Private equity and the path to net zero

A new epoch emerges

KPMG International

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The drive to net zero represents a massive opportunity for private equity to create a new era of growth, value creation and returns.

The global shift towards net zero carbon emissions represents the one of the greatest economic transformation since the industrial revolution. It is expected to permeate through every economy, sector and business. It will help transform infrastructure, cultures, behaviors and investment flows. It will help drive geopolitics, influence regulation and encourage significant policy changes. No company, asset or investment will remain untouched.

In many respects, that makes it a great fit for private equity (PE). PE's basic thesis is all about following investment flows, identifying untapped sources of value, and pulling them forward. And it is a particularly strong thesis in times of deep transformation and transition. Given the depth and breadth of this transition to net zero, private equity should be moving into a new epoch.

It is a critical risk…

By now, most PE houses and fund managers are beginning to recognize that climate risk is a financial risk. Already, companies with strong environmental, social and governance (ESG) credentials are enjoying strong multiples while those slow to evolve their engagement with higher emitting business practices are seeing valuations slump. A slew of new international and national regulations and standards are expected to bring even greater transparency to the real climate-related risks facing many companies. KPMG professionals have seen that some sectors are already facing a difficult investment climate.

What makes this particularly interesting for PE houses is the timelines involved. PE typically wants to build value and exit an investment within three to five years. And it would be safe to assume that — in five years' time — a successful exit would need to be supported by a robust decarbonization pathway and data that demonstrates progress on implementation, not just intent. That means that PE houses should be thinking about decarbonization and the path to net zero today.

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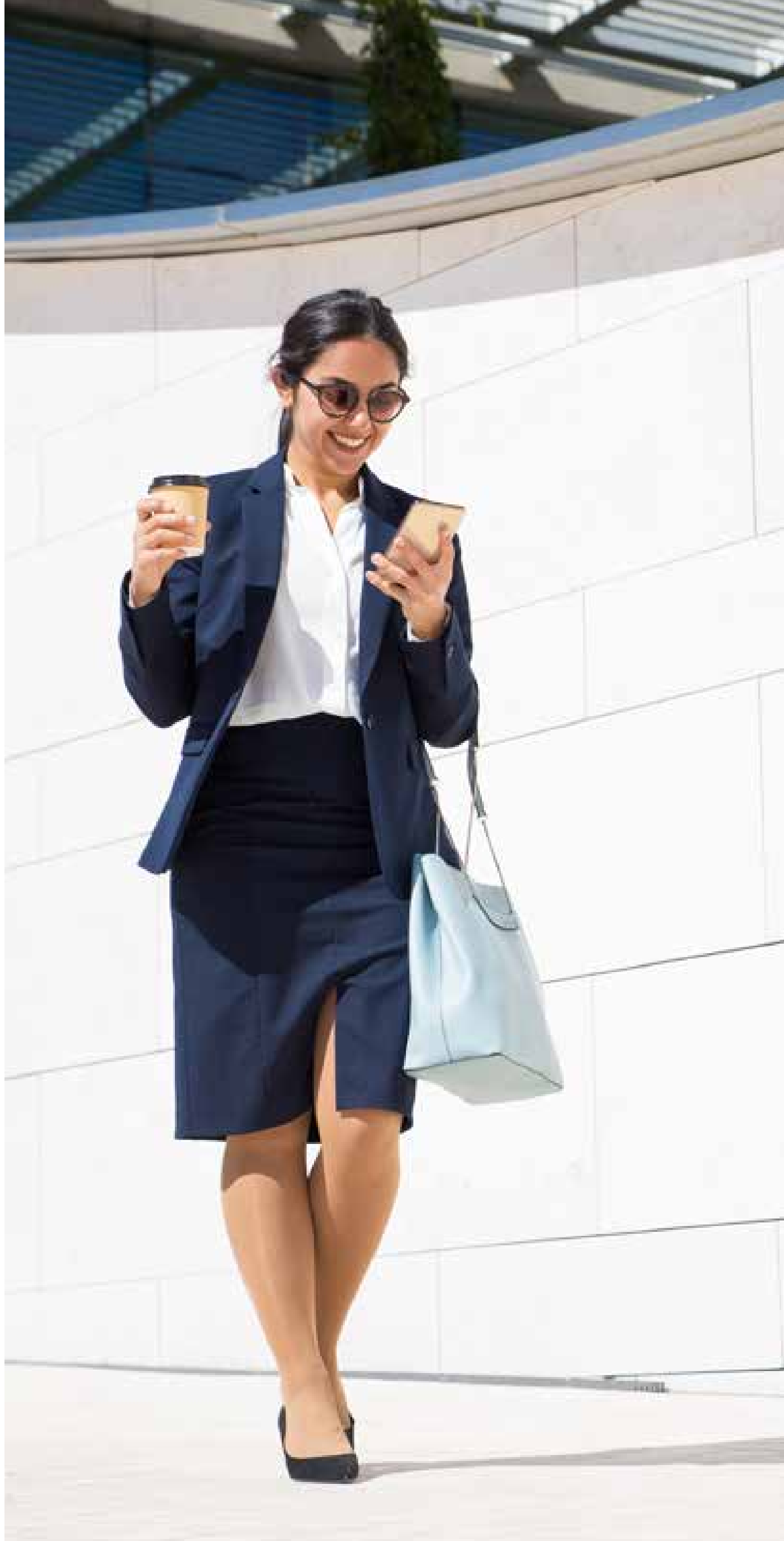

