INVESTMENTS

Boosting returns by reducing carbon emissions

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16 February 2016

In part two of our green economy series, José Rojo looks at how GPs can reduce carbon emissions in existing portfolios, and finds out how LPs are encouraging funds with greener credentials

*To read the first part of this feature, **click here**.*

As several private equity firms, including Ambienta and Jadeberg, seek to generate returns based on the need to embrace cleaner energies as well as for corporates to reduce their carbon emissions, one notable entrant into this space is Gimv. Listed on Euronext Brussels since inception, the firm invests from its balance sheet and is therefore free to allocate its currently raised €1.1bn on a deal-by-deal basis. Deal opportunities are sourced and financed via four segment-specific platforms; one of the four, branded Sustainable Cities, channels investment into the green economy.

Set up in 2012, Sustainable Cities seeks strong performers within sectors including heating, ventilating and air conditioning (HVAC); speciality chemicals; water management; waste treatment and recycling; and transportation and energy. Deploying equity tickets of €10-50m, the scheme has so far invested €150m through seven transactions in Benelux, France and Germany. The potential of the sustainability segment within Gimv's core markets has surpassed expectations, says principal Laurens Rosenmöller: "Of our four platforms, Sustainable Cities has been the most active, investments-wise, over the past three years. We've been more successful than we thought we would be."

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In defiance of those who link a thriving green economy with state support, Gimv's Sustainable Cities has not received a cent of public subsidy and is expected by the GP to perform just as strongly as its other platforms. "We believe competitive returns can be made in the green economy," says Rosenmöller. "We try and avoid challenging areas such as the latest renewable energy technologies and instead focus on more traditional businesses, such as our recent investment in Itho Daalderop and Klimaatgarant."

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Volatility impacts listed private equity

According to Rosenmöller, Itho's and Klimaatgarant's specialisation in energy efficiency was the main attraction to the deal. "In the Netherlands, there is currently pressure from the government and bill-paying customers for energy-neutral homes, especially with newly built ones. Itho Daalderop was well positioned to profit from that trend." As the European Commission pushes for a 20% energy efficiency goal by 2020, it is fitting that the way is being led by Dutch businesses, familiar with operating in a densely populated, highly energy-intensive environment.

The strengths of a greener portfolio
Aside from direct investments into the green economy, there is another way for private equity to contribute to – and make a profit from – the worldwide fight to curb emissions; namely to reduce the carbon footprint of its portfolio companies. The impact accurate carbon reporting can have on one's asset is a lesson many in the business world have learned in recent times. Indeed, the legal cases that institutional investors are preparing against Volkswagen after losing money due to the emission scandal highlights this neatly.

Although an extreme example, the Volkswagen case illustrates the risks private equity could face if it continues to lag behind with carbon reporting. A recent report by the Institutional Investors Group on Climate Change singled out private equity houses, urging the industry to improve reporting standards. Given the lack of data, the document suggested institutional investors sidestep GPs and run emission tests with the underlying companies themselves.

Slowly but surely, change is sweeping across the industry. In late November 2015, days before world leaders kicked off the Paris climate conference, prominent French private equity houses Apax Partners, Ardian, Eurazeo, LBO France and PAI Partners unveiled a common emission-curbing initiative. Dubbed the Initiative Carbone 2020 (IC20), the scheme will draw on PwC's Escher methodology to measure the carbon footprint of each GP's portfolio.

Already ongoing, the tests will first be carried out among five portfolio companies per investor. The plan is to extend the measurements to all other portfolio businesses and publish comprehensive carbon data by 2020. According to Blaise Duault, head of public affairs and compliance at PAI, the five GPs have mostly chosen recently acquired companies where a significant stake is held. The rationale is to maximise the GPs' power to introduce changes and provide enough time to carry them out.

Candice Brenet, who oversees CSR for Ardian, adds that the five investors have so far targeted sectors where the carbon challenge is greatest. In Ardian's case, this includes an airport operator, an oil and gas transport service provider, a toymaker and an industrial measuring specialist. Unlike similar schemes in the past, IC20 factors in indirect emissions, as well as direct ones, which has helped identify challenges beyond traditional polluters such as chemical companies and manufacturers. "There are sectors where the carbon footprint goes beyond the company's core activity," says PAI's ESG representative Caterina Romanelli. "For instance, retailers, e-commerce and businesses in the communications field."

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It is not yet clear whether the initiative by the five GPs, which represent a combined €70bn AUM, will inspire the wider European industry to follow suit. "We're not looking to name and shame polluters or launch a plan that is superficial and only seeks to tick all the boxes," says Romanelli. "We are trying to think long-term, take the lead with this and set up a process so that other GPs can come on board and adapt things to their needs and means."

