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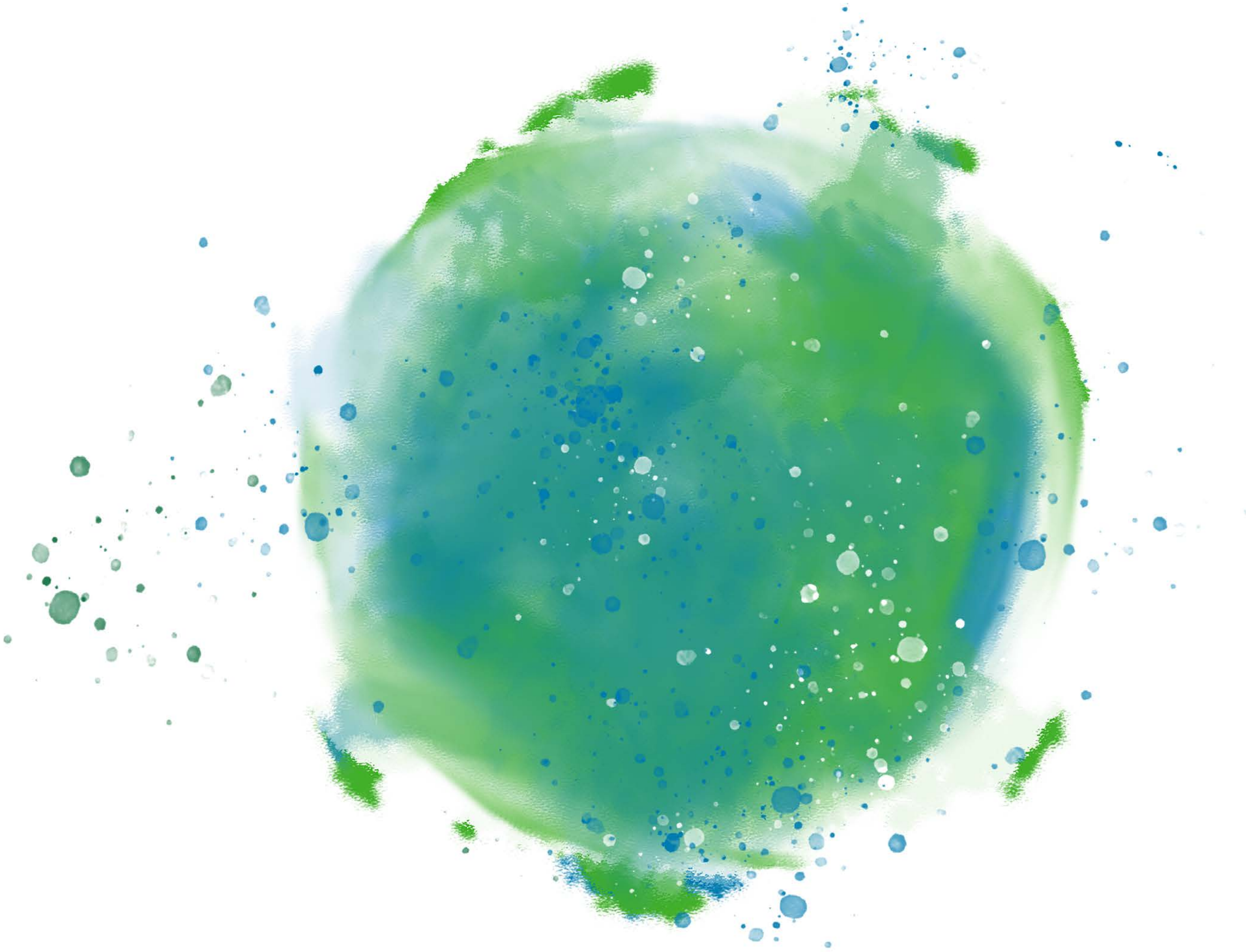

# Private equity investment strategies and decarbonization

Awareness of the global need for ESG and decarbonization is growing. And with it, so is scrutiny of the sizeable private equity industry. Institutional investors, regulators, and the wider public increasingly demand that PE firms proactively address their negative externalities. Global decarbonization efforts will require significant investments over the coming decades, providing an ideal opportunity for PE to allocate capital and finance the transition towards a net-zero economy. The specific characteristics of the private equity business model, such as the full-ownership model, the operational control of portfolio companies, the value creation, and long-term investment compared to the public market, uniquely position the PE industry as a potential leader of transformation. Accepting this role benefits the economy and serves PE firms as a means for risk mitigation, value creation, and attracting investors.

