BLOG

Climate change: The new propellant in private equity

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"Every event in history occurred against the backdrop of some climate change" – Sapiens: A Brief History of Humankind by Yuval Noah Harari

Private equity (PE) firms are gearing up, by including climate strategies in their ESG themes

What was considered backwaters a decade ago has in recent times risen to become a global phenomenon: environmental, social and governance (ESG) investing. Global awareness of ESG themes also has raised particular interest in climate change, calling for joint action among limited partners (LPs) and general partners (GPs) to mitigate climate risk.

Climate concerns are an important ESG motivator

The US SIF Foundation's 2019 biennial Report on US Sustainable, Responsible and Impact Investing Trends (2019) showed that climate change was the top criterion for asset management firms, representing USD3tn in assets.

LPs demanding action

With climate change becoming a globally understood concept, (LPs) are demanding that GPs report ESG isssues – from fundraising and other action taken to combat climate risk

Financial returns

To cater to LPs' demands, PE firms are targeting financial returns combined with responsible investing

*A study conducted by a German investment fund and University of Hamburg in 2015 of more than 2,000 PE firms found that 63% showed a strong correlation between ESG performance and positive returns, while 10% showed a negative effect

Market to capture

A developing economy offers scope for unmet capital needs of PE to be met through investment in renewable sources of energy, due to the lack of access to basic essentials such as electricity

Tipping point

With climate risk putting pressue on existing resources, PE firms are adopting ESG standards to ensure long-term stability through judiciously utilising resources

PE firms are shifting focus towards climate themes right from the onset

PE firms, especially those engaged in fundraising, trying to manage climate risk have gained the attention of shareholders (LPs). Climate change is a complex global issue and to respond to it, PE firms have started disclosing the carbon footprints of their portfolios, adopted sustainable investing themes such as investing in resilient infrastructure in developing countries (to judiciously utilise existing resources), and forayed into impact investing through the issuance of a new debt-financing instrument: green bonds. The money raised through green bonds is diverted towards eco-friendly projects, helping the PE firm to be recognised as engaged in responsible investing.

Recent climate-focused PE firms' fundraising include the following:

LeapFrog Investments	In 2010, raised its first Impact Investing Fund, which was closed at USD135m (oversubscribed by 35%); a second fund was closed at USD400m
Adani Green Energy	In June 2019, issued green bonds worth USD500m that were oversubscribed three times
Sampension	In December 2019, the Danish pension fund invested EUR40m in a new German green bond issue
Canada Pension Plan Investment Board	In January 2019, it issued a EUR-denominated green bond worth EUR1,000m

Challenges facing environmentally focused PEs

Although many PE firms have incorporated environmental concerns in their investment strategies to meet shareholder requirements, most struggle with clarity on implementation. PEs incorporating responsible investing as a strategy merely because it is trending has resulted in green-washing, making their green investment initiatives directionless.

The gap between expectations and reality among LPs and PE firms make it vital that PE firms understand shareholder expectations and how to appropriately work towards meeting then. Quality data is also critical for making a climate-centric investment. In addition, different firms have differing techniques for measuring, scoring and rating companies, and the resulting lack of standardised ESG data is a challenge for PE firms.

The United Nations-supported Principles for Responsible Investing (UN-PRI) framework was formed in 2006 to create awareness among financial management firms, and was signed by asset management firms representing USD6.5tn in assets. The number of fund managers who have signed the framework grew to 2,000 in 2018 from 1,200 in 2013, representing USD82tn of AUM. However, a benchmark for ESG reporting and enforcement is still lacking. Unlike for financial data, which has reporting standards such as GAAP, there is no standard reporting method for ESG data. The lack of proper market infrastructure to measure impact investing is another challenge faced by PE firms.

Addressing existing and emerging challenges in climate-centric investing

Hong Kong Exchanges and Clearing Limited (HKEX) recently issued stringent ESG reporting requirements for listed companies. The UN-PRI also announced mandatory reporting as per the Task Force on Climate-related Financial Disclosures (TCFD) for PRI signatories, to tackle climate-related risks through transparency in reporting. However, unlike listed equity managers, PE firms are lagging in ESG reporting, likely due to the size of the funds they manage and the companies they usually invest in.

Amid the tightening ESG norms, it is the need of the hour for PE firms to take greater ownership of ESG reporting and responsible investing. Researching, collecting, analysing and reporting the vast amounts of ESG data is key for making a well-informed impact investment. Acuity Knowledge Partners prides itself in having a strong research and RFP writing team assisting PE firms and hedge funds to conduct comprehensive ESG research and supporting credit firms in responding to RFPs, in terms of climate change in particular.

Sources:

University of Cambridge report: Unhedgeable Risk: How climate change sentiment impacts investment

UNPRI website

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