

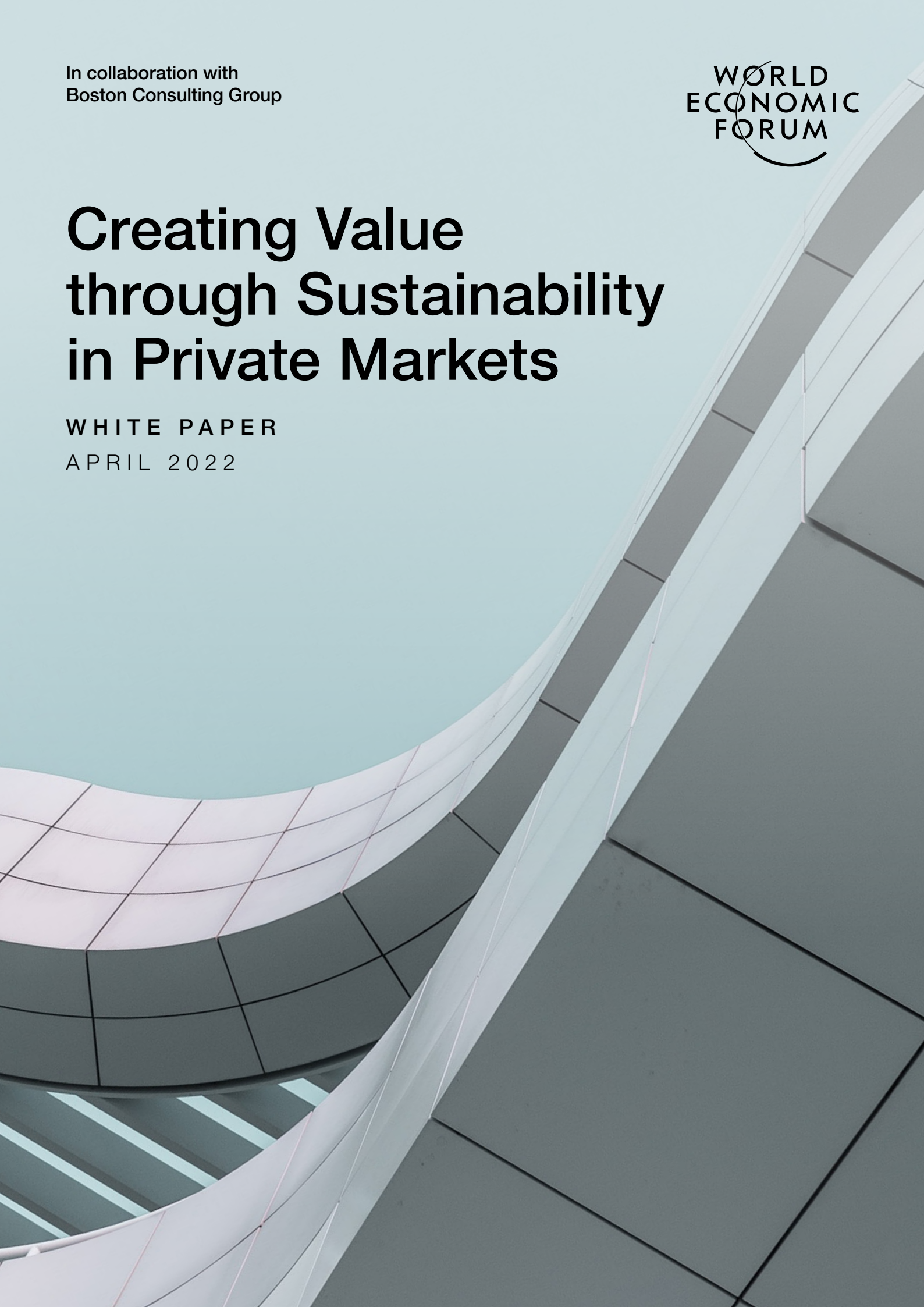
In collaboration with
Boston Consulting Group



Creating Value through Sustainability in Private Markets

WHITE PAPER

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Foreword



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The pressure on investors to make real progress on environmental, social and governance (ESG) issues has rapidly escalated. Private equity, with a full ownership governance model, long-term investment horizon and relative freedom from the short-term pressures, is well placed to lead this sustainable finance revolution. Taking leadership on this issue presents an opportunity for the industry to drive tremendous social and environmental impact. However, failure to take an intentional role in driving this impact could create the perception that the industry will become the home for “bad assets” divested from public markets, drawing reputational and regulatory scrutiny. The industry must act now.