### Recent geopolitical events and their impact on low-carbon investments

Recent geopolitical events such as the Covid-19 pandemic and the war in Ukraine have further boosted sustainable investments. Covid-19 offered investors a ravaging reminder of the need to prepare for large-scale risks as it brought other systemic vulnerabilities, such as climate change, into perspective.[1] The pandemic also confirmed that ESG-rated funds perform better, even in a crisis. Several studies have found that, despite the severe market crash caused by the pandemic, ESG-related investments (both funds and indexes) outperformed their benchmarks.[2] For example, an analysis conducted by the index provider MSCI suggests that higher-rated ESG funds fared better during pandemic-related declines and volatility than their lower-ranked counterparts.[3] Research by Bloomberg found that an "average ESG fund" only declined by half compared with the S&P 500 over the same period in 2020.[4] An evaluation by HSBC found that both 'climate-focused' stocks and stocks with ESG scores outperformed others by 3–7.6%.[5] The war in Ukraine has had an equally massive impact on sustainability-related economic considerations.[6] While the Russian invasion of Ukraine might complicate the path towards net zero in the short term, it will accelerate net-zero transition efforts in the long term as it has made the need for a different kind of energy security and economics excruciatingly clear.[7] Decarbonization and a move towards renewable energy generation in Europe are not only in line with achieving net zero, but they are also a way to end the energy reliance on Russia – making the war a catalyst for decarbonization.

### Climate integration in private equity: the current state of play

Various studies show that investors' investment strategies are changing. Sustainable funds are seeing significant inflows. Climate change is viewed as one of the most pressing issues within the scope of ESG. A growing number of investors recognize climate risks as an investment risk for their assets and are integrating sustainability into their investment decisions. According to a recent study, nearly half of the surveyed institutional investors have either already made a public commitment to net zero by 2050 (31%) or are in the process of making this commitment (16%).[8] This suggests that the net-zero focus among limited partners (LPs) is only gaining momentum. Other recent surveys indicate that LPs are very likely to modify their investment strategies in response to climate change. In the 2020 Coller Capital Global Private Equity Barometer, 28% of LPs declared that they intended to reduce their investment in oil and gas, 42% indicated that they were planning to make greater investments in climate-friendly products and services and 40% wanted to invest more in renewable energy.[9] Moreover, a recent survey of LPs by INSEAD's Global Private Equity Initiative found that 77% use ESG as a criterion when selecting General Partners (GPs).[10] 40% of PE firms also stated that they would let a transaction fall through because of negative ESG findings,[11] illustrating that net-zero carbon emissions are a widely discussed topic within the PE industry. Still, only 10% of climate-related funds (i.e., funds that use keywords such as climate, net zero, and carbon in their names or the description of their approach) are on track to meet the Paris Agreement goal of limiting global warming to "well below" 2°C (compared to approximately 11% of the broad fund universe and 12% of green funds).[12] This shows that there is still a long way to go to achieve net zero.

Private equity has the potential to be a key driver for a low-carbon economy due to its full-ownership model, value creation, operational control, and longer holding periods than other investments.

## Drivers of the growing focus on decarbonization within investment strategies

Motivations and ambitions behind PE action on incorporating decarbonization into investment strategies vary considerably. One of the key drivers is external pressure from regulators, stakeholders, and the wider public. Stakeholders, such as portfolio companies, customers, the media, and potential employees, are calling for more climate alignment to achieve the goal of net zero by 2050. The political dynamic is leading government entities to increase their focus on climate-friendly activities and growth. Additionally, new regulations require public and private market actors to disclose ESG-related data. The Sustainable Finance Disclosure Regulation (SFDR) puts the financial sector under scrutiny by legally requiring LPs to include sustainability risks in their investment decisions and report them transparently. LPs are passing this transparency requirement on to their GPs. Based on this and other legal requirements, LPs will increasingly seek investment opportunities with, for example, low climate risk or low emissions. This makes good, i.e., low, sustainability-related numbers more attractive for institutional investors. With legal and public pressure increasing, LPs might raise their requirements, obliging GPs to incorporate climate-related risks into their investment strategies to align their investment activities with carbon reduction targets and deliver the required ESG data.

