

News from the Front Line: ESG Insights

Issue 2

Introduction

With climate change, PE investors should look for opportunities while they work to avoid risk

The year 2015 represented a critical juncture for all investors concerned with climate change. Scientists confirmed that 2015 was the hottest year on record, global clean energy investments hit a record high of \$329 billion in 2015 and, perhaps most important, the COP21 conference held in Paris in December resulted in an agreement by 195 countries to hold the global average temperature to less than 2°C. Consequently, investors and businesses are increasingly joining development banks, industry associations, government agencies and NGOs in initiatives like the Green Infrastructure Investment Coalition to develop strategies for the rapid transition to a low-carbon economy.

Climate change is a genuine risk for PE investors. New regulations and increased influence from LPs are driving action everywhere. In France, for example, the Energy Transition for Green Growth Act passed in August 2015 requires all asset owners and managers to disclose their exposure to climate change risk and conduct carbon footprint assessments of their portfolios.

In our previous issue of [News from the Front Line: ESG Insights](#), our premier issue, we introduced the many aspects of ESG that are of concern for private equity LPs and GPs. In this issue we focus entirely on climate change, both as a source of risk, as well as a source of new opportunities. In the three articles that follow, our contributors describe their efforts to discover new opportunities amid massive changes. First South Pole Group shares practical advice for investors concerned with how to properly assess climate change risks. Then, the Swedish pension fund, AP6, talks about conducting carbon impact assessments across their portfolio and using it as an engagement tool with their GPs and portfolio companies. Finally the Long-term Infrastructure Investors Association (LTIIA) discusses why climate risk is particularly relevant for infrastructure investors and how it's helping its members navigate in a rapidly changing economy.

We hope you find these articles valuable and we encourage both your comments and your ideas for future issues of this newsletter.

“Climate change is a genuine risk for PE investors. New regulations and increased influence from LPs are driving action everywhere.”

South Pole Group predicts massive change for PE, with opportunities for those who adapt to climate change early

For Dr. Max Horster, Partner and Financial Industry expert at Zurich-based sustainability solutions provider South Pole Group, the future for private equity investors and managers is clear: they must prepare for massive changes. All of us are looking at a global economy undergoing a massive transition, perhaps the greatest one since the beginning of the industrial revolution. The recent COP 21 conference resulted in an agreement among 195 countries to reduce their carbon emissions to hold global warming to less than 2 degrees centigrade. This means doing more than merely limit the growth of greenhouse gas emissions, principally carbon dioxide. Those 195 countries and the businesses that operate within their borders will need to substantially reduce their carbon emission footprints.

Clearly, the most immediate implication of the COP 21 agreement is the expectation for significantly greater regulation. Another key outcome is the growing influence the discussion of regulatory change is already having on investors, emboldening them to aggressively manage climate change risk.

Dr Horster identifies two motivations driving private equity investors and managers in this regard. First, GPs, and by extension their LPs, traditionally have close ties to the executive management within portfolio companies. They also have much greater levels of ownership. Most importantly, private equity invests for the long term, requiring LPs and GPs to carefully consider long-term climate risks.

The second motivation involves identifying climate change risks as opportunities. In this regard, GPs are ideally positioned at the beginning of the curve. They can make strongly focused thematic (i.e., “green”) investments, and with their close ties to portfolio company management, they can build a climate change advantage.

The pressure to address climate risk will place a higher premium on transparency for an industry that has only recently begun to deal with such demands from regulators and investors in the wake of the financial crisis of 2008. It makes sense for LPs and GPs to perform their carbon impact assessments early and thus turn transparency into an opportunity by showing responsible management and a full understanding of their climate risks.

One of the big challenges is how to measure climate risk. Dr. Horster believes that it should involve a structured dialogue between GPs and LPs. Rather than focusing on any single aspect, like a carbon footprint for example, such measurement should include the broader climate impact of any investment. An assessment should always evaluate what companies are already measuring, ask if companies are calculating their own emissions, set emissions targets and have a climate strategy.

