KPMG — Private Equity and Path to Net Zero Podcast

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Hello, and welcome to **"Global AM Perspectives",** a new KPMG podcast series for asset managers, fund managers and investors around the world. Through discussions with leaders from KPMG and major market players, this series will include short episodes that look at some of the most pressing issues, emerging trends and market opportunities within the asset management, real estate and private equity industries. In this episode we discuss how 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 one of the greatest economic transformations 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.

We are delighted to be joined by Bridget Beals Partner, Co-Head of Climate Risk and Decarbonization Strategy KPMG in the UK, Mike Hayes Climate Change and Decarbonization Leader, Global Head of Renewable Energy KPMG International and Josh Hesterman Advisory Managing Director, ESG Climate Advisory KPMG in the US to discuss some further findings and steps asset managers can take to succeed.

Presenter

With that Bridget, Mike and Josh on behalf of our listeners I would like to welcome you to the podcast.

Bridget if I can come to you first what are some key trends you are seeing as private equity firms are faced with when considering decarbonization?

Bridget

So, when we talk about the scale of change that's required to deliver on net zero, I often talk about this with my clients as being the biggest economic shift since the Industrial Revolution. So every fabric of our society has to change. It has to evolve in order to deliver on that zero or low carbon economy. And it really comes back to what you were saying in your intro around this being the greatest commercial opportunity of our time.

In the short term, regulation is a key driver of action for many companies. But fundamentally, this whole agenda comes back to large directional shifts in financial value and large directional shifts in value pools. So LPs are really asking for more information from GP's around how they're stewarding those low carbon outcomes across their portfolio. They want to understand that the capital that they're putting in funds is aligning to the energy transition or low carbon economy, or indeed maybe that it's aligning to impact based outcomes.

And those LPs want to see capital deployed in a way and manner that really does support low carbon outcomes, fundamentally in the belief that what's good for the planet will ultimately also be good for business.

Presenter

Okay, excellent. And Mike, how can this translate into shareholders value?

Mike

I think that's a really important question. I'm going to give three examples, but they're just examples of how you can create shareholder value from taking on these types of activities that Bridget mentioned in her response. First of all, I talk about operational efficiency. There's a number of well-known decarbonization solutions that actually produce positive NPV, and I don't think they get sufficient recognition.

Two examples I use are power purchase agreements, procuring renewable energy. Through that method, you can often get a better price than you would on the conventional merchant markets. And secondly, the one that I feel most strongly about is energy efficiency, the cost savings and the carbon savings you get through proper implementation of an energy efficiency transaction are badly understood in the market.

And I think there's real value from those two solutions. I also want to take it the other way around the consequences of doing nothing. I mean, clearly there's the possibility of greater carbon taxes and other regulatory changes. But one example I would like to give is the possibility that capital markets will change their attitude to companies who are not decarbonizing, and we should not assume continued ability to raise capital, equity and debt markets all over the world are starting to think about where they place their investor monies. So I think that's a really important consideration.

Thirdly, I talk about leaning into growth markets, ensuring that products that clients produce are capitalizing on trends in markets for lower carbon products and services. And this is becoming a reality in the market.

Consumer sentiment is changing. We're no longer talking about things like green premiums necessarily. What we're talking about is increased demand for greener goods and services. And I think companies will understand that trends in the consumer markets are the ones that can create real value in the future. So they're my three quick examples, but I could probably give lots more.

Presenter

Thanks, Mike. Josh, coming to you. What are some reasons you see as to why firms would be hesitant when considering the transition?

Josh

Sure thing. Thanks. And I think the first two relate pretty specifically to what Mike just walked through in his section, those being cost and timing. When I speak about cost, that's really, you know, the fact that a lot of these initiatives have real capital attached to them. So, there's a need to set aside these monies and make sure that they're available to sort of fuel the energy transition and the underlying initiative that they drive that.

But we're still early on, I think, in our journey of being able to describe and utilize the tools that we need to talk about the return on investment. And so it oftentimes becomes a bit of a stumbling block when clients look to something that they need to spend this money on. But maybe doesn't have the same level of rigor or diligence yet behind it that we built up in the last several decades on analysis like operational improvements and things that typically find themselves into diligence cases for PE houses.

The second is around timing. And so again, I think that just when you look at the relative time scale that most of private equity is operating on and the sort of 5 to 7 year hold period, you just don't have a lot of it and you're looking to really figure out very quickly where that capital has to be put in the portfolio.

It's got a natural capital lag getting these projects stood up and effectively executed and then tracked to make sure that they're doing what they need to do within the timing required for that return that we just spoke about. And so I think that that's a really tricky sort of balance to make within the span of only a handful of years as opposed to the 2030 and 2050 larger scale timeframes we often talk about when we talk about the energy transition. And then I think maybe unique to certain parts of the globe is the reputational risk or reputational sort of thumbprint that may come with either climate or ESG initiatives. So, certainly the comments out there, especially as we enter into various political races in the next year or so, there can be a cast of what does this mean, more broadly to the body politic.

