FLEXSTONE PARTNERS

SUSTAINABILITY

NEWSLETTER – JANUARY 2026

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EUROPE SUSTAINABILITY REGULATION
JANUARY UPDATE

01

EU Deforestation-free Regulation

The EU Deforestation-Free Regulation, entering into force progressively from 2026–2027, imposes strict due-diligence obligations on companies placing cattle, cocoa, coffee, soy, palm oil, rubber, wood and derived products on the EU market:

- Operators and traders must prove that products are deforestation-free, legally produced, and geolocated to the plot of land where they originated.
- For corporates, the consequences include accelerated supply-chain restructuring, the need for robust traceability technologies, and heightened exposure to enforcement actions, including product removals and substantial financial penalties. Companies with opaque sourcing or high-risk geographies face increased interruption risks and potential loss of EU market access.
- **For financial institutions, the regulation enhances ESG-risk visibility but also intensifies expectations to assess deforestation exposure in portfolios**, with tools such as geospatial modelling and supplier-level datasets becoming essential.

EUDR enforcement timeline

30/12/2024
EUDR becomes applicable
(no enforcement yet)

↓

30/12/2026
Enforcement for large firms (operators & non-SME traders), Non-compliant goods banned

↓

30/06/2027
Enforcement micro and small operators

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EUROPE SUSTAINABILITY REGULATION
JANUARY UPDATE

02 ESMA Guidelines on ESG Claims and Greenwashing

ESMA released supervisory expectations to ensure ESG and sustainability **claims are accurate, specific and evidence-based**:

- Firms must **align stated ESG objectives with actual investment processes, data sources, and portfolio construction**.
- Vague sustainability language, exaggerated claims, or overstated exclusion policies are flagged as misleading practices.
- Managers must demonstrate clear KPIs, consistent ESG integration, and traceable internal governance across research, allocation, and stewardship.
- Supervisors across the EU will use this guidance to harmonize monitoring and enforcement, increasing scrutiny of fund documentation and marketing.
- Consequence: asset managers face higher compliance expectations, stronger accountability for ESG claims, and greater legal/reputational risk if sustainability statements cannot be substantiated.

Accurate	Accessible
Substantiated	Up to date

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03

U.S. Withdraws from Major International Climate & Sustainability Organizations

The U.S. administration announced its withdrawal from several key international bodies involved in climate action, clean-energy cooperation, and sustainable development:

- Exit targets include major multilateral organizations coordinating climate data, policy alignment, and technology transfer, including:
  - International Energy Agency (IEA)
  - International Renewable Energy Agency (IRENA)
  - Green Climate Fund (GCF)
  - Intergovernmental Panel on Climate Change (IPCC)
- The move signals a significant shift away from global climate cooperation and reduces U.S. engagement in cross-border sustainability frameworks.
- The withdrawal may create a competitive gap in clean-energy innovation and international financing efforts, benefitting more active jurisdictions such as the EU and China.

Key Implications for Investors:

- **Regulatory fragmentation:** EU becomes predictable; U.S. becomes uncertain at federal level.
- **Capital flows:** EU may attract more climate-aligned capital; U.S. climate-risk premia increase.
- **Standards divergence complicates cross-border ESG analysis** and portfolio alignment.
- **Strategic positioning:** EU and China gain influence in global climate governance; U.S. risks losing leadership in clean-tech diplomacy.

Simon Stiell, Executive Secretary of the UNFCCC commented:

"It will mean less affordable energy, food, transport and insurance for American households and businesses, as renewables keep getting cheaper than fossil fuels, as climate-driven disasters hit American crops, businesses and infrastructure harder each year, and as oil, coal and gas volatility drives more conflicts, regional instability and forced migration.

"It will also mean less American manufacturing jobs, while every other major economy ramps up its clean energy investments, powering economic growth and energy security, and pushing renewables past coal as the world's top energy source last year."