Once all the critical data has been collected, the question for PE investors and managers is determining the best way to use it. Dr. Horster cautions that transparency and reporting are just the starting points. Having carbon footprint numbers is a good first step because it provides a strong signal that you are dealing with the risk associated with climate change from an investor or manager perspective. It helps focus attention and enables a comparison of emission trends and carbon intensity across a portfolio. Still, there is more to managing climate change risk than “simply trying to bring down GHG across a portfolio.”

For LPs, Dr. Horster’s advice is to have a process in mind that sets up a key timeline and milestones, be prepared to collect qualitative data, and engage with GPs directly on this information, using automation wherever possible. GPs need to leverage their close relationships to both their LPs and the executives running their portfolio companies.

Finally, he points out that private equity has passed a huge milestone in the past year. “In 2014 there was hardly any discussion at all about climate risk, but since COP21, the topic’s importance has soared. Looking back, investors used to say that it couldn’t be done, that you

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couldn't address climate change as an investment opportunity. Now, they see the possibilities of embracing it."

About Dr. Maximilian Horster and South Pole Group

Maximilian Horster is a Partner and Financial Industry Expert at South Pole Group. The company is the world's leading provider of climate solutions. South Pole Group helps public and private sector organizations measure sustainability impact and develop climate proven policies and strategies. Areas of expertise cover every key sustainability-related area of climate change, such as forests & land use, water, sustainable cities & buildings, as well as renewable energy and energy efficiency. For more information, visit www.thesouthpolegroup.com.

"Their second, and perhaps more important, objective is to engage with their companies and asset managers directly on climate change."

The Sixth Swedish National Pension Fund uses its carbon assessment to build engagement on climate change

The Sixth Swedish National Pension Fund (AP6), is setting a high bar among pension funds for engaging with its asset managers and companies on climate change. AP6 has a mission to invest only in private equity and a major focus on responsible investments. AP6 is a signatory of the UN Global Compact and Principles for Responsible Investment (PRI) and has just finalized its second climate analysis of the private equity portfolio.

"Last year was the first time AP6 did a carbon footprint assessment," explains Anna Follér, Sustainability Manager at AP6. That assessment was performed on a sample that covered about eighty percent of the value of its private equity portfolio and included both direct and indirect investments.

This year's assessment has two main objectives. The first goal is to collect more hard data on carbon emissions compared to the first effort, which included a very high proportion of estimates. Measuring and reporting carbon emissions is not as common among privately owned companies compared to listed companies, so AP6 faced an immediate challenge.

"We collect actual carbon emission data if it's available, but not all companies in our direct portfolio measure their carbon emissions and the case is the same for the portfolio companies of the private equity funds that we invest in," explains Follér. "So we don't have information for all companies and we will have to use estimates to fill the gaps. But we are quite confident that the level of reported data will increase over time."

Their second, and perhaps more important, objective is to engage with their companies and asset managers directly on climate change. The main purpose of that engagement is to learn how both companies and asset managers are handling climate change related issues in their operations and their investments. Although the carbon footprint provides valuable information it doesn't provide AP6 with complete information on either portfolio climate risk or portfolio climate impact. "We need a more holistic approach to climate change in the portfolio and this year's approach is a step in that direction," says Follér.

Their first assessment in 2014 provided AP6 with valuable experience that allowed them to "dig deeper this time."

"I think the key lesson that we learned is to be committed and to be involved on this topic, explains Follér. "Last year we focused on establishing a carbon footprint, based on publicly available information. We also carried out internal training to increase awareness and integrate climate change into our investment and ownership processes. Through that process, we became aware of the need for increased carbon transparency among privately held companies. Therefore we are working to promote carbon transparency and climate change integration in the investment process."

Significantly, AP6 was contacted by several LPs that wanted to discuss their process and challenges. Those discussions, while not part of their formal assessment, revealed growing

interest within the private equity community to analyze and engage on climate change.

