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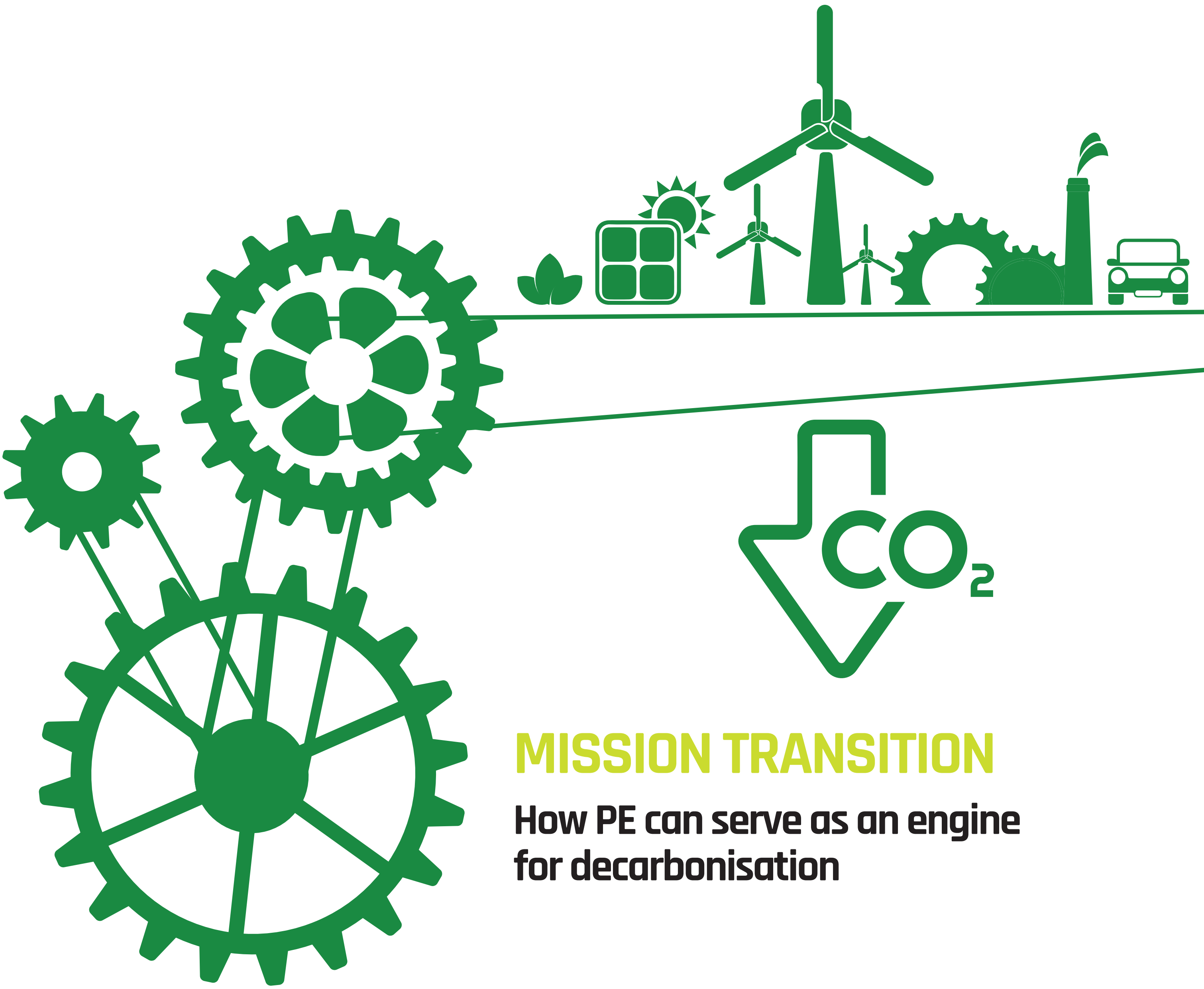
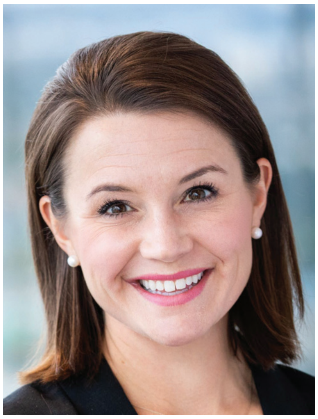