… and a significant opportunity

It would be easy for PE leaders and general partners (GPs) to frame decarbonization as a risk and to approach it solely as a compliance issue. But that view would ignore the significant value creation opportunities that could be achieved through a more strategic, proactive approach to decarbonization.

The leading PE houses, for example, are reading into recent policy signals — the US's Inflation Reduction Act (IRA), the European Union's Green Deal or the REPowerEU policy framework — that governments are 'all in' on supporting the shift to net zero. That has helped reduce the risk around certain asset classes and encouraged a significant amount of capital flow into emerging and up-scaling technologies.

They are also seeing the upside of decarbonization-related value creation opportunities at an investment and portfolio company level. Some PE houses are leaning into the trends by investing in companies that service renewable energy assets, for example, or that enable the circular economy. They recognize it's not just policy makers that are keen on green; consumers are, too. And they anticipate that these trends will help deliver sustainable growth, almost regardless of wider market conditions.

Don't get left behind

Already, we are seeing the pressure to embrace decarbonization influencing fundraising for GPs. Our conversations with leading GPs suggest they are spending an increasing amount of time responding to limited partners (LP) requests for decarbonization-related disclosures, reporting and information. LPs may not always know exactly what 'good' looks like. But they want to be confident that their GPs are thinking strategically and proactively about the issues.

Our conversations with LPs, on the other hand, indicate that institutional investors — sovereign wealth funds, pension funds, and other large investors — are already comparing their GP's activity on this issue. And they are starting to channel their investments towards those houses that demonstrate commitment to action and transparency. Simply put, if your peers are doing it better, you may have reason to worry about your future fundraising ability.

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Take a holistic approach

No matter where you stand versus your peers, PE leaders and managers should be thinking about decarbonization from multiple angles — this applies at the fund level, within individual portfolio companies and even at the point of investment.

At the fund level, GPs should be thinking critically about where they want to play and the impact that will have on their fund composition. Some may decide to differentiate themselves as a leader in decarbonization technologies. Others may decide they will focus on helping industries at the sharp end of this transition — like steel, mining and resources — accelerate their path to net zero. Some may choose to put the pursuit of Alpha over all else. Regardless, choices should be made. Exclusions may need to be created. Sectors may need to be prioritized.

At the point of investment, PE leaders and managers should make sure their investment teams are conducting robust ESG and climate due diligence with a particular focus on carbon emissions and decarbonization plans. Then they should carefully transpose those findings into financial statement impacts, both over the hold period and upon exit. What might seem like an excellent investment opportunity based on today's financials may ultimately end up as a stranded asset if others' decarbonization plans make the asset obsolete. Robust ESG due diligence wouldn't just pick up on these risks, it would also uncover future value creation opportunities that could enhance the value of the asset over the long-term. The important thing is to provide your investment committee with the right data at the right level of detail to help make smart long-term investment decisions.

At the portfolio company level, PE execs should start assessing their assets' decarbonization plans and seeking out opportunities to create additional value by aligning activities and operations to a decarbonization pathway. An asset manager's ability to push for change can largely depend on their level of control — PE's ability to drive change in an early stage asset, for example, will likely be diminished since most tend to take only smaller equity stakes in earlier stage companies. However, given the short timeframes preferred by PE investors, most managers should move quickly to find and execute on decarbonization value creation upside opportunities.