For LPs seeking to conduct their own assessments, Follér suggests using existing industry guidelines and frameworks, like the CDP reporting framework and the IIGCC Guide to Climate Change for Private Equity Investors and use those as a foundation for building an approach that really fits their portfolios and their investment strategies.

AP6 has recently finalized the analysis and published the results in the 2015 annual report.

About AP6

Sixth Swedish National Pension Fund (AP6) was created in 1996 with a legislative mandate to invest in unlisted companies (i.e. companies that are not quoted on the stock market). Investments are made directly in companies and indirectly through funds. As of 31 December 2015, AP6 had SEK 26.4 billion under management.

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The LTIIA Offers Timely Advice on Climate Change for Infrastructure Investors

For investors in infrastructure, whose assets comprise all the transportation, communication, residential, commercial and social facilities that every person, community, nation and economy depend upon daily, climate change is critically important. Infrastructure assets are responsible for a huge portion of the total carbon emissions in the developed world. For example, a 2013 report published by the British Treasury (“Infrastructure Carbon Review,” HM Treasury, Crown copyright 2013) indicated that infrastructure was responsible for more than 53 percent of the total carbon footprint of the U.K. and predicted that the impact would increase to 80 percent by 2025 and 90 percent by 2050, at current rates.

Failure to adequately address environmental concerns, like carbon emissions, in infrastructure can not only trigger financial liabilities, but can result in serious environmental damage and human costs, including the loss of life. The long hold periods of such investments amplify these risks and make carbon emission reduction critical to sustaining financial performance.

Significantly, investors see both risk and opportunity. While some take a more financially focused view that carbon should be monitored as any other risk factor, other more socially responsible investors believe that it is their duty to support efforts to reduce the carbon footprint of every project.

One of the first risks to consider is the likely effect on a portfolio’s performance of increased fuel prices and stricter regulation carbon pricing. A second concern is the significant reputational risk associated with carbon-heavy projects, which might deter responsible and ethical investors from otherwise valuable projects. On the other hand, policy changes that encourage the use renewable energy can provide opportunities for alert investors.

To help its members navigate these critical issues, the Long-term Infrastructure Investors Association (LTIIA, <http://ltiia.org>) recently published an ESG handbook (Environmental, Social and Governance Handbook for Long Term Investors in Infrastructure, LTIIA, November 2015). It points out a proposition increasingly discussed in the investor community: “What can be measured can be managed.” It cautions investors that it is essential to address carbon-related issues and include an analysis of climate risks as well as opportunities during the investment phases of projects. A qualitative assessment of the climate-related risks with potentially negative financial, operational, commercial, or reputational consequences should form the basis of a systematic risk analysis.

Additionally, the Handbook identifies methods investors can employ to work with the various stakeholders in any infrastructure project, such as local authorities, community groups and contractors, and engage them in addressing climate change in systematic and easy-to-understand ways. One suggested method involves the use of advance carbon calculation tools as a way to lay the groundwork for measurement and mitigation.

The ESG Handbook was developed by LTIIA members together with the UN-PRI and was debuted during the COP21 summit in December 2015. Its purpose is to help investors improve ESG compliance across different infrastructure sectors and geographies by offering best practices, case studies and guidance on standards. More than twenty organizations contributed to the Handbook, including the Global Infrastructure Basel Foundation, Meridiam Infrastructure, SWEN Capital Partners, the PRI and other institutional investors, asset managers, development banks, advisers and not-for-profits.

About the LTIIA:

Founded in Paris in 2014, the Long-Term Infrastructure Investors Association (LTIIA) is an international not-for-profit association. The LTIIA develops and promotes a business conduct code in the infrastructure industry, protecting the long-term interest of the infrastructure industry in its fields of intervention, as well as promoting research and analysis of infrastructure investment throughout the political world, research institutions and professional associations.

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