In addition to their primary focus on optimally aligning with stakeholder expectations, some investors are intrinsically motivated by the desire to make a positive impact on society and thus actively contribute to achieving net zero. Indeed, impact investing, which directs capital to businesses that generate environmental or social benefits, is on the rise, attracting a growing number of PE funds. According to the Global Impact Investment Network, 67% of impact investors surveyed in 2018 invested in private equity, accounting for 22% of their total assets under management.[13] The mitigation of climate-related risks within the portfolio is another intrinsic motivation that PE firms are increasingly mentioning as they come to understand the systemic nature of climate impacts on investment performance. As privately held companies face climate-related transition risks, the PE industry must change its way of doing business and make climate considerations integral to both portfolio and risk management to remain viable and attractive to investors. Decarbonization is an imperative that has only just begun to gain traction and will continue to be relevant for many years. Forward-thinking GPs recognize that not stepping up to help portfolio companies participate in the energy transition and reduce emissions is a genuine business risk. Institutional investors across a multitude of industries are already pricing climate risks into their valuations and behavior – rewarding smart climate-related choices. For instance, investors in the energy sector now value profit from renewables at a materially different multiple than equivalent profit from coal.[14] By integrating climate issues into their investment strategies, private equities are making themselves fit for the future.

Recent evidence has demonstrated a positive correlation between high ESG corporate ratings and valuation and profitability.[15,16,17] Other studies have found a positive correlation between high carbon efficiency and both operating performance and lower systemic risk levels.[18] In practice, a thoughtful ESG strategy can lead to efficiency and effectiveness gains in areas where doing good for the environment and society pays direct dividends in terms of performance and financial results. There is, for example, the potential to receive a premium for assets with strong sustainability performance, also called sustainability arbitrage. Many LPs have already recognized this potential for value creation through sustainability and increasingly state better investment performance as a critical reason to incorporate ESG topics into their investment strategies. The mindset shift of PE firms towards ESG as value creation shows that they realize that, by ensuring their portfolio is aligned with the transition to sustainability and a decarbonized economy, ESG offers a real business opportunity. ESG is a lever for transformation that firms can use together with other levers, such as digitalization. As evidence suggests that sustainable companies have begun to outperform their conventional counterparts and impose lower credit risk, banks are increasingly offering lower lending rates to companies that can prove their sustainable performance. This lower cost of capital may be another added value of decarbonizing portfolios.[19]

As a whole, there is a wide range of driving factors for decarbonization within the PE industry. While many motivational factors may run in parallel, each investor's aspirations will vary based on their stakeholders' priorities, the firm's values, market context, and core competencies.[20] But regardless of the motivation, the main question remains: How do you decarbonize a portfolio?

## Divestment versus transformation

There are two options when aiming to decarbonize a portfolio: (1) divesting from high-emitting assets or completely ruling out high-emitting sectors/assets, or (2) transforming these assets by helping portfolio companies reduce their emissions. While many PE investors are divesting and even plan to increase their divestments in the coming years, a portion of the market is willing to hold these assets – and intends to decarbonize them.[21,22,23]

When choosing between these two strategies, it is important to consider which solves the core problem. While divestment offers a short-term quick fix for the individual investor, it does not remove these high-carbon assets from the market but simply displaces them. So, while overall emissions in the investor's portfolio decrease, global emissions do not. This practice is, therefore, merely a sector rotation and does not effectively contribute to the goal of net zero by 2050. Furthermore, this strategy could leave high-emitting assets in the hands of potentially less ambitious stewards only interested in harvesting cashflows, possibly even magnifying overall risk for the PE industry from an increasingly negative public perception and further regulatory pressure.

On the other hand, actively working on emission reduction within the portfolio companies supports the transition towards a low-carbon economy as actions are implemented to decrease overall emissions. This active contribution to the net zero goal also sheds good light on the PE industry among the wider public and regulators. However, decarbonizing high-emitting assets is complex – as well as cost and time intensive. It demands advance planning, timely action, and a fundamental redesign of existing processes, sites, and, potentially, business models.[24] During this process, there might be short spikes in emissions across the portfolio rather than a steady downward trend. A longer time horizon for decreasing GHG emissions may be needed. High-emitting assets can pose the financial risk of being stranded in the transition towards a net-zero economy.[25] By including carbon emission criteria, PE investors may be able to apply various arbitrage strategies, potentially offsetting the resources needed for decarbonization. After all, companies that do not make the transition will most likely eventually disappear, which should be reflected in the determined terminal value. One of these strategies is to demand a carbon discount on the purchase price when entering the investment when investors foresee that they will need to allocate significant resources to a potential portfolio company's carbon transformation. Additionally, having successfully transformed a portfolio company, investors can demand a sustainability arbitrage at the exit.[26]

In summary, divestment is a short-term quick fix that does not reduce global emissions and is, therefore, no strategy towards net zero. Instead, private equity must improve the emission performance of assets, transforming them to help reach the goal of net zero by 2050.

