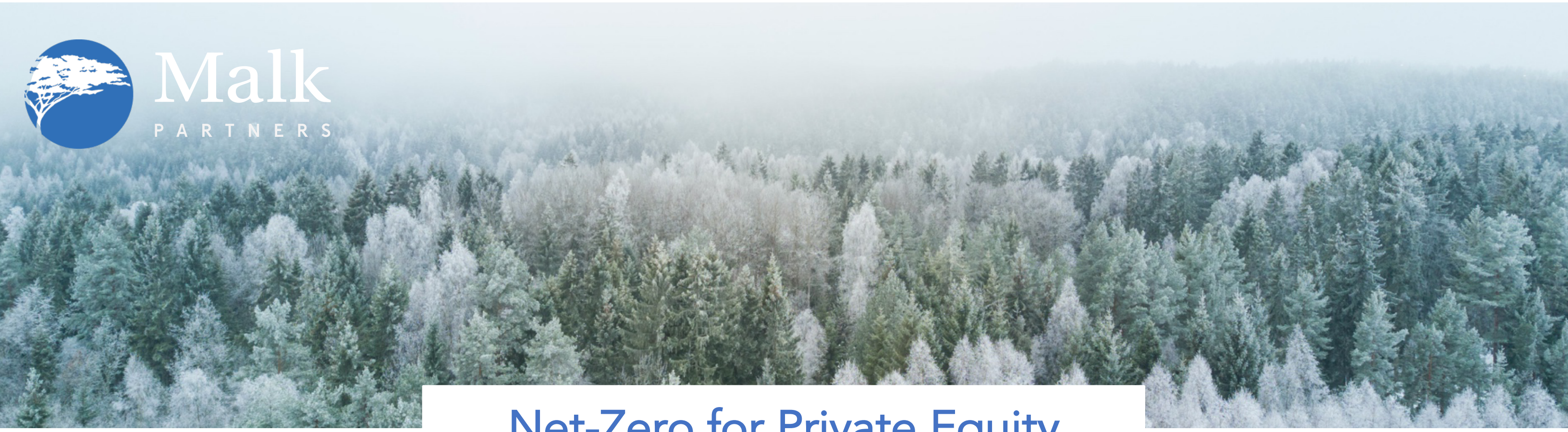

Net-Zero for Private Equity

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Key Takeaways

- Interest in net-zero investment strategies is on the rise, and investors who take the lead on net-zero are most effectively positioned to take advantage of the transition to a net-zero economy
- The global net-zero transition cannot occur without the buy-in of private equity
- Emissions reduction initiatives may help asset managers align with increasing LP sustainability preferences, stay ahead of emissions regulations, and capitalize on sustainability premiums
- There are many strategies at PE firms' disposal to reduce emissions and execute upon net zero goals

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What is Net-Zero?

Net-zero emissions refers to an ideal state in which all greenhouse gas (GHG) emissions generated by human activity are neutralized through technological advancement, sustainability transformation, carbon capture, and carbon offsets. Carbon neutrality, while similar in principle to net zero, refers only to the neutralization of carbon emissions, whereas net zero applies to all GHG emissions (e.g., carbon, methane, nitrous oxide, and other hydrofluorocarbons).

If net-zero is achieved, human-generated emissions would stop driving global warming and reduce the worst effects of climate change (e.g., food insecurity, infrastructure damage, biodiversity loss). Scientific consensus dictates that to avoid such effects, global warming must be limited to 1.5 degrees Celsius, a goal requiring net-zero be reached by 2050.

Net-zero commitments were catalyzed in 2016 when 196 countries agreed to the Paris Climate Agreement, the terms of which included a commitment to limit global warming to 1.5 degrees Celsius. The Paris Agreement prompted global acknowledgement of the need to transition to a net-zero economy, leading to increased emissions regulation by governments and shifting consumer preferences toward sustainable products and services. As governments and consumers drive the transition toward a net-zero economy, the private sector has begun to recognize that corporations' long-term success may depend upon their ability to thrive in a carbon-constrained economy. To that end, goals of achieving net-zero emissions have risen to the top of corporate agendas, as corporations and investors seek to avoid the costs of a laggard transition (e.g., stranded assets, diminished valuations) and capitalize on the estimated $275 trillion in investment opportunities presented by the transition to a net-zero economy.

