Engaging Asset Managers on Net-Zero Commitments

INSTITUTIONAL LIMITED PARTNERS ASSOCIATION

IN COLLABORATION WITH:

MALK PARTNERS

What Is Net-Zero?

Net-zero refers to a state in which greenhouse gas (GHG) emissions from human activity are negated. It is driven by the belief that a global transition to a low-carbon economy is underway, motivated by current environmental risks worldwide. Unlike carbon neutrality, which applies only to carbon emissions and can be facilitated largely through carbon offsets, net-zero requires near complete abatement of GHG emissions. Some net-zero strategies permit carbon offsets only for residual emissions that cannot otherwise be eliminated through technological advancement or sustainability transformation.

Theoretically, if net-zero is achieved, human-generated emissions would not significantly drive global warming and thus avoid, or at least reduce, the worst effects of climate change (e.g., food insecurity, infrastructure damage, biodiversity loss). Scientific consensus advises that to avoid such effects, global warming must be limited to 1.5°C total, requiring net-zero by 2050.[1]

Net-zero commitments were catalyzed in 2015, when 196 countries agreed to the Paris Climate

KEY TAKEAWAYS

- Net-zero alignment positions asset owners to mitigate climate risk and capitalize on investment opportunities in the transition to a decarbonized economy
- Net-zero plans will be unique to individual asset allocations and priorities within an asset owners' organization
- Net-zero implementation strategies for asset owners investing in PE may include target setting, asset allocations, and/or GP engagement strategies
- GP selection and engagement is key to success in meeting an asset owner's net-zero goals within their PE portfolio

[1] IPCC, Global Warming of 1.5 Degrees Celsius

Agreement, the terms of which included a commitment to limiting global warming to 1.5°C.[2] The Paris Agreement prompted global acknowledgement of the need to transition to a net-zero economy, leading to increased emissions regulation by governments and shifting consumer preferences toward sustainable products and services.

As governments and consumers drive the transition toward a net-zero economy, many corporations and their investors recognize that long-term success depends on the ability to transition to and thrive in a carbon-constrained economy. While net-zero commitments are often motivated by environmental and financial risk mitigation (e.g., mitigating risk of stranded assets, diminished valuations), net zero also constitutes a significant investment opportunity. McKinsey estimates that a net-zero transition by 2050 will require approximately $275 trillion in financing for renewable energy resources and infrastructure to decarbonize the global economy.[3]

Net-Zero Incentives for Asset Owners

Asset owners' longer-term investment horizons amplify their exposure to systemic climate change risk, increasing the importance of proactively managing and mitigating risk in their portfolios. A net-zero commitment with focused action is the most effective climate risk mitigation strategy available to asset owners, positioning them to alleviate risk from cross-asset interdependencies. For asset owners interested in making a net-zero commitment, reaching net-zero would require their portfolios (including alternative investment portfolios), to produce near-zero GHG emissions.

Large investment portfolios typically mirror the global economy. Asset owners continuously assess long-term evolutions in financial markets that may require changes to investment strategies for their portfolios. As the economy shifts away from emissions-intensive industries, asset owners that preempt that shift can mitigate transition costs and target related investment opportunities. Research shows that decarbonization can drive alpha for investors, and asset owners that invest in green opportunities arising from the transition may be well positioned to realize these returns.[4] The sustainability market is growing and can allow companies to credibly charge a premium for green products, in turn lowering risk, increasing value, and incentivizing investment.

[2] United Nations Climate Change, The Paris Agreement

[3] McKinsey & Company, The net-zero transition

[4] Harvard Business School, Decarbonization Factors

Net-Zero Incentives for Private Equity Investors

Facilitating a net-zero transition is a substantial task for asset owners seeking to simultaneously sustain strong returns, maintain a diversified portfolio, and mitigate climate risk. Aligning these priorities with net-zero goals is key to an institutional allocator's net-zero transition.

Each asset class presents its own challenges for net-zero alignment. For private equity (PE) specifically, asset owners face challenges in aligning the PE business model with net-zero goals and collaborating with General Partners (GPs) to do so. These challenges facing GPs in executing steps toward net-zero contribute to asset owners not receiving the data on net-zero that they expect or hope to receive from asset managers.

Reliance on GPs

The PE business model relies on generating growth to drive returns during a relatively shorter hold period (compared to the longer 20- or 30-year net-zero time horizon). This can disincentivize GPs from making the long-term capital expenditures necessary to facilitate a net-zero transition. Delivering on net-zero commitments also requires asset owners and their GPs to track and reduce emissions across their portfolios at a pace aligned with a net-zero goal. GPs face administrative challenges in collecting emissions data across portfolio companies. Most portfolio companies (particularly in the US) do not track or report on emissions prior to entering a GP's portfolio. Further, when portfolio companies begin tracking emissions, it can be a substantial undertaking that requires an appropriate budget and resources. As a result, many GPs typically do not pressure portfolio companies to track emissions. Further, GPs may be cautious to provide firm-level emissions disclosures that could result in scrutiny of their own sustainability practices. These hesitancies compound on challenges between net-zero and the PE business model.