Such action could be rightfully motivated by risk mitigation or the desire to have a positive impact as outlined, but there is another key motivator that is gaining credence – placing real financial value on the table for investors who are able to develop differentiated strategies and capabilities. Several private-equity investors see sustainable finance as the next big wave in value creation and are getting a head start by developing proof points and internal capabilities.

That said, most of the industry is grappling with a number of key challenges that are impeding progress towards aspirations. First, while investors may believe in the potential for value creation through sustainability, knowledge gaps remain regarding the range of levers that can be deployed.

Second, investors may understand the value-creation levers, but grapple with how to organize internally to apply them successfully; and relatedly, how to drive transparency at an ecosystem level to ensure sustainability actions are appropriately valued in the market. Finally, investors committed to sustainability have struggled to take an active role in transforming assets with poor performance on environmental and social dimensions (“bad assets”), focusing instead on sector screening and in some cases divestment, which potentially leaves these assets in the hands of less responsible stewards. A host of internal and ecosystem-wide barriers must be addressed if private equity is to take a leading role in transforming such assets.

In this paper, we have compiled perspectives and experiences from an extensive panel of private-equity investors who are working to address these challenges. This compilation is not meant as a rubric or “playbook” as each firm’s approach will vary based on stakeholder priorities, market context and core competencies – there is no one-size-fits-all approach. Rather we present these learnings as a scan of the “art of the possible”, which limited partners (LPs) and general partners (GPs) can employ as they craft their own sustainability journeys. We hope that the paper helps the industry make swifter progress towards assuming its role as a leader in sustainable finance.

Executive summary

Investors across the landscape of private and public markets are facing ratcheting pressure to allocate their capital in ways that create progress on environmental and social issues, in addition to delivering returns. In private equity, general partners (GPs) and limited partners (LPs) are increasingly being held to account by their respective stakeholders. However, taking action to address environmental and social imperatives, often referred to as “sustainable finance”, does not have to be simply a compliance consideration for private equity – there is an opportunity for the industry to create real financial value; in fact, private equity is uniquely positioned to lead the way in capturing value through sustainability.

Yet there is significant variation in both the starting point and the aspirations of private-equity GPs and LPs regarding sustainability. Some are primarily focused on best-effort navigation of stakeholder pressures. Others are starting to build a case for value by beginning to create proofs of concept to encourage a broader internal conversation about sustainability. There are also those who are differentiating themselves in the market by incorporating sustainability into their investment processes and actively working to expand their involvement in the space. It is tempting to think of the three groups as being on a continuum from laggards to leaders – however, each firm’s aspirations will vary based on its stakeholder priorities, market context and core competencies. Sustainable finance is not one-size-fits-all.

Nevertheless, regardless of their starting point or aspirations, LPs and GPs largely navigate a set of similar challenges (Figure 1). For example, even when organizations believe in the potential for value creation through sustainability, they may have limited understanding of the range of value-creation levers that can be deployed. In addition, LPs and GPs may understand the levers but not be organized internally to apply them successfully. Furthermore, LPs often struggle with how best to engage GPs on sustainability and trigger productive action.

Perhaps the biggest challenge lies in the scope of sustainable finance efforts undertaken. Private equity’s full-ownership model and flexibility to take a longer-term view relative to public markets should enable the industry to transform sustainability-laggard assets; thus far it has not fully capitalized on this opportunity. Climate is a good example – overall, the industry is committing to net-zero objectives, but firms are working towards those targets primarily by sector screening and selection, not through transformation of assets. Although more than 70 new climate funds were launched

between 2019 and 2021, most focus primarily on financing climate-related technologies and enablers, not decarbonizing existing heavy-emitting assets. Some sector rotation may be optimal for individual investors looking to hit their targets, but it is not sufficient for society to reach emissions-reduction goals – the high-emitting assets continue to exist, likely under less responsible stewardship. Worse still, some funds are amassing high-emitting assets to harvest cash flows, exposing the industry to regulatory and reputational scrutiny.

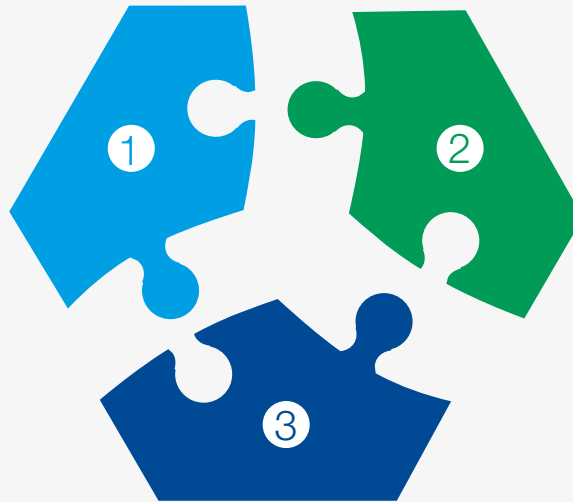
To assess the current state of the industry and highlight leading practices in sustainable finance, extensive interviews were conducted for this paper with more than 30 leading GPs, LPs and industry experts worldwide. The findings were also pressure-tested in roundtable discussions. This publication summarizes the results, giving the broader industry a better understanding of where firms are on this journey, and what is achievable. (One clarification: in line with industry parlance on sustainable finance, in this paper the term “sustainability” is used beyond its traditional focus on environmental considerations to include societal and governance considerations as well.)