Duault echoes his colleague's sentiment: "This will not be a revolution that private equity can undertake on its own. To act on this, we need to involve all stakeholders, including the CEOs of our portfolio companies." In his view, although GPs should try and persuade managers that curbing emissions leads to a stronger business, any action on that front must mirror the CEO's own vision of the company and its needs.

There is also the consumer to consider. "It might be easy for a car maker to have its models run on carbon-neutral energy, but consumers can't be forced to buy them. Ultimately, companies still need to put out a viable, cost-effective product," says Duault.

Green shoots: the LP perspective

"We had a process with a significant private equity player where we told them they weren't going far enough. Their answer was that we weren't their only LP, that their other backers did not approach them with such demands. We politely chose to leave the table," Anna Follér, AP6.

While private equity firms are looking to increase the green credentials of their portfolio companies as a means of creating more value, LPs, particularly pension funds, are also keen to get in on the act.

In December last year, heavyweights including the UK's BT Pension scheme, France's ERAPF and Denmark's PKA applauded the Paris COP21 deal and, more importantly, acknowledged their sector's responsibility in the fight against climate change.

The stance of the three managers should not come as a surprise. All are part of the Institutional Investors Group on Climate Change (IIGCC), a body chaired by BT's Donald MacDonald, which represents a combined €13tn in managed assets. IIGCC's member roster highlights how LPs are spearheading the green revolution. Indeed, most of its 120 affiliates are pension funds and banks from across the globe, while the GP presence is reduced to a few names including BlackRock, Amundi Asset Management, HgCapital and Hermes.

It would appear institutional investors hailing from the Nordic region are leaders when it comes to the battle against climate change. AP6, one of the seven Swedish public pension funds and the only one allowed to invest in private equity, joined the Carbon Disclosure Project (CDP) transparency initiative last March. Eight months later, it announced it would coordinate carbon footprint reporting with the AP1, 2, 3, 4 and 7 funds. In line with the IC20 project by five French GPs, the six entities will now measure both direct and indirect emissions across their respective portfolios.

Crossed wires

With SEK 23.6bn under management, AP6 is a powerful player within the institutional investment space. However, how much traction does the Swedish investor truly have when pushing for a greener approach among the GPs it backs?

According to Anna Follér, a sustainability manager at the pension fund, reactions have been diverse: "The experience was very positive with some of the fund managers, who were ready to listen when we brought up emission reporting and other environmental aspects in our meetings. When, as an LP, you ask the tough questions, it is not so much about box-ticking as it is about an open mind, a shared ambition."

However, the LP-GP dialogue on sustainability is not always as fluid, Follér says: "We had a process with a significant private equity player where we told them they weren't going far enough. Their answer was that we weren't their only LP, that their other backers did not approach them with such demands. We politely chose to leave the table."

During its due diligence phase for assessing fund commitments, AP6 ranks GPs with a 'sustainability score' based on documentation they provide and the replies they give to AP6's questions, among other aspects. The score is then monitored every year and can prompt a discussion with the GP if progress does not take place. It can also be the basis for the pension fund to turn down an investment opportunity.

According to Follér, LPs keen on a greener private equity fund portfolio face a shortage of reliable information: "A year ago, when we decided to establish the carbon footprint of our portfolio, we realised that while emission data is more or less simple to source in the listed space, the picture is different with non-listed companies; we had to rely a lot on estimations, for instance."

Flight from fossil fuels

Another key consideration for institutional investors is mounting pressure to move away from fossil fuels. Last December, a report from think-tank Carbon Tracker warned that investors supporting the fossil fuel industry stood to lose $2tn because of climate change action and a booming renewable industry.

Just one month prior to that report, German insurer Allianz vowed alongside French peer CNP Assurances and bank Caisse des Dépôts to freeze their fossil fuel investments. The trio, representing €865bn in assets, pledged to channel the freed-up capital into the green economy.

The example is just the latest in a long series. After noting that thermal coal had approached "retirement age" and predicting an 18% slump in coal prices, Goldman Sachs recently unveiled a plan to inject $150bn into the low-carbon transition by 2025.

Even those LPs whose wealth rests on oil and gas appear to be shunning fossil fuels. In February 2015, Norway's $850bn-strong sovereign fund revealed it had divested stakes in 32 coal mines, citing fears of shrinking demand due to regulatory changes.

Although she urges the LP community to engage in the divestment debate, Follér believes the pressure on private equity is not as strong, as direct investments in fossil fuel extraction and reserves are rare: "If you own a coal mine, then you are feeling the pressure right now, but there is a whole scale of greys." One such grey area, she says, is oil and gas services. As long as the world continues to require energy, there will be a need for businesses that provide maintenance and support to power producers, both renewable and non-renewable.