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ESG MARKET INSIGHTS

01 Sustainability momentum remained strong in 2025

Science-Based Targets initiative (SBTi), over 10,000 Companies Validated

- SBTi passed 10,000 companies with validated science-based climate targets, marking a major milestone in global corporate decarbonization.
- This surge was driven by regulatory pressure (EU CSRD, UK SDR, emerging ISSB adoption) and investor expectations for credible, Paris-aligned transition pathways.
- The increasing share of companies setting near-term and net-zero targets, improves comparability and accountability.
- It creates a more transparent universe for investors to evaluate transition-risk maturity, capex alignment, and sector-level ambition.

CDP, a 70% Increase in Companies Achieving Top Reporting Scores

- CDP reported a 70% jump in companies receiving “A” scores in climate, forests, and water disclosures.
- The trend reflects rapid improvements in data quality, supply-chain mapping, and governance as firms prepare for CSRD and ISSB integration.
- Strong performers tend to have more robust transition planning, clearer KPIs, and better-managed nature-related risks.
- Higher-quality disclosures facilitate investment screening, enable stronger stewardship, and reduce greenwashing risk across markets.

Key Insights for Investors

- Corporate climate alignment is accelerating at scale, improving the reliability of ESG data flows.
- Easier to differentiate leaders vs. laggards based on validated targets and transparent reporting practices.
- Strengthens portfolio-level climate-risk assessment and supports more credible engagement on decarbonization.
- Creates a deeper, more consistent universe for transition finance, sustainability-linked instruments, and thematic climate strategies.

Go to Article 1 and Article 2

02 The defence industry in ESG funds

The defence sector in the EU

- Through the war in Ukraine, the European defence industry has gained attractiveness in terms of favorable public opinion and financial returns. With the perceived necessity to re-arm Europe, the defence industry and the European Commission are pushing for broader private sector financing. As a result, EU guidance now narrows exclusions to only treaty-prohibited weapons, removing the automatic exclusion of most defence players from Article 8 and Article 9 funds.
- The inclusion of the defence industry in ESG labelled fund has sparked debate among actors.

The Pros

- Policymakers increasingly argue that national security is a prerequisite for sustainable societies, making defence a contributor to social stability through the slogan: “no sustainability without security”.
- Defence companies have shown strong performance during heightened geopolitical tensions, offering attractive risk-return characteristics which can diversify investment portfolios.
- There are arguments for strong governance metrics in the defence sector.

The Cons

- Major asset managers explicitly state that defence activities do not qualify as sustainable investments, even if allowed in Article 8. The argument is that an industry whose ultimate impact is to kill, injure, or destroy cannot be socially or environmentally sustainable.
- Defence is still viewed by many NGOs and investors as inherently incompatible with sustainability goals due to persisitent association with violence and conflict escalation.
- Including defence in “sustainable” funds risks public criticism or regulatory scrutiny, especially if sustainability claims are loosely justified.
- Lastly, the inclusion of defence may lead to potential accusations of shifting or “watering down” ESG standards with ESG funds already under pressure for their inclusion of companies in the oil and gas sector.

Conclusion

This high-level overview of the pros and cons reflects the ongoing debate of the defence industry inclusion in ESG funds. Another argument could be made for the creation of separate specific investment label for the defense industry and re-armament of the EU.

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NEW IN RESEARCH
CDP CORPORATE HEALTH CHECK 2026

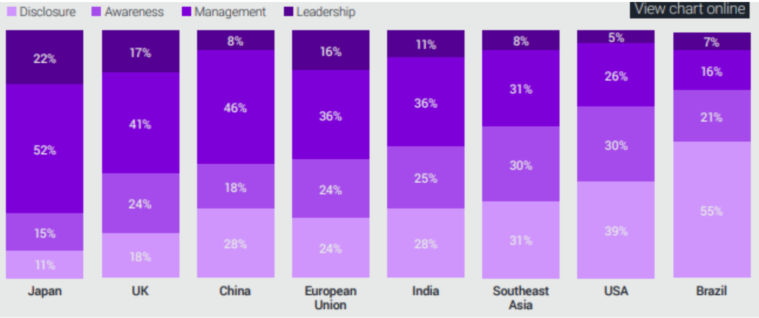
01

CDP Key Takeaways

The CDP Corporate Health Check identifies key trends in sustainable and financial performance. Key takeaways include:

