A Climate Roadmap for Private Equity

and Other Alternative Asset Managers

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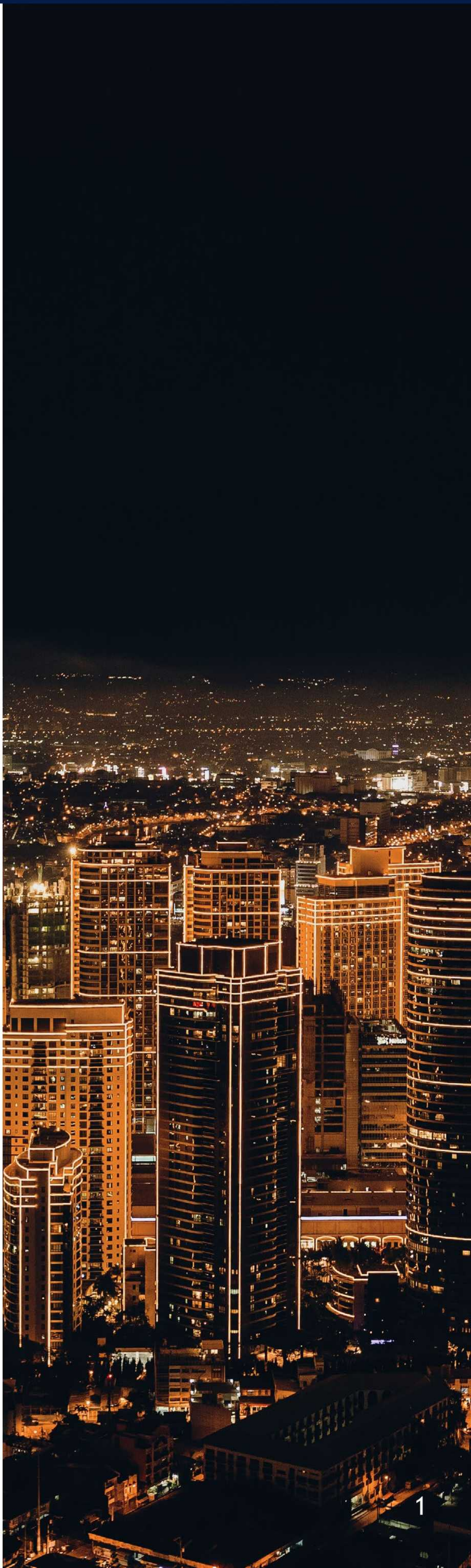
The value at stake

One of the most significant developments in the world of ESG over the last few years has been the awakening of the finance sector to the urgency of climate change. We have seen this in public markets, as firms like Blackrock and Vanguard take voting action against companies that are not sufficiently addressing climate. But it is also manifesting in private markets, as money flows into climate tech funds, private equity firms begin committing to science-based targets, and more investors seek to understand and reduce their climate risk exposure.

The focus on climate by institutional investors, sovereign wealth funds, and others is driven from their fiduciary responsibility—they believe it is essential to managing risks and providing long-term returns. Larry Fink, CEO of Blackrock, outlines this view on climate in his latest CEO letter, "our investment conviction is that sustainability- and climate-integrated portfolios can provide better risk-adjusted returns to investors." Leading alternative asset management firms have come to the same conclusion. "If you're not ahead of the game, you put yourself at a competitive disadvantage," said Diana Propper de Callejon, Managing Director at Cranemere. "As a holding company and long-term investor, we must understand the impacts that climate change will have on a company when we decide to invest."

Portfolio companies now face a variety of climate-related risks and opportunities that should be considered, including:

- Regulations in Europe, UK, California and soon more broadly in the US
- Operational disruptions in complex, global supply chains
- Business customers seeking to cut carbon across their value chains by pressuring their suppliers to report on and reduce GHG emissions.
- Consumer brands finding opportunities to differentiate from their competitors through a focus on sustainability broadly—climate often being a central part of the agenda.
- Employees, especially younger generations, are seeking employers that have strong values and proactive initiatives to help mitigate climate change.
- Reduced cost of capital through green loans and credit facilities
- Operational efficiency and asset modernization



More than a distracting investor request or regulatory requirement, many firms now view effective climate management as an opportunity to expand their investment multiple. Paula Luff, Director of ESG Research and Engagement at the hedge fund DSC Meridian said "we view climate change as the ultimate disruptor whose impacts extend well beyond the energy ecosystem. Focusing on climate and decarbonization themes makes us better investors."

