

The Changing Climate for Private Equity - Exploring the Integration of Climate-Related Risk and Opportunity Assessment in Private Equity Investment Strategies

by

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In order to mitigate the effects of climate change, it is estimated that the global economy will need to achieve net zero emissions by 2050. This reduction in emissions would help curb global temperature rise to around 1.5 degrees Celsius above pre-industrial levels, and may limit the catastrophic physical effects of a changing climate (McKinsey, 2022). In order to achieve this goal of reducing global emissions, a major influx of investment capital will be required to finance the technologies and infrastructure required. Trillions of dollars of new investment funding will need to be poured into low carbon technologies if the global economy is to reach this net zero target by mid-century. However, there are incentives beyond limiting the impacts of climate change since low carbon technologies and associated infrastructure could provide investors with significant returns, making sustainability investing a considerably attractive strategy. A \$1.8 trillion investment today in early warning systems, climate-resilient infrastructure, global mangrove protection, and water security could provide \$7.1 trillion in net benefits over the next decade (Agrilinks, 2020).

The investment case is clear but investors are needed to help infuse capital into these strategies. The private equity (PE) investment market will continue to play a critical role in financing this transition as evidenced by its rapid growth over the recent decade and expected

increase in managed assets in the near future (see Figure 1). If the PE market is able to successfully integrate climate into their processes, they will be poised to realize significant gains from their associated investments.

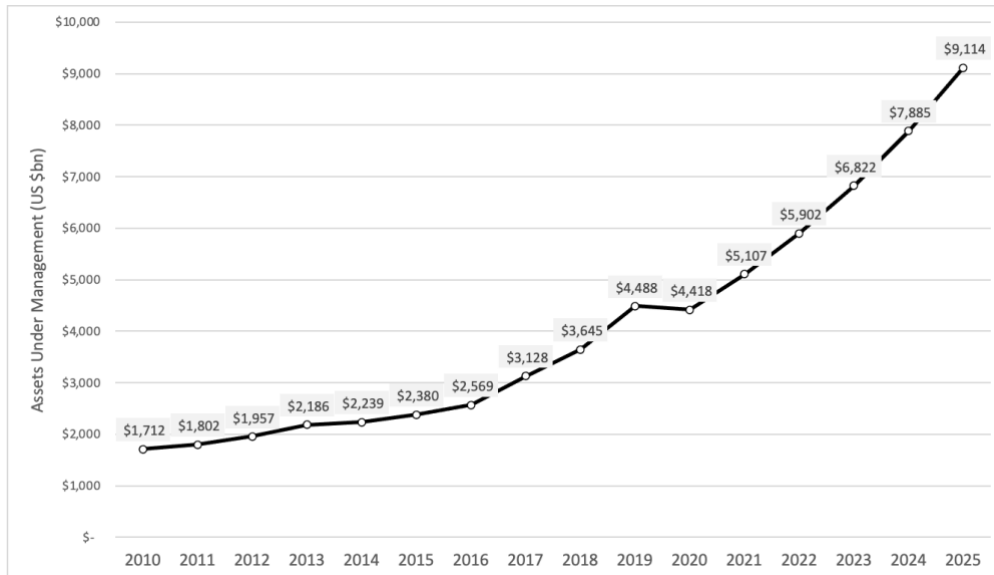


Figure 1: Private Equity AUM and Forecast, 2010 – 2025 (Joyce, 2020)

During my internship with ERM, I co-authored *The Changing Climate for Private Equity*, a market-facing report that aimed to assess the private equity market’s activity in financing the transition to a low carbon economy, with the goal of assisting the PE market to further integrate climate-related risk and opportunity assessment into their investment strategies. The report was a collaborative project developed between non-profit organization Ceres and private environmental consultant Environmental Resources Management (ERM), and published through ERM’s thought leadership platform, the SustainAbility Institute. The objectives of the report were to gain a better understanding of how the market was assessing climate, encourage private markets to further align their investment strategies with the objectives of

the Paris Agreement, and ultimately provide the private equity sector with a set of best practice recommendations that could be used while engaging with their portfolio companies to develop overall investment strategies to further support climate action. Through extensive desktop research and stakeholder interviews, I conducted an in-depth analysis of climate in the PE market which ultimately served as the foundation for the final report. Published in June of 2021, the report can be found at www.sustainability.com.