Incentives for Private Market Investors

Incentives for firms to transition to net-zero have been driven largely by LP sustainability preferences and focused primarily on mitigating financial and regulatory risk. A 2022 survey of LPs conducted by Bain found that more than 30% of LPs have already set net-zero commitments, and as that number continues to increase, PE firms will need integrate decarbonization into their investment management strategy to ensure LPs remain on track to meet their net-zero goals. Increased regulatory disclosures are also driving PE firms to begin decarbonizing, as European regulations (e.g., SFDR, CSRD) and proposed SEC rules in the U.S. are likely to expose emissions-intensive portfolios to heightened investor scrutiny.

While some sustainability-minded investors' interest in decarbonization may be ideological, net zero strategy can also help GPs avoid stranded fossil fuel assets and adverse cross-asset interdependencies, align portfolios with LP and end-customer sustainability demands, and stay ahead of emissions regulations. Large investment portfolios are more or less a mirror of the global economy, and as the economy shifts away from carbon, firms that preempt the transition can mitigate transition costs and potentially outperform peers. While still up for debate, research conducted in 2019 by Harvard Business School and State Street found that decarbonization can drive alpha for investors, and firms that invest in green opportunities arising from the transition may realize these outsized returns.

Private Equity Status Quo and Go-Forward Outlook

With PE AUM forecasted to exceed $11 trillion by 2026, the global net-zero transition cannot succeed without the buy-in of the private equity industry. Net-zero alignment requires PE firms to track both firm-level and portfolio wide emissions, set science-based targets, and develop a transition strategy to achieve net-zero by 2050. Despite the widespread governmental adoption of net-zero goals and the immense quantity of assets under management affected by climate change, goals and commitments have not translated directly into action. Private equity firms have been slow to embrace net-zero, with very few firms signing on net-zero commitments and even fewer having developed realistic strategies to achieve their goals. Indeed, after facing the potential of losing current signatories, GFANZ recently dropped a requirement that members commit to phase out fossil fuels, indicating a faltering commitment to net-zero implementation among PE firms.

PE firms' hesitancy to commit to net-zero may be due in part to concerns that the private equity business model of buying and selling portfolio companies every three to five years is not compatible with generating as high of returns, or even recouping the cost of decarbonization expenditures. Indeed, the costs and related feasibility of a net-zero commitment are heavily dependent on the composition of a firm's portfolio, as well as its LPs' interest in investing in the net-zero transition. However, while not all PE firms may be prepared to make a net-zero commitment, not taking any action toward facilitating net-zero transition exposes PE firms to certain business risk as emissions continue to garner increased consideration from LPs, customers prefer more sustainable companies and products, and as energy and resource costs increase for emissions-intensive corporations. In short, even if a PE firm cannot feasibly commit to a net-zero by 2050 goal, tracking emissions and developing a strategy to reduce them within a time frame feasible for the firm manages related risks, and a lack of a strategy and related goals leaves the Company exposed. This dearth of execution on net-zero also presents an opportunity for firms considering net-zero strategies to lead the charge, as net-zero goals are likely to only continue increasing. Beginning alignment now provides an opportunity for firms to differentiate themselves from competitors and reduce the impending financial impacts of the climate transition.

Net Zero Strategies for Private Equity

Most asset managers leverage a blend of net zero transition strategies tailored to their investment strategy, portfolio composition, in-country regulatory environment, and LP preferences. The most prevalent approaches to decarbonization include the following, in escalating order of relative difficulty and complexity:

- Economic Intensity – an approach that seeks to drive greater carbon efficiency per dollar by investing in more energy efficient companies and/or divesting from major sources of emissions. GPs can improve carbon efficiency of their portfolios by investing in companies that already energy-efficient and have a smaller carbon footprint than industry average.

- Portfolio Coverage – another strategy well-suited to PE investments, portfolio coverage takes a bottoms-up approach to facilitating net-zero transitions by increasing the percentage of net-zero-aligned investments. Portfolio coverage for net-zero can be executed by either creating firm-wide net zero goals, or by enabling certain portfolio companies to develop and progress against their own net zero goals over the course of the hold period.