The first section of the report unpacks some of the key approaches private-equity players are taking to capture value through sustainability. The second section articulates the primary changes to organizational culture, structure, personnel and processes LPs and GPs are making to better position themselves to take advantage of sustainability opportunities. The final section unpacks some of the barriers that are hampering private-equity investors from leaning into sustainability transformations in carbon and sustainability issues more broadly, and discusses some important “unlocks” that could accelerate action.

FIGURE 1 | Private-equity LPs and GPs are navigating a set of similar questions as they put the pieces together to take a leading role in the sustainable finance revolution

1 What are the levers through which PE can create value through sustainability?

- With several investors still viewing sustainability as a compliance issue, there remain gaps in knowledge about value creation opportunities
- Lessons from investors who have begun to develop proofs of concept can light the way for investors who are earlier in their journey



2 How can PE investors organize internally to capture these value creation opportunities?

- Where understanding of value levers exists, investors may still not be organized internally to deploy them successfully
- Lessons from investors already making changes to their organizational culture, structure, personnel and processes can light the way, though there is no one-size-fits-all approach

3 How can private equity take a leading role in ambitious transformations of “bad assets”?

- Typical divestment and sector rotation approaches do not remove these assets from operation
- Full-ownership models and longer time horizons than public markets should enable private equity to lead these transformations, if the identified investor-level and ecosystem barriers can be overcome

Source: World Economic Forum and Boston Consulting Group analysis

Opportunities to create value through sustainability

Private-equity investors are beginning to create value through sustainability in several ways.

Based on conversations held with LPs and GPs, private-market investors have several strategic options to capture value through sustainability. These options include:

- **Investing in sustainability leaders:** Investing in companies with leading sustainability performance to maximize exposure to sustainability tailwinds and minimize exposure to sustainability risks.
- **Sustainability-as-a-service:** Investing in companies that provide data, consulting, engineering and other transformation services to companies making the sustainability journey.
- **Shifting the whole portfolio:** Continuous improvement of sustainability performance for the full portfolio year-over-year, through the wide deployment of levers, potentially leveraging a shared playbook.
- **Transforming sustainability laggards:** Buying and transforming assets with lagging sustainability performance across environmental and social factors, by deploying a well-developed toolkit of sustainability-focused strategies and capabilities.

Across these strategies, three core drivers of value are seen.

Directly quantifiable impacts on P&L:

Sustainability actions can protect revenue, increase revenue or reduce costs, yielding directly quantifiable impacts on profit and loss (P&L). For example, Novolex, a former Carlyle portfolio company that manufactures packaging products for food service providers and grocers, has set an ambitious target of reducing greenhouse gas emissions (GHGs) by 20% by 2025. This industry-leading target positions Novolex as a vital supplier in its customers' efforts to reduce their own emissions. Furthermore, through securing cost-competitive renewable power contracts and implementing high return-on-investment (ROI) energy-efficiency

projects – ranging from basic measures such as LED lighting to more advanced measures including efficient compressed air systems, chiller systems and motor-driven equipment – Novolex has been able to make progress towards its targets while simultaneously reducing its operating costs.

Similarly, HireVue, another Carlyle portfolio company, provides a suite of hiring technology platforms that increases the diversity of new hires while simultaneously reducing time-to-hire and costs. This value proposition to companies that are increasingly prioritizing diversity has enabled HireVue to scale rapidly, nearly doubling cumulative interviews conducted on its platforms since June 2020.

Sponsors can also take advantage of sustainability tailwinds and pivot assets into adjacent segments. OMERS Private Equity, the investment arm of the pension plan for municipal employees in Ontario, pursued this strategy. One of its portfolio companies specialized in environmental consulting specifically for oil and gas and mining customers, but it expanded into new markets such as tech server farms.

Several sponsors interviewed have also captured quantifiable value by reducing cost-of-capital with sustainability-linked debt, which has seen massive growth in recent years thanks to demand from lenders seeking sustainability-themed products.