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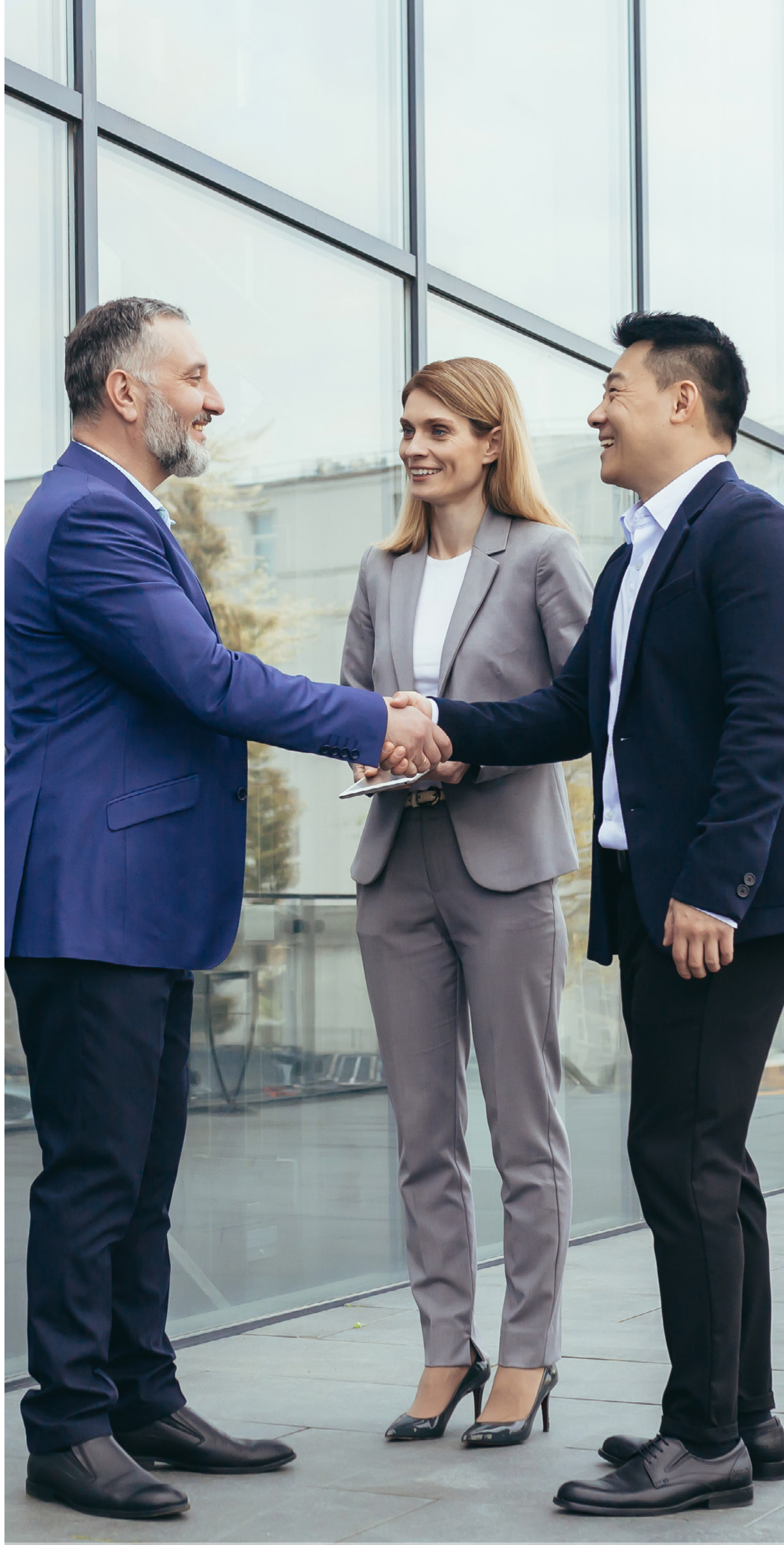

Three steps to help you succeed

KPMG professionals' collective work with PE executives, GPs, managers and their LPs indicates that the leading houses are rapidly progressing on their decarbonization and net zero strategies. Broadly speaking, they are focusing their work into three main steps:

1

Define the ambition

GPs and fund managers are taking the time to understand the trends and think about how they will influence valuations and market activity in the future. They are looking at current and future regulation and policy frameworks to identify new opportunities and increased signals of certainty. They are interacting with their LPs to assess expectations and transparency requirements. And they are using all of this information to articulate a clear ambition to their investors, investment teams, regulators and other stakeholders.

2

Map the pathway

With the common ambition clearly defined, the leaders are connecting climate change to their business. They are conducting rigorous ESG and climate due diligence and integrating it into their core financial due diligence. They are getting down to the transaction-level data of their assets to identify real and sustainable value creation opportunities through decarbonization. And they are prioritizing what they can achieve within the investment period to ensure enhanced valuation on exit.

3

Operationalize the plan

Modeling and reporting a carbon reduction plan does not always equal real change. One of the most important steps is to operationalize the strategy and the decarbonization pathway across the organization — at the fund level, at the portfolio company level and at the point of investment. In our view, this will undoubtedly require the adoption of some new policies, new technologies and new capabilities. And it will likely require managers to become far more active in the management of their investments.

You can do it

One thing is absolutely clear: PE has the power and the capital to influence massive change far beyond their individual investments and assets.

Private equity could play a key role in advancing new ideas and new technologies. It could help pull through the future value and benefits of decarbonization. It could help drive an orderly and responsible wind-down of unsustainable businesses and sectors. It could help accelerate the transition plans and decarbonization pathways of viable businesses. And it could help drive real, meaningful change.

The path to net zero could be a defining opportunity for PE — the dawn of a new epoch of growth and value creation. We look forward to seeing how PE houses and managers respond.

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