grid hardening. It was a key point of focus by the U.S. Senate, because over 40% of the nation's population lives in coastal communities (making up $1 trillion in assets). One of the chief concerns is the availability of insurance and the impact on home values. We are beginning to see insurance providers either stop offering plans (or risk becoming insolvent) in high weather-risk areas like Florida. This puts millions of homeowners in a vulnerable situation, as their homes and wealth (through home equity) are at risk of being devalued due to property being uninsurable or unmarketable.

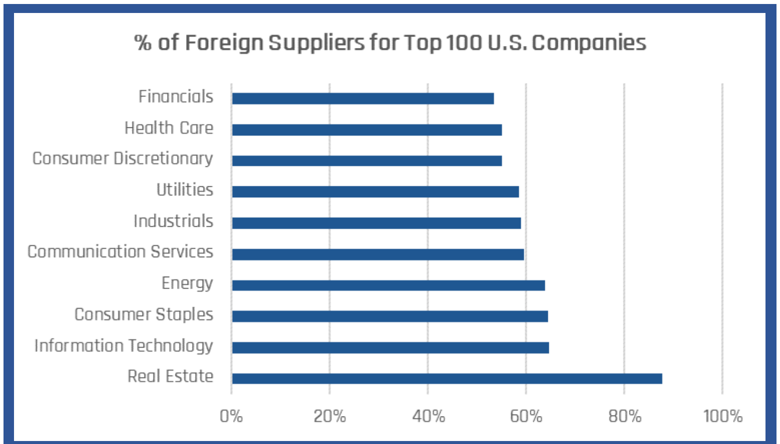
Where we continue to see friction among policy makers, especially in congress (and state treasurers), is the way that ESG is integrated within public pension funds. Earlier this year, congress was focused on addressing the Department of Labor's ERISA provision for ESG, which was then vetoed by the president. A fair number of states have also looked to pass policies restricting "ESG" investments, driven by concerns over what is seen as the politicization of investments and energy security. Only a handful, however, have made it to the state governors' desks and have been signed. Along with the focus on retirement plans, congress has also looked to "rein in" agency actions. More specifically, this includes the SEC's recent rulemaking agenda and the CFTC. The Inflation Reduction Act and its subsidies, European corporate disclosure laws, and concerns regarding collusion and the formation of possible concert parties (to promote ESG related goals among organizations like Climate Action 100+) will continue to be a target for certain policymakers going into 2024.

A New "S" and "G" in ESG: Security & Geopolitics

There is a growing sentiment that "Security" is the new "S" component in ESG. We couldn't agree more.

We see cybersecurity as one of the key security components. The U.S. remains among the top nations with the highest average data breach costs, as the healthcare, financial, biotech, energy, industrials, and technology sectors are the top targets of threat actors. This year's cyber-attacks like the 3CX supply chain breach, the U.S. government email breach which included both the Commerce and State Department, and the casino operators attack in September (coupled with the rising cost of cyber-insurance premiums) highlight the need for increased training, technology, and enforcement.

In response, we've seen two cyber-catastrophe bonds come to market, the most recent being a $75mm public cyber-catastrophe bond issued by Long Walk Reinsurance, and earlier this year, Beazley launched the first private $45mm cyber-cat bond. It's likely that we will continue to see more cyber-cat issuance in the years ahead, along with the possible integration of cyber-related use of proceeds within financing frameworks as organizations look to communicate to both regulators and investors how they are investing in security.



Bloomberg-SPLC

Another growing area of focus is ensuring supply chain resiliency considering geopolitics and maritime concerns (including ocean floor mining). Increased supply chain "security and resiliency" (specifically maritime) is likely to be top of mind coming into 2024. Despite conversations of "decoupling" and "deglobalization," many companies still have a substantial number of foreign based suppliers. For instance, you'll find on average that the top 100 U.S. companies (by market cap) have 59% of their suppliers based outside of the United States (source: Bloomberg data).

The continued conflicts in Israel, Ukraine, and in the Red Sea (Houthi attacks and their possible expansion into the Mediterranean) will drive-up costs as companies and governments explore workarounds and alternate routes.

Another focus point for 2024 and onward is likely going to be ocean floor mining. As companies and nations look to transition from hydrocarbons to electrons, demand for minerals is expected to rise exponentially. It's increasingly likely that the ocean floor will be a key source of those minerals. We see evidence of this as Norway looks to ready plans for deep-sea mining which could put it at odds with Russia, the U.K., and other E.U. nations. We also saw members of congress direct the DoD to consider the domestic processing of seabed resources (like polymetallic nodules) under the National Defense Authorization Act. A resolution has also been reintroduced by the U.S. Senate to ratify the U.N. Convention for the Law of the Sea, showcasing the growing concern over maritime access and resources in a multipolar world.

Bottom Line

- While GSS issuance was light this year relative to previous years, if 2024's interest rate and political environment is more constructive, we could see a rebound especially for social and sustainability bonds.
- We see geopolitics and security as growing areas of focus for investors and other stakeholders given increased concerns around maritime access and resources related to a more electron-driven economy.
- More funding & investments for AI and cyber. With this year's two cyber-catastrophe bonds and the SEC's new cyber disclosures, we see an opportunity for issuers to incorporate cyber spend into bond frameworks in order to help attract a possible lower cost of capital for such projects.

- Should the Fed cut rates, we could see an uptick in more climate tech VC/PE activity especially in early-stage funding which has taken a hit this year.

Further Resources

Morningstar Reports: https://assets.contentstack.io/v3/assets/blt4eb669caa7dc65b2/blt7d329f330547f085/6537e909de6c442b29970d4d/Global_ESG_Q3_2023_Flow_Report_final.pdf

PWC: https://www.pwc.com/gx/en/issues/esg/state-of-climate-tech-2023-investment.html

Bloomberg-Citigroup CEO Fraser Says the "New S" in ESG Is Security: https://www.youtube.com/watch?v=3tNwEBgRb-c

The Metals Company: https://investors.metals.co/news-releases/news-release-details/thirty-one-members-congress-call-upon-pentagon-develop-plan

Foreign Policy: https://foreignpolicy.com/2023/12/28/iran-red-sea-shipping-houthis-attacks/

IBM Report: https://www.ibm.com/downloads/cas/E3G5JMBP

Senate Committee on Budget: https://www.budget.senate.gov/hearings/rising-seas-rising-costs-climate-change-and-the-economic-risks-to-coastal-communities

SEC Cyber Rules: https://www.sec.gov/news/press-release/2023-139