The findings from the desktop research and the stakeholder interviews demonstrated that the private equity market is significantly lagging behind public markets in their adoption of climate-friendly investment strategies. Figure 2 demonstrates the low number of firms taking measures to understand and mitigate the exposure of their portfolios to climate risks.

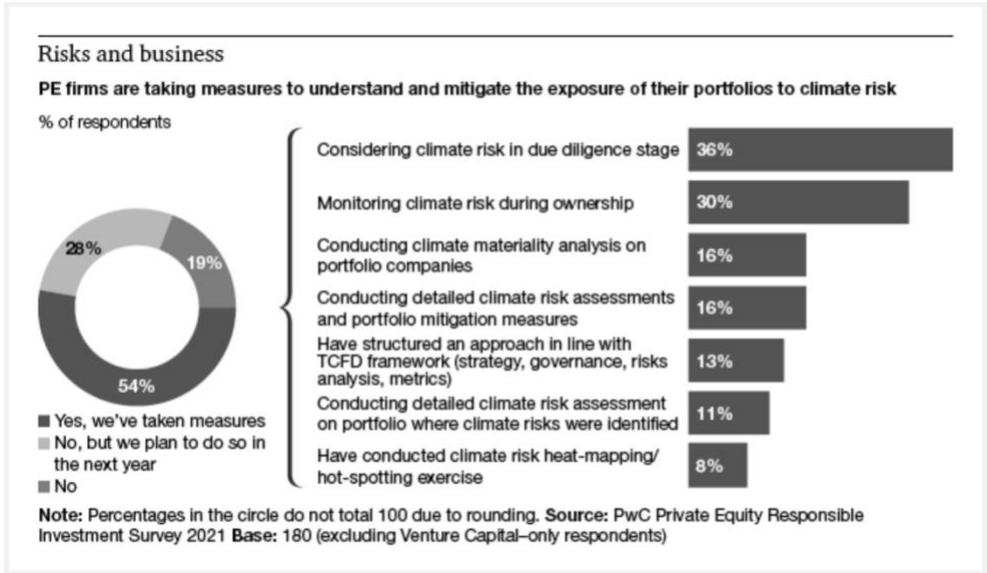


Figure 2: PE Firms Taking Measures to Understand and Mitigate Climate Risk (PwC, 2021)

There are various reasons as to why this might be the case. The PE market is faced with significant barriers to entry into sustainable investments including a lack of data availability and an unfilled need for standardization of related reporting. Even so, there are some emerging solutions being adopted by leaders in the market. These emerging solutions, including setting

net zero policies and engaging with high-emitting portfolio companies to decarbonize their operations, have been found to have great success in the integration of climate into a private equity strategy. These emerging solutions helped frame the final recommendations, which range from setting a portfolio-wide 2050 net zero strategy to utilizing existing reporting frameworks and standards like the Sustainability Accounting Standards Board (SASB) and the Task Force on Climate-Related Financial Disclosures (TCFD). It is hoped that with the guidance of our findings and recommendations in the report, the private equity market will find future success in further integrating climate-related risks and opportunities into investment practices.

As highlighted, private equity will play a significant role in transitioning the global economy to low carbon activities. Primarily, their growing influence on investment markets and the global economy allows them to exert significant pressure on large and small scales. Additionally, due to their unique investment strategies and processes, particularly with investing in privately held assets instead of public equities, private equity can fill the finance gap where other investment strategies may not be able to effectively invest. Furthermore, there is already a steady pipeline of climate-focused businesses ready for investment by PE firms. Drivers influencing the acceleration of climate integration in PE (see Figure 3) include superior returns and attractive investment opportunities, increased stakeholder pressure, and dynamic political and regulatory landscapes. These pressures are slowly but surely encouraging private markets to integrate climate into their processes.