In this white paper we seek to outline the elements of an effective climate management program today and into the future. We believe these practices unlock long-term business value for investors as climate change's role as a disruptor and driver of business transformation becomes more evident. While most of the information is framed in the context of private equity, many of the insights and recommendations apply across other alternative asset strategies. Our research included interviews with ESG leaders from a range of relevant asset managers focusing on private companies.

Where to start?

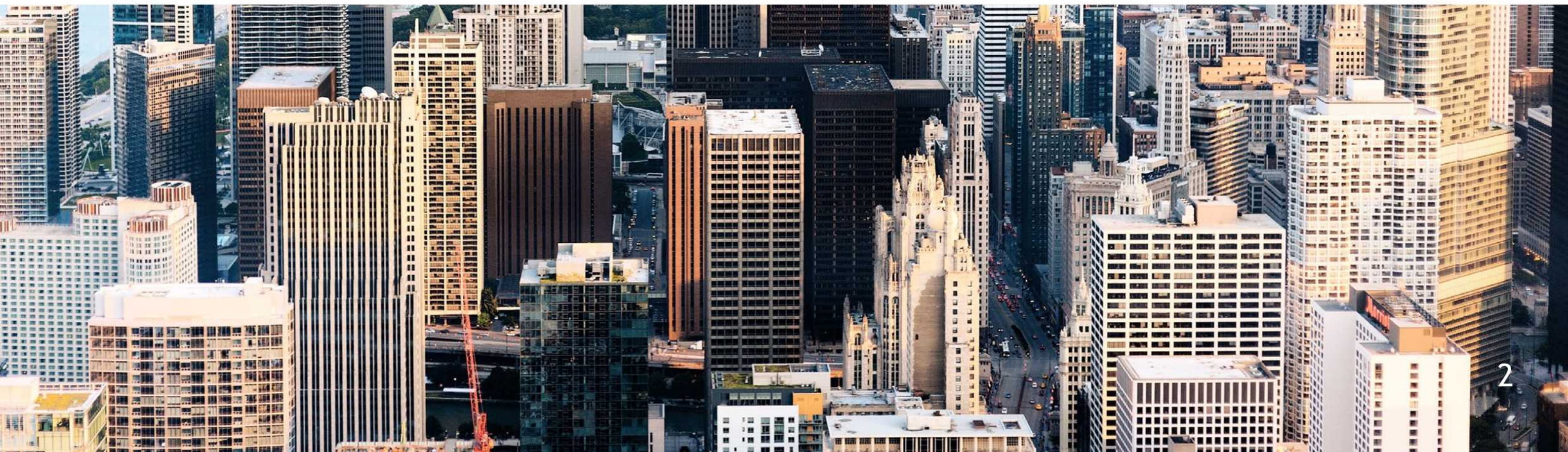
For firms just starting their climate efforts, and lacking in-house expertise, taking action can feel daunting. We suggest establishing practices that will meet the needs of key stakeholders today and position the organization to evolve into more advanced practices over time.

Today's drivers

Today, there are many factors that contribute to the need private equity firms feel to address climate. There are recent and emerging regulatory frameworks such as EU Sustainable Finance Disclosure Regulation (SFDR), mandatory Taskforce for Climate-related Financial Disclosures (TCFD) style reporting in the UK and anticipated SEC rules relating to climate disclosure. PRI signatories must begin reporting on climate risks following the TCFD framework. But perhaps the most visible and immediate driver for many companies is Limited Partners (LPs), which have substantially increased their focus on climate over the last few years. While the landscape is far from settled, the need to provide LPs with visibility on the climate impacts and risks faced by the portfolio is clear.