Enhanced long-term viability of a company's operating model:

In addition to directly quantifiable P&L impacts, several sponsors see value in sustainability actions enhancing the long-term viability of the business model. A prime example is employee engagement. Japan-based Unison Capital notes that the ageing population in its home country creates labour constraints. In that environment, strengthening the employee value proposition and thus retaining talent has become a differentiator for its portfolio companies. Following the acquisition of a pharmaceutical company, Unison rolled out a series of employee-focused

programmes, including converting contract-based workers (who accounted for 50% of the workforce) to full time, instituting a formal performance evaluation system, raising compensation and introducing an employee stock option programme, in which 90% of employees participated. These initiatives helped the company boost retention rates, contributing to strong financial performance over the holding period.

In addition, efforts to ensure that suppliers are acting responsibly and adhering to the social and environmental values of customers mitigates risk and creates opportunities to strengthen the customer value proposition. Furthermore, a significant motivator for many sponsors and companies to integrate sustainability into the business model is mitigation of regulatory risk and preservation of the licence to operate.

Valuation premiums at exit: A third important driver of value is market premiums at exit for assets with strong sustainability performance. Isolating the effects of sustainability in realized

premiums is challenging, given the absence of the counterfactual for an individual portfolio company or publicly shared data across several companies for a statistical analysis. However, there is consensus among sponsors that strong sustainability performance leads to a valuation “halo”. This effect is driven by a scarcity of assets relative to an increasing number of sustainability-focused funds or strategic buyers seeking to deploy capital, along with a recognition of the risk mitigation and strengthened customer value proposition of assets with strong sustainability performance.

Despite these drivers of value, GPs and LPs cite several roadblocks that hinder their ability to pursue sustainable value creation, including cultural barriers, inertia, lack of access to expertise and measurement challenges. The next section of the report discusses tactical steps that can be taken to overcome these roadblocks.

2

Organizing to capture sustainability opportunities

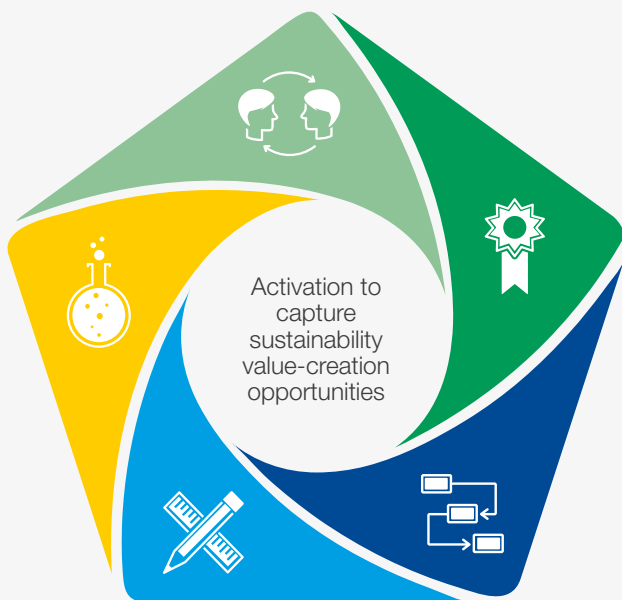
Private-equity firms must make intentional organizational changes to capture value through sustainability.

Effectively capturing value creation opportunities requires changes to organizational culture, structure, personnel and processes. From conversations held with GPs and LPs, it is clear

there are many ways to capture value through sustainability effectively; however, several common themes stand out (Figure 2):

FIGURE 2

Private-equity firms must make intentional organizational changes to capture value through sustainability



- ▶ **Drive a cultural shift throughout the organization**
Create a culture that actively seeks out and cultivates sustainability opportunities across the organization, extending beyond dedicated functions such as IR
- ▶ **Install champions with operational expertise**
Install senior sustainability champions with the operational experience to understand industry-specific materiality and move beyond “checkbox” exercises
- ▶ **Integrate sustainability into the full investment life cycle**
Create explicit and intentional processes to integrate sustainability into the value-creation plan from sector strategy, through diligence, ownership and exit
- ▶ **Strengthen measurement systems**
Join collaborative platforms working towards comparability; develop custom metrics for asset-specific material issues; track progress through regular reviews
- ▶ **Embrace experimentation**
Encourage and enable experimentation to test and refine nascent value-creation opportunities; rapidly scale successful pilots

Create a cultural shift throughout the

organization: A common starting point for LPs and GPs on the sustainability journey is to create teams that are responsible for stakeholder reporting, often as part of investor relations (IR). Interacting with deal teams and portfolio companies that are limited to reporting purposes only is not sufficient to drive value-creation opportunities – a culture that actively seeks out and cultivates these opportunities must permeate the entire organization.