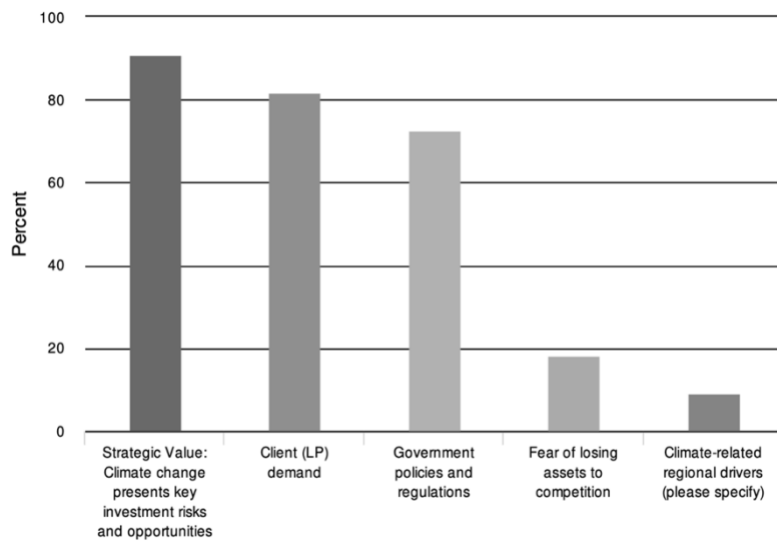


Figure 3: PE Firm Primary Motivators to Integrating Climate Considerations (Ceres & the SustainAbility Institute, 2021)

Private equity faces a significant number of challenges while further integrating climate into their strategies and activities. These processes, though not impossible to overcome, are the primary reasons behind the PE market lagging when compared to their public market counterparts. The primary challenges are as follows:

- Limited access to consistent, high quality data;
- Absence of universally adopted and mandated frameworks and standards;
- Inconsistent regulatory requirements;
- Lack of universal net zero standards and frameworks;
- Challenges securing internal buy-in; and,
- Insufficient pressure from limited partners

Should the private equity market be able to successfully address these challenges, they will be well poised to capitalize on the potential earnings to be found in the market. Some firms are already taking action and capitalizing on early gains. These actions may include increased executive-level engagement, enhanced ESG (environmental, social, and governance) metrics

and climate policies, net zero goals, utilization of existing reporting frameworks and standards, and the integration of science-based targets.

The actions outlined above by the climate leaders in the PE market helped inform the ultimate recommendations for the final report. Recommendations for the private equity market to further integrate climate-related risks and opportunities are summarized in Table 1.

Priority	Recommendation
1	Embed the considerations of climate-related risks and opportunities into the policies and practices that guide private equity firms' own governance, due diligence, risk management, and engagement of portfolio companies.
2	Enhance and accelerate climate-related disclosure and transparency efforts of private equity firms and the companies in which they invest.
3	Establish the business case required to make a public commitment to achieve portfolio-wide net zero emissions by 2040 or no later than 2050 ; ensure this includes setting science-based targets.
4	Identify and capture value from investment opportunities relating to financing the low carbon economy transition , including increasing investment in companies and seizing opportunities to invest in presently high-emitting companies that can transform through defined decarbonization strategies that the firm can support.
5	Promote greater industry alignment with, and uptake of , existing and emerging ESG, climate-related, and Paris-aligned frameworks as well as related guidance, net zero commitments, science-based targets, standardized data, metrics, and tools.

Table 1: Priority Recommendations for the PE Sector to Integrating Climate Considerations

Should the PE market successfully follow these priority recommendations, it is hoped that they will be more efficient in their integration of climate-related risks and opportunities into their strategies. Furthermore, it is hoped that through acceptance of these recommended actions, private equity firms will further set an example for the wider financial industry on how to successfully integrate climate metrics into strategies and will encourage the PE market to realize its role in financing the transition to a low carbon economy.

The Changing Climate for Private Equity was developed to assess the private equity market's positioning and activity with respect to climate-related risks and opportunities, with the goal of providing a guideline of recommendations for firms to further integrate climate metrics into their strategies and policies. Though the PE market will have a significant role to play in the transition towards a low carbon economy, it was demonstrated that few firms are taking advantage of the potential opportunities. This is likely due to the significant hurdles the market faces, such as inconsistent data, a lack of frameworks, and lack of internal support. However, some firms are paving the way by taking aggressive action and engaging with their high-emitting portfolio companies to decarbonize or by setting ambitious net zero commitments. These activities and more helped shape the ultimate recommendations provided to the private equity market by Ceres and the SustainAbility Institute with the goal to help private markets recognize their significant contributions toward addressing the climate crisis.

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