Today our clients report four key pieces of information that LPs are looking for:

1. Carbon footprint data of the portfolio
2. Targets and reduction performance of portfolio companies
3. Information on the process for, and outcomes of, climate risk assessments
4. Climate-related commitments made by the GP, such as a Science Based Target Initiative (SBTi) approved goal or a Net Zero commitment



Actions to set a strong foundation today

We believe there are five core practices that are a good place to start.

1. Educate key stakeholders
2. Get your own house in order
3. Begin considering climate risk
4. Complete GHG inventories for your Portfolio companies
5. Help PCs set and achieve reduction targets

1. Educate key stakeholders

Establishing the climate practices described below will require buy-in and input from business leaders within the private equity firm as well as its portfolio companies. To reduce friction and position for success, a good first step is to provide education and training for these leaders on climate, its impact on business, expectations of key stakeholders and leading practices (e.g., climate literacy training). It often helps to legitimize the topic by sharing benchmarking information on how peers and LPs/customers are addressing climate already.

Cranemere is heading down this path now by educating leaders of their portfolio companies on the importance of addressing climate. Propper de Callejon shared that the company is "going to conduct learning sessions on climate and SBTs for the CEOs and other key people. We want our companies to understand the relevance and urgency of this set of issues."

2. Get your own house in order

For a typical private equity firm, the greenhouse gas (GHG) emissions associated with its own operations are a tiny fraction of the emissions of their investments. However, it is still important to complete a GHG inventory of Scope 1 and 2 emissions for the organization and set targets to reduce these emissions over time. GPs that take action demonstrate commitment and authenticity. They also gain first-hand experience of the challenges and roadblocks that portfolio companies are likely to face when asked to complete their own inventory and drive reductions. Caroline Löfgren, Chief Sustainability Officer at Hg Capital agrees. "Once we had calculated our own footprint as a firm, it was easier to get our PCs on board as well because we had established a clear path that our companies could follow."

It is important to prioritize actions that will drive real reductions within your emissions footprint. Offsets can be used in addition to, and after, these reductions to help strengthen impact but should not be viewed as sufficient in and of themselves.

While a full Scope 3 inventory isn't essential for GPs conducting their first inventory, you should strongly consider including emissions from business travel and third-party advisors, as these can be significant sources of emissions and the ability to influence is relatively high. We recommend expanding the breadth of your Scope 3 inventory over time.

3. Begin considering climate risk

Conducting light touch, qualitative risk assessments at each portfolio company is a common step. Guidance provided by the TCFD provides an important framework for considering climate risk exposure and management, and PRI signatories are now required to report in alignment with the TCFD framework.

Seek to identify the most significant physical and transition risks and estimate whether the potential impacts of those risks are low, medium, or high in the short, medium and long term. The CDP climate questionnaire includes questions on climate-related risks and opportunities and getting portfolio companies to the point where they have reasonable responses to these questions can help to frame this effort.

The private equity owner should then conduct an analysis to look across the assessments from their portfolio companies and identify hotspots and commonalities to inform their own climate risk assessment.

Löfgren shared how Hg employs many of these practices. “We help our portfolio companies conduct climate change risks assessments as part of their onboarding that look at physical and transition risk, seeking to understand where we are exposed to low, medium or high levels of risk. We also seek to assess the companies’ resilience to potential climate impacts.”

4. Complete GHG inventories for your Portfolio companies

A portfolio company GHG inventory is an essential first step that provides a frame of reference for setting reduction goals and measuring progress. Recently, we have seen a surge in interest from GPs looking for solutions that can support their portfolio companies in completing GHG inventories.

It is worth noting that many organizations find completing an inventory to be challenging, especially in the first year or two. Expect to find that important data informing the GHG inventory will not be tracked or will require effort to consolidate. Companies should take learnings from the first inventory that will help them enhance the data collection process and improve inventory efficiency and quality over time.

5. Help PCs set and achieve reduction targets

Setting targets and driving real reductions is where the rubber meets the road, and the private equity sponsor has an important role to play in influencing ambition and unlocking meaningful action. Sanaz Raczynski, Managing Director at Kohlberg & Co, points out “It’s important as the PE sponsor to help our companies in the goal-setting process. Once we get one company that’s doing it well, it becomes easier to get others on board.”