Permira is a good example of how operating model levers can create such a culture shift. Permira initially created a sustainability function as part of the IR team, but the function was integrated into deal teams both by being physically co-located with them and by actively participating in investment committee meetings. An early initiative undertaken by the team was a portfolio scan to identify immediate sustainability-related cost-saving and risk-mitigation opportunities; this demonstration of a clear link to value enabled the sustainability team to gain credibility with the deal teams early on. “Once they started to see how the sustainability team can engage with portfolio companies, they began to see it as part of the value creation process not as a comms function,” says Adinah Shackleton, Head of ESG at Permira.

Another important tactic for driving cultural change is internal communication of impact stories and celebration of innovation. KKR has pursued this strategy for its broad-based ownership programme. As Pete Stavros, Co-Head of Americas Private Equity at KKR, observes: “The video testimonials are really powerful. Seeing how this changes people’s lives makes everyone think about how they could have similar impact.”

Based on these insights, primary tactics that firms can use to create the required culture shift include the following:

- Craft internal communications to celebrate successful sustainability innovations
- Report key areas of sustainability progress in quarterly reviews
- Co-locate sustainability with investment teams and support them to contribute to investment committee meetings
- Create broad accountability through reporting line changes (where appropriate) to create alignment between sustainability and broader investment objectives
- Integrate sustainability targets into individual incentive structures

Designate internal champions with operational

expertise: Installing senior-level champions with operational experience can be an accelerant for building institutional capabilities and moving beyond superficial, box-ticking exercises. Such champions can drive credible engagement

internally, both with portfolio company management teams and other stakeholders.

Clayton, Dubilier & Rice (CD&R) provides a compelling illustration. Several partners are ex-chief executive officers who naturally embrace sustainability initiatives as the integration of multistakeholder perspectives into the business model for long-term financial sustainability and – perhaps more importantly – have the requisite industry experience to identify unique factors that are material for a specific business. This in-house expertise has enabled CD&R to navigate the sustainability landscape and identify the highest-impact opportunities. “You need to pick your battles. It’s no different from picking growth initiatives. We were too small in some businesses to drive material impact and chose not to invest, but large enough in others to be a force for change,” says Vindi Banga, a partner at CD&R. Recruiting several ex-chief executive officers into leadership in the way CD&R has done may not be a practical path for all GPs. However, designating a few champions with the right operational expertise for specific industries or sustainability themes can dramatically accelerate progress along the learning curve.

Another approach to accelerate ESG outcomes is to partner with responsible investment professionals who have experience in implementing sustainability programmes in a given asset class. Ken Bloomberg, Managing Director and Global Co-Head of Private Equity at APG Asset Management, notes: “Our private-equity team works side by side with APG’s Responsible Investment team. They have a nuanced understanding of the investment process and specialize in specific asset classes and sectors. As a result, they have a shared language with the investment teams. That has been essential to achieving our goals: financial and sustainability outcomes for APG’s pension clients.”

Integrate sustainability into the full investment

life cycle: Creating value through sustainability requires LPs and GPs to intentionally embed sustainability throughout the investment life cycle:

- **Origination** – investors can identify sustainability themes at the outset to inform potential deal activity. For example, APG engages GPs both in traditional fund placements and co-investments to actively source investment opportunities with positive impacts on UN Sustainable Development Goals.
- **Due diligence** – in assessing sustainability opportunities and risks during due diligence, investors can progress from standardized checklists and questionnaires to more robust situation-appropriate tools. Permira is building out its institutional “playbooks” based on target sector, geography and degree of risk. “We encourage teams not to think about it as a one-size-fits-all checklist. We have different approaches and specialist advisers for different sectors. We started with higher-risk sectors like

manufacturing, chemicals and cybersecurity and are working our way through expanding to more sectors,” says Adinah Shackleton of Permira.

- **Ownership and value creation** – investors can use a sustainability lens to identify opportunities for value creation within a company as part of the full-potential plan. At Brightstar Capital Partners, for example, deal teams are required, at a minimum, to explore opportunities to make every portfolio company more energy-efficient. Additionally, Brightstar is focused on putting in place forward-thinking employee policies – for example, on parental leave – as part of the standard “playbook” for portfolio companies. “In the era of the ‘Great Resignation’, that is simply good business,” says Michael Drexler, Brightstar’s Chief Strategy Officer.
- **Exit planning** – leading up to the exit, investors can focus on articulating portfolio company sustainability performance and opportunities to attract a wider array of sustainability-focused buyers. In preparing a tyre recycling portfolio company for sale, Carlyle worked with management to robustly quantify the company’s environmental impact – such as the amount of waste diverted from landfills – and establish long-term sustainability objectives with key focus areas. Carlyle was able to position the company as a leading sustainability platform able to divert tyre waste from landfills and produce higher-value beneficially reusable products. That positioning was key to a successful exit.