As one of many investors in each fund, a singular asset owner's ability to influence GPs' appetites for tracking and reducing emissions can be limited. However, while it is difficult to individually influence a given GP, a GP may be responsive to broader investor trends. A 2022 ESG survey of asset owners conducted by ILPA and Bain & Company found that more than 30% of respondents had already set net-zero commitments.[5] As the number of asset owners with net-zero commitments grows and these commitments flow into fund underwriting, PE firms will increasingly be incentivized to integrate decarbonization into their investment management strategies.

[5] Bain & Company, Limited Partners and Private Equity Firms Embrace ESG

Timelines for Implementing Net-Zero

Asset owners distribute across different asset classes and industries. A climate action plan that works for one asset owner may not work for another. To implement net-zero, asset owners must first decide on carbon reduction targets that are both feasible and desirable for their existing asset makeups.

The specifics of implementation timelines may vary between asset owners, but net-zero pathways should aim to achieve net-zero by 2050, alongside intermediate goals, which are necessary to keep targets under a 1.5° scenario. Achieving net-zero in the long-term will not be possible without setting intermediate goals, like pushing portfolio companies to begin tracking emissions.

Asset owners making net-zero commitments will need to prioritize setting realistic transition timelines. Those that cannot feasibly meet a 2050 net-zero transition goal can still identify and commit to a realistic longer-term transition timeline that mitigates climate risk and capitalizes on related opportunities at a pace aligned with broader institutional priorities.

Strategies for Implementing Net-Zero

Asset owners with net-zero transition plans may also leverage the Net-Zero Asset Owner Alliance's (NZAOA's) framework for implementing a net-zero commitment, as well as resources and best practices from peers successfully pursuing net-zero plans. Joining a community of like-minded peers can be helpful to connect with others on the net-zero path.

Net-zero transition strategies typically involve a blend of prevalent approaches, which asset owners should leverage to create their own transition plans. Prevalent transition strategies include the following, in escalating order of relative difficulty and complexity:

- **Economic Intensity** – an approach that seeks to drive greater carbon efficiency per dollar by investing in more energy efficient companies and/or ceasing to finance major sources of emissions. Asset owners can improve carbon efficiency of their portfolios by investing in sustainability-oriented funds and with GPs that integrate ESG considerations into their investment processes.

- **Portfolio Coverage** – another strategy well-suited to PE investments, portfolio coverage takes a bottoms-up approach to facilitating net-zero transitions by increasing the percentage of net-zero-aligned GPs, funds, and assets in an asset owner's portfolio. Portfolio coverage for net-zero can be executed by either investing with GPs that already have net-zero goals, or with GPs that support their portfolio companies in developing and executing transition plans.
- **Sectoral Decarbonization/Capacity/ Technology-Based Reductions** – a method that right-sizes carbon intensity reduction targets to reflect the paces at which different sectors and economic activities decarbonize. For example, fossil fuel industries cannot expect to decarbonize at the same rate as low-carbon industries. Sectoral pathways provide a useful benchmark for asset owners to align their investment activities with broader net-zero goals and create specific plans for increasing engagement or decreasing investment in certain sectors.
    - Most asset owners focused on these reductions align their emissions reduction plans to sectoral decarbonization pathways defined by the International Energy Agency. Other sectoral pathways include Goldman Sachs' sectoral decarbonization framework and the Transition Pathway Initiative's (TPI) Sectoral Decarbonization pathways.[6]
- **Absolute Contraction** – a one-size-fits-all method that ensures that companies setting targets deliver absolute emissions reductions in-line with global decarbonization pathways. For asset owners, absolute contraction typically requires divestment from carbon-intensive industries.

While carbon offsets are not permitted within certain frameworks such as the Science Based Targets initiative (SBTi), investment in carbon offsets may be a necessary final step to minimize residual emissions that cannot otherwise be accounted for. Offsets, or 'negative emissions' within an asset owner's net-zero plan should be minimized, given limitations of current carbon capture technology and the quantity of carbon that nature can absorb. Such considerations should be included as part of an asset owner's net-zero target.

Once an asset owner has decided on reduction targets and transition strategies, it should track reductions year-over-year to determine progress towards intermediate goals and ensure continued asset allocation and strategy decisions remain in-line with net-zero ambitions. To track their emissions within PE funds, asset owners must request emissions data from GPs or otherwise estimate emissions of portfolios. Estimates can be done via tools like Implied Temperature Rise, a forward-looking metric designed to show the temperature alignment of companies, portfolios, and funds with global temperature goals (e.g., Paris goal of 1.5°C).[7]

[6] IEA, An updated roadmap to Net Zero Emissions by 2050; Goldman Sachs, Carbonomics; Transition Pathway Initiative, TPI Sectoral Decarbonisation Pathways

[7] MSCI, What is Implied Temperature Rise (ITR)?