## Barriers and hindrances to decarbonization

### Lack of high-quality and comparable data

GPs and LPs face several barriers that hinder their ability to deeply embed climate considerations into their investment strategies. One of the main barriers is the need for more consistent, reliable, and high-quality data at the LP, GP, and portfolio company level. At the portfolio level, missing alignment on which data should be collected and the absence of universally accepted climate performance metrics hamper effective disclosure, translating into insufficient data at the GP level. Research has suggested that only a minority of GPs receive sustainability reports from their portfolio companies.[27] According to a recent study, only one in eight private equity firms publicly discloses that they receive ESG reports from their portfolio companies, and only under 4% share whether ESG issues impact financial performance. On this basis, LPs are barely able to determine the depth of commitment PE firms may have to decarbonization, let alone understand the carbon performance of PE-backed portfolio companies.[28] The SFDR will probably solve these difficulties to some extent, as it requires institutional investors (LPs and GPs with 500 and more employees) to report on environmental indicators such as GHG emissions, the carbon footprint, and the GHG intensity of investee companies. Both data availability and data quality enable value creation at various levels. Only if there is data on the status quo and performance of a (potential) portfolio company can the PE firm properly analyze climate risks and opportunities, implement appropriate measures for carbon emission reduction and track their development. Later, the data can be used to report to institutional investors and demonstrate progress. This offers a comparative advantage against peers, as LPs can better compare performance among GPs when they have access to comprehensive data. PE firms can also use the data to profitably communicate the achieved emission reduction when selling the portfolio company, potentially receiving a sustainability premium on top of the sale price.

But even when GPs can gather the required data from portfolio companies, the information is not necessarily comparable due to the lack of universal frameworks or standards. Missing measurement uniformity complicates the analysis of the portfolio's total climate risk and performance monitoring, and the communication of progress towards targets. The Corporate Sustainability Reporting Directive (CSRD), which will come into effect in January 2024 and applies to companies subject to the Non-Financial Reporting Directive (NFRD), will help address this issue at a corporate level by obligating even smaller companies to report on non-financial information from 2026.

### Capability gaps

Another significant barrier is the lack of internal knowledge among investors and at a corporate level. As decarbonization has only recently appeared on the private equity agenda, the industry needs more data and expertise to effectively include decarbonization in the whole private equity process. GPs lack the capabilities to include decarbonization in due diligence, scan the market for sustainability transformation opportunities, and execute ambitious programs. There is also a gap in the resources and expertise needed to analyze reported data and efficiently integrate this information into investment decisions. But not only are PE firms short of the internal skills, knowledge, and capability to address decarbonization and data issues adequately, they need more personnel. A recent study showed that only 25% of private equity firms have a dedicated ESG team.[29]

This insufficient integration of decarbonization into the investment process means that carbon reduction measures are not sufficiently enforced once the investment in a portfolio company has been made. A recent study found that only 29% of investment managers addressed these topics within the scope of a 100-day plan following the start of an investment. And only 34% of PE investors established climate performance indicators in their portfolio companies and demanded regular reporting.[30]

## Actions to overcome existing barriers

While there is no one-size-fits-all approach to successfully incorporating decarbonization into the investment process, there are steps PE firms can undertake to map their own path towards overcoming the existing hurdles. Dismantling the key challenges described above and fully realizing the investment opportunities that the net-zero transition provides will require an overhaul of the entire organization. In addition to ensuring compliance with any obligations the entities may have under the SFDR or other legal requirements, there are several tools that private equity can use to improve its climate profile. We recommend taking the following steps:[31]