- Sectoral Decarbonization/Capacity/Technology-Based Reductions – a method that right-sizes sustainability transformation targets to reflect the paces at which different sectors and economic activities decarbonize (e.g., setting different targets for fossil fuel industries, vs. technology companies). Most asset managers focused on sectoral reductions align their emissions reduction plans to sectoral decarbonization pathways defined by the International Energy Agency. Other sectoral pathways include Goldman Sachs' sectoral decarbonization framework and the Transition Pathway Initiative's (TPI) Sectoral Decarbonization pathways.

- Absolute Contraction – a one-size-fits-all method that ensures that companies setting targets deliver absolute emissions reductions in-line with global decarbonization pathways. For asset managers, absolute contraction typically requires divestment from carbon-intensive industries.

Setting and Executing Upon Net Zero Targets

The latest science suggests that limiting warming to 1.5 degrees C depends on CO_2 emissions reaching net zero between 2050 and 2060; as such, effective net zero targets should be set no later than 2060. Firms can reference extensive guidance published by the Science-Based Targets Initiative (SBTi) and Initiative Climat International (iCI) to set effective interim and final net zero targets and align with best practices for reporting. While carbon offsets are not permitted within certain frameworks such as the SBTi, investment in carbon offsets may be a necessary final step to minimize residual emissions that cannot otherwise be accounted for and should be included as part of an asset owner's net-zero target.

Once an asset owner has decided on reduction targets and transition strategies, the success of such targets relies on the degree to which they are incorporated within firms' investment strategy, due diligence, portfolio operations, and annual reporting. Key tools for integrating net zero targets include:

- Aligning on near-term and long-term decarbonization goals for current portfolio companies
- Integrating sustainability transformation opportunities into investment strategy
- Incorporating decarbonization challenges and opportunities into due diligence
- Training portfolio operations teams to develop and execute sustainability transformation strategies, including emissions reduction goals upon exit
- Tracking progress against emissions reduction goals at the firm-level and across portfolio companies

While the strategies above are designed to implement net zero strategies, they are also effective tools for firms that are not prepared to set a net zero target yet, but still aim to reduce their exposure to financial, regulatory, and climate change transition risk through emissions reduction initiatives.

Net-Zero Resources and Initiatives

While PE firms can independently commit to net-zero, membership in an established net-zero alliance improves firms' likelihood of success by serving as an external accountability mechanism and providing firms with transition tooling and knowledge-sharing opportunities. The Glasgow Financial Alliance for Net-Zero (GFANZ), an initiative launched in 2021 to coordinate net-zero efforts across all sectors of the financial system, includes initiatives such as the Net-Zero Asset Management initiative (NZAMi), an initiative allowing asset managers such as PE firms to organize and work together towards net-zero. This initiative is the most popular alliance for PE firms to join, though the table below provides a more comprehensive list of resources for firms interested in committing to net zero targets.

Initiative Name	Description
Science Based Targets Initiative (SBTi)	The SBTi is a partnership between CDP, the United Nations Global Compact, World Resources Institute (WRI) and the Worldwide Fund for Nature (WWF). Science-based targets are the most widely recognized standard for companies and financial institutions around net-zero target setting and tracking. It lays out clear step-by step guidance for any firm looking to begin alignment with net-zero
UN Race to Zero	Race to Zero is a global campaign to rally leadership and support from business, cities, regions, and investors for a resilient zero-carbon recovery. Collectively these actors cover nearly 25% of global CO2 emissions and over 50% GDP.
NZAOA	The NZAOA is an alliance of asset owners committed to reaching net-zero emissions in their portfolios by 2050. The NZAOA represents $10.6 trillion AUM and contains several LPs that are encouraging asset managers to align with Net-Zero.
NZAMi	The Net Zero Asset Managers initiative is an international group of asset managers committed to supporting the goal of net-zero greenhouse gas emissions by 2050 or sooner. It currently hosts $43 trillion AUM and is a helpful resource for firms looking to set net-zero goals.
iCI	The initiative Climat International (iCI) was founded by a group of French private equity firms with the goal of contributing to the Paris Agreement's objective of limiting global warming to well-below 2 degrees Celsius, and recently started a North American Chapter. Members commit to sharing knowledge, experience, and best practice to help standardize practices on climate risk mapping, disclosure, and target-setting in PE.

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