Embrace experimentation: Although leading firms are already realizing value through sustainability, the space is still evolving and each portfolio company, GP and LP will face unique opportunities and challenges. Realizing the full potential requires investors to embrace experimentation, using small-scale pilots to test and refine value creation levers and internal processes.

Once pilots are successful, they can be scaled to other portfolio companies. KKR, for example, has been using its industrials portfolio to experiment with ways to improve relations between hourly factory workers and management, including an employee ownership scheme. Following early pilots, the programme has grown to more than \$500 million of total equity awarded to more than 20,000 non-management employees in multiple portfolio companies. Building on this success in its industrials portfolio, KKR is now rolling out the model across its entire US private-equity business.

Not all experiments are as visibly successful as KKR’s current employee ownership scheme, but several GPs and LPs interviewed are at various stages of piloting new sustainability initiatives within their portfolio. As one interviewee says, “We’re careful with what we put out into the public domain, but we’re very daring in our pilots. That’s how we will find the right levers for disproportionate impact.”

Strengthen measurement: Measurement is the most frequently cited obstacle to meaningful engagement on sustainability. GPs struggle to accurately compare sustainability performance data across assets, and LPs struggle to compare performance among GPs. Meanwhile, both groups struggle to identify the most critical metrics to track.

Earlier in their sustainability journey, LPs and GPs might have established procedures for capturing the most readily accessible metrics (such as utility consumption) for reporting purposes. However, as they focus more on value creation through sustainability, reporting systems need to be more customized to capture progress against most material sustainability issues at the asset level as part of the core evaluation of investment performance.

Moreover, in contrast to the other key conditions discussed in this section, measurement needs to be addressed at an ecosystemic level for data to be comparable, rather than at the level of individual organizations. The ESG Data Convergence Project, an industry initiative led by CalPERS and Carlyle, and supported by BCG, was launched in September 2021 to streamline private equity’s fragmented approach to sustainability reporting. The group represents the industry’s first LP-GP partnership focused specifically on standardizing ESG data in private equity. Since its launch, it has grown to include more than 140 GPs and LPs, representing \$12 trillion in AUM and more than 1,600 portfolio companies. The initiative has coalesced around a starting point of six key metrics: Scope 1 and Scope 2 greenhouse gas emissions; renewable energy; board diversity; work-related injuries; net new hires; and employee engagement – which will be tracked, aggregated and benchmarked to create a critical mass of comparable material sustainability data.

Another ongoing effort is the Institutional Limited Partners Association (ILPA) ESG Assessment Framework, which is designed to help standardize LP assessment of GP maturity. Additionally, at the COP26 event held in late 2021, the International Financial Reporting Standards (IFRS) Foundation announced the formation of the International Sustainability Standards Board to develop a global baseline sustainability disclosure standard for public markets to meet investors’ information needs.

To strengthen their measurement capabilities, private-equity investors can take several potential actions, including:

- Select key metrics and build measurement systems focused on most material sustainability issues. The Value Reporting Foundation framework (previously the SASB framework) offers an excellent starting point for identifying the most material issues for specific sectors
- Include discussions of progress against identified sustainability metrics in quarterly reviews

- Join existing platforms working towards measurement standardization as a starting point to mitigate the complexity of sustainability impact measurement and coordination

The identified changes to organizational culture, structure, personnel and processes mirror the hallmarks shown by digital-savvy private-equity sponsors (see Lessons from digital).

As with digital initiatives, LPs are often the key trigger for GPs to integrate sustainability into their capital allocation decisions. It's evident that some LPs are starting to play this role and as a result are achieving better sustainability outcomes. For example, CalPERS engages GPs with four key tenets:

1. **Standardize measurement:** Asking for sustainability reporting in a standardized way minimizes the administrative burden, allowing GPs to focus on outcomes instead of paperwork. While sustainability is a complex topic, a straightforward set of metrics, consistently reported, is a tremendous improvement over the status quo. Notably, this standardized, quantitative approach should also give GPs an opportunity to realize premiums on the exit multiple.

2. **Use data to inform decisions:** Once key metrics are selected, the numbers should speak for themselves. While they will not provide the entire narrative, they can offer a basic assessment of operational sustainability performance and allow for deeper integration of sustainability into all aspects of the investment life cycle.

3. **Focus on improvement over time:** LPs must keep GPs focused on generating real impact – capital must be deployed towards improving assets over the holding period, rather than cherry-picking sustainability leaders.