### Developing a holistic investment strategy

LPs and GPs need to develop a clear net zero investment strategy to align their PE portfolios with net zero and to both measure and transform the carbon footprint of their portfolios. This strategy should focus on achieving two goals: (1) decarbonizing existing investment portfolios consistent with the goal of global net zero emissions by 2050, and (2) investing in climate solutions that enable a low-carbon economy (new acquisitions).[32] GPs must ensure more sophisticated disclosure, goal setting, and risk and opportunity assessments (incl. investment management methods and tools evaluating transition risks). Hence, their strategy should include a long-term emission reduction framework and a detailed plan to reach portfolio emission targets. Additionally, climate-related risk and opportunity considerations should be integrated into policies and practices guiding the PE firm's governance, due diligence, risk management, and engagement of portfolio companies. The integration of decarbonization into the full investment lifecycle – as well as into the minds of employees at the level of LPs, GPs, and portfolio companies – is crucial. An understanding of the decarbonization ambitions needs to permeate the entire organization.

### Developing capabilities and culture

Integrating sustainability into the core of private equity is vital. Putting climate issues at the heart of organizational culture, structure, personnel, and processes better positions both LPs and GPs to take advantage of decarbonization opportunities. Capacity and culture building will lead to better governance and internal engagement (including greater senior leadership and board-level awareness and participation), more robust climate policies and practices, and improved company-wide integration of climate-related risk and opportunity thinking.[33] The incorporation of climate issues into internal policies and frameworks is a good starting point for creating a cultural shift throughout the PE firm. This should be coupled with employee training that provides a broad understanding of climate and decarbonization matters and the PE firm's ambitions. Periodic workshops that refresh knowledge on legislative changes, current decarbonization trends, and the PE firm's internal policies will ensure that climate considerations become pervasive. These training sessions should also give PE employees guidance on what portfolio companies need to do to comply with the PE firm's climate and reporting standards. Supporting portfolio companies while implementing a climate strategy and reporting practices also requires capabilities and knowledge within the PE firm itself. These include identifying relevant issues and best practices for dealing with them, providing measurement and reporting tools, benchmarking against other portfolio companies, offering access to internal and external experts, and monitoring regulatory developments. Investments in capabilities enable GPs to credibly support portfolio companies in their transformation and build best practices. Another important tactic for driving cultural change is the internal communication of impact stories and the celebration of innovation. Setting up a dedicated climate team with operational expertise that gives internal guidance can further enhance the cultural shift and improve knowledge management.[34,35] Decarbonization is complex. Progress and success depend on having access to specialized knowledge and building the required capabilities, using carbon measurement software, creating standardized accounting and performance tracking processes, and developing playbooks to share insights across the portfolio. Ultimately, decarbonization will only thrive when the entire PE firm perceives it not as a new obligation but as an enabler of growth and a mitigator of risk.

### Integrating decarbonization in due diligence and screening processes

Investors who wish to secure a long-term return on investment must consider their (potential) portfolio companies' performance in terms of ESG risk management. When searching for a potential investment target, PE firms need to integrate questions on ESG and decarbonization into their standard due diligence questionnaires to map a clear picture of the potential target's risks and opportunities. ESG analysis helps evaluate whether a portfolio company's earnings growth is realistic, whether there is a risk of increasing volatility, and whether to change risk premia, and outline potential scenarios for continued decarbonization. A consistent process enables the PE firm to understand a target company's starting point and intentions regarding carbon emissions. Integrating decarbonization into the due diligence and screening process allows PE firms to better align investment decisions with their own decarbonization goals. PE firms should then set clear climate incentives for the portfolio company's management to encourage the transformation process of the portfolio company and back this up with a willingness to divest if the company fails to make sufficient progress. However, successfully transforming sustainability laggards will also require a certain tolerance for assets with higher emissions in the short term. Hard-to-abate sectors will need more time to achieve long-term emission reductions, so emission targets that focus on change over time are crucial.

**Developing measurable milestones and communicating them**

The established investment strategy has to be broken down into measurable near- and long-term objectives if the decarbonization goals are to be achieved. This roadmap should outline key decarbonization milestones and a framework for tracking and reporting progress. Given the long time horizon before results become visible at the asset and portfolio level, GPs need to transparently communicate their investment strategy and long-term plan, measurable milestones, and progress to LPs (and other stakeholders) to secure and maintain buy-in. To mitigate "headline risk", PE firms should also communicate their decarbonization approach in a publicly available document that gives insight into the company's core emission principles and summarizes how climate factors are embedded into the investment process.[36] Communicating progress implies using standardized metrics to enable comparison and customized reporting to integrate the individual aspects of each investment. Industry-specific GHG benchmarking standards, including Science Based Targets (SBTi), are starting to emerge to address this issue.