In the past, it was acceptable and common for companies to set an incremental efficiency goal based on a bottom-up analysis of what was comfortably achievable. Today, it is our view that this approach is no longer viable. Stakeholder expectations have shifted significantly, and we suggest portfolio companies set a carbon reduction goal aligned with the Paris Agreement. This means the company must reduce its absolute Scope 1 and 2 footprint at the same pace that is required globally to maintain global temperature rise to 1.5 degrees Celsius. Currently, we don’t believe that either target approval—such as from the Science Based Targets initiative (SBTi)—or coverage of Scope 3 within the goal is mandatory, but the landscape is changing quickly and likely to head in that direction.

Implementing initiatives that drive emissions reduction is the next step, and this will likely take several years of continuous improvements. Portfolio companies should use the GHG inventory to identify hotspots and drivers of emissions, and then engage internal and external experts to identify and assess reduction opportunities. It is important to understand the capital investment required, the payback period, and the projected impact on carbon emissions. Many companies may find it necessary to procure renewable electricity or Renewable Energy Credits (RECs). We recommend that companies develop a multi-year roadmap that sets out a clear plan for how they expect to achieve their reduction target.

What comes next?

Emerging drivers

Management of climate-related issues in the private equity industry has evolved rapidly and will almost certainly accelerate. We see three significant forces that will drive expectations and leading practices in the future.

First, there is a growing misalignment between net zero commitments being made by an increasing number of large institutional investors and actions taken by asset managers. While many of these commitments look far into the future, the scale of action needed to meet them cannot be overstated. As Propper de Callejon put it, “we see a tremendous gap between net zero commitments and the actual actions taken and progress achieved.” As a result, it seems likely the expectations from LPs to measure climate impacts and drive reductions among portfolio companies in line with science will increase significantly.

Second, we also see leading GPs stepping up to greater commitments. The Initiative Climat International (iCI) has created momentum toward greater climate action and helped to drive the creation of SBTi’s Private Equity Guidance (which Anthesis helped to create). As these pioneering asset managers set the bar, the rest of the industry will need to follow.

Finally, we believe the coming years will bring significant advances in how private equity firms evaluate climate risks and opportunities and integrate these considerations into their decision making. Sanaz Raczynski points to a fundamental problem. “Today, most GPs don’t know how to integrate climate risk factors into financial models. Just because investment committees might have access to some qualitative climate risk information doesn’t mean they can easily translate that into quantitative financial impacts.”

Mandatory disclosure requirements and increased supply chain disruptions will force greater attention on climate risks and elevate the need for meaningful analysis. Simultaneously, we expect to see disruptive technology solutions coming to market that will make it significantly easier to conduct stochastic climate scenario analysis, understand the complex relationships between physical and transition risks, and understand the potential financial implications. Not only will LPs push their asset managers to mature their practices, but forward-looking GPs will also recognize the competitive advantage they can gain by being at the cutting-edge of climate risk analysis.

Emergent Leading Practices

There are four practices we believe we will gain momentum among General Partners in the coming years.

1. Increase ambition to set approved science-based goals
2. Facilitate coordinated decarbonization initiatives
3. Integrate climate risk management practices
4. Integrate climate risks and opportunities into due diligence

1. Increase ambition to set approved science-based goals

In November of 2021 with the support of Anthesis, the SBTi launched new guidance for how private equity firms can set a science-based target. With the launch, seven companies announced commitments and since, approximately ten others have shared their plans to set an official target this year. Momentum behind science-based targets is clearly building. General Atlantic, recently announced a climate-focused venture called BeyondNetZero which, among other progressive steps, is requiring all portfolio companies to set a science-based target. “Companies we invest in will have to set SBTs. This is red line for us, and part of our transaction process” stated Matthew Powell, VP and Head of ESG and Reporting for BeyondNetZero.