4. **Embrace different sustainability strategies:** Just as funds employ varying investment strategies, different GPs might be better positioned to deliver outcomes in different sustainability focus areas. GPs should be encouraged to identify sustainability topics to focus on to achieve disproportionate impact at the asset and portfolio level while still reporting on broader sustainability factors as part of standardized measurement schemes.

BOX 1 Lessons from digital

Implementing sustainability measures to create value has some conceptual parallels with implementing digital. Both require an ongoing assessment of rapidly evolving technologies, and both offer GPs and LPs a chance to differentiate themselves by developing a specific set of capabilities, understanding risks and taking action amid uncertainty. While not perfect analogues, the success factors observed with “digital-savvy” sponsors offer insights that can inform the roadmap for sustainability in private equity.

Committed leadership is key. Digitalization has in many cases been driven initially by a subset of anchor LPs that are deeply educated and engaged in driving digital transformation as a value-creation lever. GP leadership teams and investment committees that are similarly committed to digital value creation, both in external engagement with the ecosystem and internal celebration of successful teams, have been the most successful at driving change throughout the organization.

Embed expertise into deal teams. Rather than isolating digital initiatives in a parallel organization structure, successful firms made sure that deal teams were educated, engaged and made accountable.

Embed digital across the investment life cycle. Leading firms embedded consideration of digital value creation across every step of the life cycle, from developing a sector strategy through diligence, holding and exit.

Continuously evaluate emerging solutions. It's critical to constantly scan the market for new approaches and opportunities and commit to experimentation and scaling-up successes.

Source: Boston Consulting Group

Private equity's path to leadership in transforming 'grey assets'

Private equity can and should assume a leadership role in 'grey-to-green' transformations.

Many private equity investors today view "grey" assets – for instance, high emitters – as a potential reputational or stranded asset risk, to be avoided through exclusionary screens or divestiture. However, that approach won't solve the long-term decarbonization challenges that the world faces. Furthermore, with increasing pressure in public markets to divest high-emitting assets, there is a risk (real or perceived) that private equity could become the de facto home for these assets; such a narrative would expose the industry to reputational and regulatory scrutiny.

Instead, private-equity firms can and must improve the sustainability performance of these assets – transforming them "from grey to green". In fact, the industry is ideally positioned to play this role, due to its full-ownership model (which ensures operational control and minimizes impediments to action) and longer time horizon, relative to public markets.

Despite these structural advantages, however, the industry is not yet leaning into this opportunity to a noticeable extent. Discussions with industry participants have identified capability gaps, measurement limitations and length-of-holding periods as barriers to meaningful engagement on sustainability transformations (see Figure 3). When it comes to decarbonizing heavy emitters, three additional barriers stand out:

- **Levels-based emissions reduction targets** disincentivize the acquisition and decarbonization of high emitters. Such targets, such as those aligned to the [SBTi framework](#), are critical in driving companies and investors to reduce

their carbon footprint from a starting baseline. However, levels-based frameworks do not provide credit for decarbonization of assets added to the portfolio after the baseline is established. On the contrary, because emitting assets take time to decarbonize, adding them might cause the portfolio to miss interim reduction milestones.

- **Funds in the market willing to harvest cashflows from emitting assets** – although many private equity investors are eschewing high emitters, a portion of the market remains that is willing to hold these assets. (Private equity has invested \$1.1 trillion in the energy sector since 2010, more than 80% of which was directed to fossil fuels, according to an analysis of data compiled by Pitchbook on private-equity energy deals since 2010.) In addition to being a reputational risk for the industry, these investors price out climate-committed investors that could decarbonize these assets or accelerate their retirement.
- **Assets could become stranded during holding periods**, due to the absence of societal consensus and clear supporting policy on the necessary retirement or decarbonization trajectories of high-emitting assets along the path to net zero.

Barriers

Three core barriers prevent PE from leading in ambitious transformations of “bad assets” ...

... with additional barriers specific to decarbonization of heavy emitters

- **Lack of sustainability expertise to scan** the market for sustainability transformation opportunities and execute ambitious programmes
- **Lack of measurement uniformity**, which complicates communication of progress against targets, exposing investors to “headline risk”
- **Lengthy period to capture value from sustainability**, which may exceed the typical holding period, disincentivizing ambitious programmes

- **“Levels-based” portfolio emissions reduction targets** disincentivize acquisition and decarbonization of high emitters
- **Funds willing to harvest cash from high emitters** price out climate-conscious investors who would decarbonize or retire the assets
- **Risk of assets becoming stranded during holding period** due to absence of societal consensus and supporting policy on the retirement or decarbonization trajectories of high emitters