**Increasing reporting and transparency**

A greater effort must be made by private equity and portfolio companies to increase their transparency and improve reporting. Climate-related reporting in private equity should be threefold: (1) reports issued regarding the PE firm's own corporate approach, (2) reports issued by the PE firm addressed to its investors, and (3) reports issued by portfolio companies addressed to the PE firm. PE firms may want to consider issuing a framework requiring portfolio companies to report on a set of climate factors to ensure they receive all material information. These reports are essential for internal steering and can, additionally, be used for external communication. At the portfolio company level, decarbonization improves operations and saves costs (e.g., costs for energy, resources, carbon taxes, and/or emission certificates)[37] and can be profitably leveraged to elevate external perception. Several studies have shown that consumers are shifting their purchasing power to more sustainable companies.[38] Transparency at the portfolio company level might have additional benefits since recent research has found that an increase in carbon disclosure is positively associated with a subsequent change in carbon performance, with transparency functioning as an external motivator to decrease carbon emissions.[39] PE firms may wish to consider voluntarily complying with the SFDR, even if they are not legally obliged to, as a way of appealing to LPs, who depend on this information to comply with the SFDR themselves. The availability of this legally required data, combined with the fact that more LPs are emphasizing sustainable investment, will give decarbonization-focused GPs a competitive advantage over their laggard peers.

By transforming high-emitting assets rather than simply avoiding and/or divesting from them, private equity can play an essential role in achieving net zero goals.

**Collaborating to address key barriers**
Actions taken by individual investors are indispensable – but they will not be enough to transform the whole private equity world. Accelerating decarbonization in private equity will require an intentional, collaborative approach from all participants. Decarbonization can be incentivized even more effectively when LPs, GPs, industry bodies, and regulators join forces to find solutions to these complex issues. A collaborative approach to common challenges will allow the industry to better engage in sustainability transformation. LPs need to position themselves as catalysts for change by advocating for decarbonization to be linked to fund mandates and investment decisions while urging GPs to produce measurable results. GPs must invest in decarbonization to develop strategies and capabilities to reduce emissions at the portfolio and company level. Both LPs and GPs must enhance their collaboration on disclosure standards that include asset-level transparency, industry-wide net-zero commitments, the standardization of emission-reduction frameworks (such as SBTi), data, metrics, and tools as well as guidance during this process. Engaging with peers to jointly face the key challenges of their respective sectors promotes holistic solutions to the most pressing issues of our time. Regulatory and industry bodies must create spaces for proactive dialogue and mutually beneficial alignment within the private equity industry. Promoting greater industry alignment with an integration of existing and emerging climate-related and Paris-aligned frameworks while jointly addressing common challenges will help the industry manage systematic climate risks and opportunities and decrease the risks of remaining high-emitting assets.

**Private equity must play a key role in decarbonization**
As changes in policy and regulation are likely to accelerate in an effort to green the economy, carbon-intensive technologies and business models will become outdated. Private equity must evaluate this transition risk for each investment and make it an integral part of their decision-making process. While integrating decarbonization holistically into the investment strategy is not going to be easy, the PE industry has both great potential and leverage to drive the decarbonization of our economy. With the characteristics of value creation and the full-ownership model, operational control, and the long-term investment horizon compared to other investments, private equity can affect real change across companies and industries.

The PE industry has the potential to be a key driver for the net-zero transformation as it provides the opportunity to transform laggard assets. Divesting from high-emitting assets and sectors, on the other hand, may be beneficial for individual investors looking to achieve their emission targets, but it does not contribute to the global emission reduction goal, as those high-emitting assets continue to exist. We cannot address the urgent challenge of decarbonization without the industry's active participation and funding.

Managing climate factors is becoming an imperative that private equity can no longer avoid; especially as the SFDR requires LPs to provide ESG-related data for their investments. For GPs, strong decarbonization credentials can function as a key competitive advantage. GPs that demonstrate their commitment to the net zero goal and have data to prove the impact of their actions are in a better position to attract investments. Hence, with a thought-through decarbonization strategy, private equity can emerge as a leader in the climate field – to the benefit of the wider world as well as its own long-term performance.

The PE industry has the potential to be a key driver for the net-zero transformation as it provides the opportunity to transform laggard assets.

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