And so there are certainly decisions that are being made about how far to push the various types of initiatives and what kind of viewpoint might be, in terms of that reflecting the entirety of the firm's view on a specific initiative. I think with that there's plenty of room to certainly continue on the road toward getting those initiatives done.

And we certainly see clients doing that. But there is another set of considerations around the general politics that that may not have been here in past.

Presenter

Thanks Josh, Bridget. Can you tell us what are the opportunities firms have if they overcome these hesitations to change?

Bridget

So I see really, three big opportunities. The first is performance. Second is reputation and finally, capability. So maybe just taking each of those in turn, think about the performance. If a firm has a huge opportunity here by anticipating that big change and those financial value shifts to actually enhance their performance in the short, medium and long term relative to peers.

And that comes back to all the different sort of layers of a private equity strategy, whether that's the ability to attract and retain capital from LP's. It's down to those fund strategies and realigning the funds to deliver where those value pools are going. And then it's that engagement with those port cos and all those levers to extract value that Mike was talking about.

So the opportunity is really there to drive an outsized financial performance. The second key thing was reputation. And I know Josh touched on it already, but there really is an opportunity to make a statement about what your firm stands for. And it doesn't just have to be about responsibility. That's also about resilience. It's also about embracing what double materiality looks like and the ability to really prove out what that really good governance, really good stewardship looks like.

Is this sort of first wave being the climate agenda, but that many more crises kind of coming down the line what does really good stewardship look like and how can a firm actually use this as a barometer to show what they can do and prove out their reputation as it is a key steward of assets going forward.

And the third thing is really about capability and talent. So firms who are seeing this big opportunity and seeing this ability to steward their assets effectively are attracting really, really good quality talent. And that talent has the capability to support them to deliver on that big change strategy, to identify those cost synergies to map out those value pools and ultimately to get the credit for the great work that they're doing through really high quality disclosure right across the marketplace with LPs or sort of regulated disclosure as well.

So I think across those three vectors, lots of opportunities for firms who are really delivering on that change.

Presenter

Okay, excellent, thanks Bridget. And so, Josh, how can KPMG professionals support clients with this?

Josh

So I think you know, really what this depends on is what level the client is looking at addressing its climate impact, the net zero concerned. So at the at the top level, certainly there is a bit of strategy work. Working directly with the GP and leadership to figure out how should assets be identified as you're thinking about getting them into specific funds. What are the evaluation criteria for those?

What frameworks are they going to adhere to either for compliance reasons or to align with the overall PE firm strategy and then understanding how that figures into performance measurement and performance management. That provides the ability to really track and understand whether you're making the kind of progress that you need to do to hit the various aims you set.

The second one is at the individual company diligence level. So looking at what all the opportunities and risks are in the climate contributors to your deal thesis. We have an extremely flexible approach and methodology for assisting in diligence around ESG and climate. This gets really specific and into the decarbonization levels, that you might be able to pull as well as looking at things like the climate risks and the macro modeling, the level of economics and and other impacts.

So there's certainly the ability to bring this into a really deal team friendly format. So getting it to a level where you're looking at the EBITA or other financial measure that tells you what that specific risk or opportunity looks like tends to be a big piece of our work. And then going down one more level into the portfolio companies themselves, we can work directly with the portfolio companies a lot of times and, high intensity carbon assets or hard to abate sectors, helping them work through their own climate journey.

So looking to understand specifically, what kinds of decarbonization initiatives there are, what kind of mitigation plans or climate action plans they'd like to put in place to make sure that they're not only making progress against their own enterprise strategy, but obviously making good on the promise and the returns that they're trying to generate as they think about think about their next exit along with their PE sponsor.

I think that really underlines a lot of the aspects of what we've talked about today is really just finding different ways to incorporate the understanding of value into the individual companies and their strategies that that resonates with the market. As you think about next steps for a client.

Presenter

And Mike would you add anything?

Mike

So before we close the session, I want to summarize three key messages from the contributions from my two colleagues and myself. First of all, low carbon is not just about compliance. It is a huge commercial opportunity. And those firms that recognize that are the ones that I think will be successful. Secondly, leading firms are taking action today because it makes good business sense and has the significant opportunity to enhance value in the whole period and on exit.

And lastly, firms should create a golden thread between their firm, bond and investment strategy to ensure that the activities on the ground are fully aligned. Those are my three key messages and delighted to have the opportunity to talk to you all today.

Presenter

That's great and thank you, Mike, Bridget and Josh for taking the time to join us on the podcast today. You have given our listeners some great insight and key takeaways. To let us know what you think about this episode, or if you have any ideas for future episodes, please email us at assetmanagement@kpmg.com. And remember, you can find our latest publications, articles and other material on kpmg.com/assetmanagement.

Join us again next time as we'll continue to explore other top of mind issues within the asset management, real estate and private equity industries so stay tuned. Thanks for listening.

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