MISSION TRANSITION

How PE can serve as an engine for decarbonisation

KEYNOTE INTERVIEW

Embedding sustainability into business plans



As regulation proliferates, GPs are increasingly turning to scenario analysis and taking a more integrated approach to sustainability and impact considerations, say KPMG's Elizabeth Ming and Simon Weaver

Q How can private equity firms support management teams in building the business case for sustainability?

Simon Weaver: A term I frequently use with clients is reporting-driven transformation. There is a significant amount of regulation that is impacting private equity firms in Europe and beyond right now. Ultimately, the reason those reporting rules are there is to try to shift the economy, even though at times it may feel like a lot of work and a lot of metrics for no clear reason. However, in many organisations it is the regulatory backdrop that plays a key role in driving the business case.

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The focus needs to be on what is material to you as an organisation, making sure you have a value lens from day one and that you are measuring the right things in order to run your business to maximise value and drive sustainability.

That is where the business case for sustainability comes in. There will be short-term business case actions that you can do today to improve the bottom line in the next 12-18 months, and others that take longer. A good example is putting LED lights into all the buildings in a hotel portfolio, which has a big sustainability impact by improving energy efficiency, but also cuts costs so is an easy win.

But what about building the business case when returns are not that immediate? For private equity, there is a tipping point that depends to a large degree on the hold period for an investment, because if benefits will not create value at exit based on the exit strategy or operationally will not kick in until after exit then an investment that will impact sustainability may not be worth making.

Elizabeth Ming: There are three groups that have levers that influence that tipping point Simon has mentioned: consumers, regulators and the corporate finance world. We talk about consumers looking for more sustainable products and services, but for the most part, when you put in a pricing differential, the data today suggests the majority are not going to shift behaviours for sustainability. So, customers will likely have a limited influence over that tipping point.

The corporate finance world is prioritising sustainability but has a fiduciary responsibility to focus on returns, thus leaving policymakers to drive change. It is regulations like the Taskforce on Climate-Related Financial Disclosures (TCFD) and the Corporate Sustainability Reporting Directive (CSRD) that will underpin transparency for the market, and regulations such as the Carbon Border Adjustment Mechanism (CBAM) and the German Supply Chain Due Diligence Act creating the business cases and increasingly driving behaviours.

SW: Indeed, we recently published a report with the World Business Council for Sustainable Development – *Building the Business Case for Sustainability* – which looks at key drivers, such as regulation, and provides a guide to embedding sustainability into business strategies.

Q Where do you see firms focusing their sustainability initiatives?

EM: One key focus area is the energy transition. Private equity firms understand both the financial opportunity and the impact they can have on the energy transition. We see private equity committing to and actively investing in every part of the infrastructure and supply chain that is going to be necessary to transition energy sources.

SW: We are also seeing a number of leaders in this space focusing on the scenario analysis aspects of sustainability regulations. That leads you to start having different conversations around planning horizons. In the private equity world, funds are looking at how long they will hold an asset and how different scenarios might play out. Scenario analysis allows you to put financials around that, influencing that tipping point discussion.

A fund might think about the jurisdictions in which a company operates, and the impact that carbon pricing would have if it were to be introduced in those markets. Scenario analysis can help work through what that would mean for value in the company and for that business versus its competitors, for example.

It can also be used to consider the reputational risk of certain actions, whether something will have a sudden impact on value and, if so, how long

Q What are the biggest challenges when it comes to developing actionable steps and key KPIs?

EM: The time horizon is probably the biggest challenge when it comes to implementation by private equity firms. Another challenge is data, which is still a developing area but is essential for understanding the financial implications, and supporting both the impact and the return story. Until we have the data to fully understand those implications and plot it against the time horizon of an investment, it will be difficult to build clear action plans.