Engaging GPs on Net-Zero Objectives

The first step in engaging GPs on net-zero is understanding how a GP's approach to net-zero interacts with that of asset owners. GPs committed to net-zero are typically members of the Net-Zero Asset Managers (NZAM) initiative, enabling asset owners to easily identify GPs that align with their net-zero goals.[8] Given that public net-zero commitments verify intention and not necessarily execution, asset owners must ensure that GP progress against net-zero commitments is verified through annual disclosures of emissions data and qualitative updates on the status of transition strategies.

Most asset owners and GPs have yet to make net-zero commitments. However, the absence of a net-zero commitment in the present should not inhibit asset owners from beginning to decarbonize their portfolios and positioning themselves to make a future commitment. Adopting an incremental approach drives near term progress and can ultimately contribute to fully achieving net-zero. To that end, asset owners should leverage DDQs, annual reports, and investor meetings to gauge how their GPs already consider GHG emissions within their investment and asset management strategies and engage with them to build on existing initiatives. This collaborative incremental approach can enable PE asset managers to navigate the learning curve net-zero poses.

Asset owners pursuing net-zero strategies should encourage current GPs to adopt the following best practices and may wish to prioritize GPs that already maintain them:

- Tracking and reporting portfolio companies' GHG emissions using Initiative Climate International's (iCI) GHG Accounting and Reporting Standards for the Private Equity Industry, which supports uniform and consistent collection of GHG data across asset owners' portfolios[9]
- Leveraging climate change scenario analyses and portfolio decarbonization pathways to inform portfolio structuring and asset management
- Setting science-based emissions reduction targets through sustainability transformation and/or carbon offsets
- Showing awareness of European regulations (e.g., SFDR, CSRD) and proposed SEC rules in the US that are likely to expose emissions-intensive portfolios to investor

[8] The Net Zero Asset Managers initiative

[9] PRI, Greenhouse Gas Accounting and Reporting for the Private Equity Sector

Net-Zero Resources and Initiatives

Asset owners can support GPs' efforts to understand net-zero for PE and set targets using iCI's guidance on net-zero in PE.[10] For specific guidance on setting science-based targets, firms should look to extensive guidance provided by the SBTi, the most broadly accepted goal setting and reporting framework for net-zero. See below for additional net-zero resources:

INITIATIVE OR RESOURCE	DISCLOSURE DESCRIPTION
Glasgow Financial Alliance for Net Zero (GFANZ)	GFANZ is a global coalition of over 550 financial institutions (FIs) committed to reaching net-zero by 2050. GFANZ serves as a forum for FIs to collaborate and share resources on how to address sector-specific decarbonization challenges. Find more information here.
Initiative Climat International (iCI)	The iCI was founded by a group of French PE firms supporting the Paris Agreement's objective of limiting global warming to below 2 degrees Celsius. Additionally, a North American Chapter was initiated in 2022. Members commit to sharing knowledge, experience, and best practices to help standardize practices on climate risk mapping, disclosure, and target-setting in PE. Find more information here.
Net-Zero Asset Managers (NZAM) Initiative	NZAM is an international group of asset managers committed to supporting net-zero GHG emissions by 2050 or sooner. It currently hosts $43 trillion AUM and is a helpful resource for firms looking to set net-zero goals. Find more information here.
Net-Zero Asset Owner Alliance (NZAOA)	The NZAOA is an alliance of asset owners committed to reaching net-zero emissions in portfolios by 2050. The NZAOA represents $10.6 trillion AUM (~10% of global AUM) and contains several asset owners that are encouraging managers to align with Net-Zero.[11] Find more information here.
Science Based Targets Initiative (SBTi)	The SBTi is a partnership between CDP, the United Nations Global Compact, World Resources Institute (WRI) and the World Wide Fund for Nature (WWF). Science-based targets are the most widely recognized standard for companies and financial institutions around net-zero target setting and tracking. SBTi provides clear step-by step guide. Find more information here.
UN Race to Zero	Race to Zero is a global campaign to rally leadership and support from business, cities, regions, and investors for a resilient zero-carbon recovery. These actors cover nearly 25% of global emissions and over 50% of GDP. Find more information here.

[10] PRI, A Case for Net Zero in Private Equity

[11] PWC, Global Assets under Management set to rise to $145.4 trillion by 2025

Supplementary
Industry Guidance

The ESG Data Convergence Initiative provides a good starting point for LPs and GPs looking to contextualize net-zero initiatives through a broader ESG lens or start with a foundational analysis of portfolio climate change data prior to evaluating net-zero goals.

INITIATIVE OR RESOURCE	DISCLOSURE DESCRIPTION
ESG Data Convergence Initiative (EDCI)	The EDCI is a partnership of PE managers committed to streamlining collection and reporting of ESG data in private investments. While EDCI does not directly support net-zero initiatives, it provides a framework for PE GPs to report their portfolio's Scopes 1, 2, and 3 emissions, which can form the basis for future net zero efforts. The EDCI covers GHG emissions as part of a broader dataset, including renewable energy, diversity, workplace safety, job creation, and employee engagement. Find more information here.