- **Environmental leadership delivers financial outperformance:** Companies at CDP "Leadership" level outperform peers in market-cap growth across 7/13 sectors.
- **Physical climate risk is a large yet under-managed risk:** Companies report USD 1.47tn in physical risks, with 26% near-term; yet only 9% invested in physical adaptation in 2025
- **Adaptation finance is a major emerging opportunity:** A 2025 research paper by the World Resources Institute suggests that every US $1 invested in climate adaptation can yield over US $10.50 in benefits over a decade, with average annual returns between 20% and 27%
- **A significant gap remains:** Companies are good at identifying climate and nature risks, yet few invest accordingly.

Performance on climate-related issues according to CDP rating category



Go to the full report

NEW IN RESEARCH
STANFORD AND BCI CONFIRM ESG-BASED RETURNS

02 ESG Value Creation in Private Equity: From Rhetoric to Returns – Key Takeaways

Stanford and BCI shared how ESG contributed to significant value creation in their investment portfolio, offering insights into their methodology:

- **ESG must be a financial driver not a separate:** The report shows that ESG, when treated as a material operating discipline, improves profitability, risk exposure, and exit valuation, aligning directly with fiduciary duty.
- **Only when ESG is embedded across the investment lifecycle can it enhance returns:** BCI integrates ESG into diligence, post-close value creation, and exit strategy. This lifecycle approach strengthens risk mitigation, improves management alignment, and supports exit multiple expansion. ESG is a lever for both risk reduction and EBITDA impact
- **Quantification is essential to investor credibility:** BCI evaluates ESG initiatives using EBITDA contribution, risk mitigation, and valuation uplift, requiring at least 0.25x multiple impact for prioritization. This financial discipline ensures ESG is comparable to other operational levers

The report shares three ESG based value creation examples:

A driver first approach for a transport company in which drivers where compensated based on a share of their load's value instead of mileage reduced turnover from 90 to 60% saving USD 18M/year. ESG activities contributed to an overall USD 144M value uplift.

In a manufacturing platform, transforming safety and operational systems avoided costly disruptions, improved commercial positioning, and enabled expansion into alternative energy markets, increasing value by USD 159M.

For a specialty insurance broker, ESG insights enabled expansion into renewable-energy insurance, climate-liability products, and carbon-credit insurance, contributing $63M in enterprise value.

Go to the full report

IN FOCUS: GLOBAL CLIMATE HIGHLIGHTS 2025

"2025: the third warmest year on record"

- **In 2025 Global temperature reached +1.47°C above pre-industrial**, continuing the steep warming trend of the last decade increasing both physical-risk exposure and regulatory pressure.
- **The past three years were exceptionally hot:** "Only two years were much warmer than 2024 when compared to the climatological state at the time: 1877 and 1878. These were during the 'Great Drought' of 1875 to 1878, **when it is estimated that around 50 million people died** in India, China and parts of Africa and South America."
- **First 3-year period above 1.5°C, a historic first:** This dramatically raises long-term transition-policy risks, including accelerated climate regulation and tightening disclosure frameworks.
- **Physical climate risks intensify across regions:** Extreme heat, droughts, floods and cyclones escalated in frequency and severity in 2025.
- **Polar regions reached record temperatures:** The Arctic and Antarctic showed record or near-record warming, accelerating ice melt and sea-level-rise projections. Sectors with coastal assets (real estate, logistics, ports, utilities) face mounting physical-risk exposure.

The WMO estimates an 86% chance that at least one year between 2025–2029 will exceed 1.5°C, and a 70% chance that the five-year average will surpass that level

Background global warming now increases at 0.25°C per decade, up from 0.18°C, implying accelerating climate impacts and shortening transition timelines for high-emissions sectors

103 tropical storms occurred globally in 2025 of which 50 reached cyclone strength and 20 became major cyclones

Over 50% of global land experienced more days with strong heat stress than average, increasing operational disruption, insurance costs and supply-chain risks.

Record-low global sea ice in February 2025, the lowest monthly extent since satellite records began in the late 1970s

Go to the full Report

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