One important implication of greater alignment with SBTi or other credible frameworks is the inclusion of Scope 3 within the target. Portfolio companies must set engagement targets to reduce Scope 3 across the value chain on an intensity basis. As target guidance is developed for credible pathways to meeting net zero (such as SBTi Net-Zero for Financial Institutions, Net Zero Asset Owner Alliance (NZAOA) Target Setting Protocol, IIGCC's Paris Aligned Investment Initiative Net Zero Investment Framework Implementation Guide, Net Zero Asset Manager Initiative (NZAMI)) it is expected that these intensity targets will be increasingly aligned to absolute reduction.

Whether SBTi or a different standard, we believe LPs will begin applying greater pressure on private equity firms to meet accepted third-party standards that align with the scientific consensus or risk facing commercial friction. We have seen momentum build steadily among large corporates to achieve SBTi certification, and a similar trajectory within private equity seems likely.

2. Facilitate coordinated decarbonization initiatives

For many portfolio companies, achieving a science-based target will not be easy. There is likely low hanging fruit to pursue like lighting upgrades and behavior change, but for most companies, simple efficiency measures will only get them partway there.

To unlock greater action, we expect private equity firms to take a more active role in enabling significant decarbonization opportunities. This may include establishing an internal price on carbon, earmarking a special pool of capital for decarbonization initiatives, or facilitating group REC, renewable energy, and removal purchases.

Investindustrial has instituted a number of cutting-edge practices to accelerate decarbonization. Serge Younes, SVP and Head of Sustainability at the private equity firm, explains "we set a theoretical carbon budget at fund creation to enable carbon reduction initiatives at our portfolio companies. This is based on an internal price on carbon that we have established, and the anticipated emissions of the fund's portfolio companies. We also leverage ESG-linked financing for our portfolio companies, which provides additional incentive to reduce emissions, whereas senior executives in portfolio companies have equivalent ESG-linked incentives. We have demonstrated the success of these efforts through many prior exits."

3. Integrate climate risk management practices

In the years to come, leading private equity firms will evolve beyond the qualitative and directional climate risk reviews many complete today. Techniques are now developing that would allow for stochastic, science-aligned scenario analysis across physical and transition risks for each portfolio company. There will also be a significant focus on the potential financial impact, and integration with existing financial modeling and risk management processes.

With greater visibility into the risk that climate change poses, we expect to see GPs more frequently prioritize management and mitigation of climate risk as an objective during the ownership period. We believe that GPs will come to view the reduction of climate risk as a promising lever that can increase multiple at exit.

4. Integrate climate risks and opportunities into due diligence

Forward-looking alternative asset managers are beginning to evaluate the climate risks and implications of an acquisition more deeply. Diana Propper de Callejon shared that "negative impact on climate has been a deal killer several times."

With a greater awareness of climate risks, proliferating commitments to drive decarbonization, and emerging disclosure requirements from regulators around the world, we believe asset managers will come to realize that climate risks need to be understood at acquisition. We anticipate diligence scopes that seek to evaluate climate risk exposure of the target company, to understand the financial implications under various scenarios. It will also be important to get line of site on the GHG footprint of the target, how it compares to benchmarks, and what the costs would be to drive science-aligned reductions during the ownership period.

The time to act is now

While climate goals are often set far into the future, 2030, 2040, or even 2050, the time to advance climate management practices is now. Serge Younes stresses that making their comprehensive climate program "took over a decade to develop, and it all doesn't happen at once." Expectations and common practices have shifted drastically in the last few years and will continue to evolve. Companies that don't continue to advance their practices will quickly find themselves behind, those that do will help to shape the landscape. "There are some firms that are just waiting until they're told what to do" said Sanaz Raczynski, "but we think it's better to take a leadership role and be the influencer."

In preparing this paper, Anthesis spoke with:

- Allison Spector, Head of ESG at One Rock Capital (private equity)
- Caroline Löfgren, Chief Sustainability Officer at Hg Capital (private equity)
- Diana Propper de Callejon, Managing Director at Cranemere (holding company)
- Matthew Powell, VP and Head of ESG and Reporting for BeyondNetZero. (growth equity)
- Paula Luff, Director of ESG Research and Engagement at DSC Meridian (hedge fund)
- Sanaz Raczynski, Managing Director at Kohlberg & Co (private equity)
- Serge Younes, SVP and Head of Sustainability, Investindustrial (private equity)

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