- **Enhanced asset-level transparency**, with proactive communication against a clear transformation plan to mitigate “headline risk”
- **Investment in capabilities** so deal teams can credibly engage portfolio companies on transformation opportunities and build sustainability “playbooks”
- **Flexibility in holding periods** where necessary to undertake ambitious transformation programmes and capture the created value at disposition

- **“Change-over-time” emissions targets** to supplement level targets, allowing for active acquisition and transformation of heavy emitters
- **Carbon pricing** to enable investors to more directly capture the value of decarbonization initiatives during the holding period
- **Clear retirement and decarbonization policies** for high emitters that provide incentives for bold transformations and make owners accountable for responsible exits

Individual LPs and GPs can take action to address key barriers ...

... along with ecosystem collaboration, notably on decarbonization

Unlocks

Source: World Economic Forum and Boston Consulting Group analysis

To take a leadership role in grey-to-green transformations, GPs and LPs individually can better position themselves to address these barriers through enhanced transparency, investment in sustainability capabilities and flexibility in holding periods (Figure 1).

Beyond actions taken by individual investors, industry-wide collaboration on shared challenges is necessary to better position the industry to engage in sustainability transformation opportunities. In carbon, mature disclosure standards with asset-level transparency and standardization of emission-reduction frameworks such as SBTi have begun to facilitate the flow of private-equity capital towards decarbonization of assets. In the future, further capital flow can be enabled through three additional unlocks:

- **“Change-over-time” emissions reduction frameworks** to supplement existing levels-based portfolio emissions targets

- **Carbon pricing** to enable investors to more directly capture the value of their decarbonization initiatives during the holding period
- **Clear retirement and decarbonization policies** for high-emitting assets that explicitly define the intended trajectories, provide incentives for sponsors to undertake bold sustainability transformations and make owners accountable for ensuring that the high-emitting assets they divest are sold not to the highest bidder but to new owners with well-defined decarbonization plans

Getting the mix of ecosystem enablers right in carbon will provide examples to follow for broader sustainability topics.

How to start: Monday morning priorities

While there is no one-size-fits-all sustainability ‘playbook’, the outlined approaches taken by LP and GP early leaders provide a menu of potential moves for firms mapping their own path.

Drawing from these insights, five “Monday morning priorities” have been identified for private-equity investors looking to take a step forward towards their sustainable value-creation aspirations.

1. Invest in capabilities and culture: The gap in capabilities is one of the primary barriers to action for LPs and GPs today. Installing champions with the right multistakeholder experience to straddle both the traditional investment and the sustainability worlds can be a vital first step in building institutional capabilities. However, operational responsibility cannot be isolated under these champions alone; LPs and GPs must intentionally shift their organizational culture, creating a sense of ownership for sustainability imperatives at all levels.

2. Focus on a long-term plan: Developing capabilities and driving a cultural change to develop value proofs will take time and likely involve false starts along the way. To stay the course, private-equity LPs and GPs need to take advantage of the greater time horizon flexibility in private markets and optimize for the long-term outcome, not just quick wins – for example, by embracing experimentation and lengthening holding periods.

3. Communicate the plan, along with measurable milestones along the way: Given the lengthy time horizon required to see results at the asset and portfolio levels, communicating the long-term plan and progress towards it to all stakeholders is vital to securing and maintaining buy-in. Communicating progress requires both

standardized metrics (to enable comparisons) and customized reporting (to accommodate the unique aspects of each investment). Asset-level transparency is critical, given that different assets have varying considerations and portfolios turn over approximately every five years.

4. Don’t just divest, transform: Divestment and sector rotation offer quick wins for a single investor, but they do not remove sustainability laggards from the global mix. As these assets continue to operate, the systemic risks they engender will ultimately affect returns across the market. Larger investors who are essentially universal owners and may have long-term obligations cannot divest their way out of these systemic risks. Sustainability challenges need to be addressed head-on by deploying capital to transform these grey assets. This is an area in which the private-equity industry as a whole has the opportunity for disproportionate impact, and individual investors have the chance to develop differentiated capabilities.

5. Collaborate to address key barriers: Addressing measurement challenges and establishing the right incentives cannot be accomplished in isolation. LPs and GPs across the industry must continue to collaborate to set standards and policies. The current momentum and relative maturity of measures to combat climate change can provide a testing ground for action on these ecosystem challenges, providing templates for system-wide collaboration across a broader set of sustainability topics.

Conclusion

The private equity industry is at a critical point.

Participants need to respond to rapidly evolving societal goals and expectations on sustainability. This presents not only financial, reputational and regulatory risks to be navigated, but also prospects for long-term value creation. Private equity must take action to seize this opportunity.



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