SW: If you imagine for a moment that you have perfect data, then the challenge is whether you have the right mindset. The level of awareness of most business leaders in terms of how sustainability will have a financial impact is limited, so the data needs to make the case. The worry is that we use data as an excuse when in fact solving the data won't necessarily solve the bigger problem around shifting to a longer-term mindset.

Another challenge is that because sustainability cuts across organisations in so many different ways, it often butts up against broader cultural issues. You might have a strong group-level approach, for example, but the portfolio companies or subsidiaries are not on board because there is a command-and-control relationship. The challenge is to make sure everyone is on the same page and genuinely working together to drive through sustainability actions.

that will take to recover. Reputational risk is harder to put a value on than something like carbon tax, but by looking at examples from other industries you can consider how certain scenarios might play out.

We are doing a lot of light-touch scenario analysis with funds to identify both challenges and opportunities within their portfolios, because the energy transition creates value-creation opportunities as well.

EM: Additionally, scenario analysis can be an important part of due diligence, identifying both risks and opportunities. We are seeing very real examples of deals stalling because regulations are going to have a significant impact on the cost of doing business. Whether it is an increase in the price of jet fuel in certain jurisdictions or the introduction of carbon pricing, existing and emerging policies and regulations can have a meaningful impact on the return profile of a business.

Q How important is it to measure impact, and what innovations are you seeing there?

EM: Measuring impact is critical to understanding progress and prioritisation. There are some meaningful industry efforts going on to create good benchmarking data, such as those by the Global Impact Investing Network and GIST Impact, in order to understand impact and financial correlations. Then there are efforts like the ESG Data Convergence Initiative, which are more about building standard definitions and templated methods for measuring and reporting metrics deemed to be more broadly decision-useful by market participants.

SW: Focusing on carbon emissions, I am talking to clients about a shift away from targeting Scope 1, Scope 2 and Scope 3 emissions, which often scares boards. Instead, the Transition Plan Taskforce talks about control and influence, which is a better conversation for management teams. There you think about what your organisation is responsible for and can control, what areas you have some level of influence over and what you are happy for the broader market to know you cannot influence but will measure and monitor.

That allows management to focus on what they can control and influence, rather than spending too much time and energy talking about things they can do little about.

The leaders in asset management are also starting to embed key sustainability metrics into business planning at the portfolio level. That is a shift that has started to gather pace in the last 12-18 months. Previously, we saw sustainability plans running parallel to business plans, and spending plans might be thrown out by chief financial officers in favour of other priorities. We are now seeing asset managers starting to drive that much more interconnected approach at a system level, which will make a big difference.

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>
> **ELIZABETH MING**

> *"We are seeing a number of leaders in this space focusing on the scenario analysis aspects of sustainability regulations"*
>
> **SIMON WEAVER**

Q What are the big themes private equity firms should prioritise around impact?

SW: For me, it is about sticking to the basics, because a lot of what we are describing is difficult to do. Make sure you focus on what you can control and influence, and do not try to solve too many things at once, otherwise you will solve nothing. Then, challenge yourself on scenario analysis and on opportunities and risks, but just start out with two or three things you know you can do well. That is a good way to build momentum, start to shift mindsets, and then going forward it becomes easier.

EM: The focus needs to be on execution, and telling the collinear value and impact story with real-life examples. Whereas five years ago we were very much focused on data and the theoretical, now it is time to execute.

In terms of topics, I think water will continue to be a focus area. That is not a new issue, but water quality and access to safe water and sanitation is now coming into focus for private equity and impact investors. Then there is the nexus of climate and healthcare, which is also moving into the spotlight and could present a lot of opportunities for investors. Finally, with the evolution of artificial intelligence, a focus on climate conscience AI infrastructure, including data centres, will be an investment priority. ■

Elizabeth Ming is the lead sustainability partner in KPMG's private equity practice and Simon Weaver is global head of ESG advisory at the firm