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PERSPECTIVES

THE "GREAT BIFURCATION": HOW SUSTAINABILITY IS RESHAPING THE EFFICIENT FRONTIER OF PRIVATE EQUITY INVESTING

Private equity LP expectations are converging, fueling the demand for so-called "green assets". GPs have long recognized this trend and are progressively adapting their model to meet client expectations. This is becoming even more critical today as:

- The institutional channel has ground to a halt for new private equity allocations, especially those not aligned with sustainability objectives;
- Governments in Europe and the US are pouring increasing amounts of money into the energy transition, turning the green sector into one of the most compelling investment opportunities of the coming decade.

This renewed focus on green assets has the potential to usher in a new efficient frontier for private equity investing, and, in turn, create a clear segmentation of investment strategies and competitiveness drivers for GPs.

The private equity sustainability playbook

European asset owners have been at the forefront of the sustainable finance wave[1]. With the growth of private market portfolios during the past low-rate period, sustainable finance policies logically expanded to this allocation bucket, driven by:

- The growing use of ESG factors in risk assessment methodologies;
- The assumption that the strong alignment of assets with sustainability objectives can generate long-term performance;
- New regulatory requirements such as SFDR[2] or the EU Taxonomy[3].

This benefits thematic and impact strategies, particularly in the private equity asset class, which is perceived by LPs as the most natural area to put the sustainability toolbox into practice.

In order to meet these expectations, GPs have embarked on a journey to gradually integrate sustainability into their strategy and investment processes:

- A first step was to integrate ESG criteria throughout the entire investment cycle, with a particular focus on transparency and reporting.
- A second step has been to publicly commit to specific sustainability objectives (in particular, climate related): GPs have committed to reduce carbon emissions in their portfolio holdings and are aiming toward carbon neutrality over the long term.
- The latest stage of sustainability integration for GPs is centered on impact objectives, including financing the ecological transition or safeguarding biodiversity.

1. See Indefi, "Beyond the tipping point", Sustainable investment in institutional Europe, Nov. 2019.
2. Sustainable Finance Disclosure Regulation, Regulation (UE) 2019/2088.
3. Regulation (EU) 2020/852.

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Emergence of a new framework for private equity investments

One of the main consequences of these changes in investment dynamics is a wide-scale asset repricing.

Green businesses are today perceived as low-risk, stable and easy to exit.

At the other end of the spectrum, companies involved in carbon-intensive sectors, such as industry or aviation, or those prone to unethical practices, are increasingly categorized as vulnerable or stranded assets and priced at a discount. Already, exit deals are failing for steadily performing businesses in non-controversial sectors (e.g. tourism) for sustainability reasons, because buyers will only consider the transaction on an adjusted EBITDA multiple, while GPs lacking in foresight are reluctant to sell at a discounted value.

Following this logic, and applying a real asset framework of reference, the private equity asset class could break up into core, core+ and value-add segments. However, private equity will differ from real assets in that value-add strategies will be predicated on the sustainable attributes of the underlying asset.

Currently, a significant share of legacy private equity portfolios should be considered vulnerable assets, including already identified "brown assets", and would therefore fall within the scope of value-add strategies.

This realization will drive increasing return expectations, commensurate with the implied level of risk. It would also offer the opportunity for what will become the mainstay private equity playbook of the years to come: supporting the transition of companies to more sustainable business models – so-called "brown-to-green" strategies.

Implications for private equity investors

The emergence of a new framework for private equity investments based on the sustainable nature of the underlying asset has significant implications.

LPs need to know what they are buying. Is the investment strategy aligned with the Paris agreement or targeting a 4° portfolio? GPs will have to clearly articulate their investment strategy along the efficient frontier and adapt their return targets accordingly.

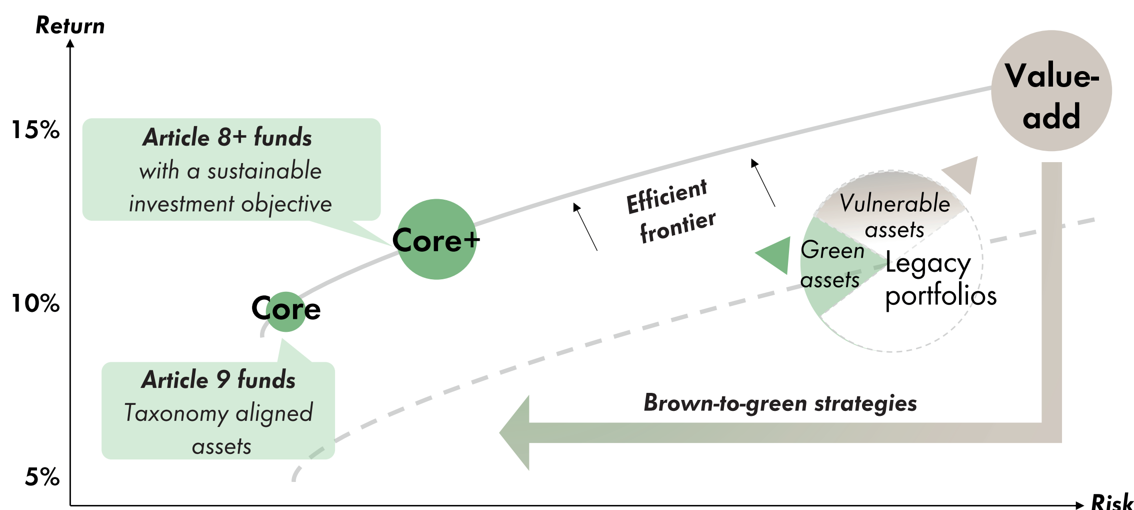
In addition, competitiveness factors at the GP level will change.

Core/core+ strategies will primarily be assessed on deployment capability (which entails the ability to identify and conduct a comprehensive assessment of the sustainability quotient of an asset). This further fosters the ongoing commoditization of private equity, currently driven by its mainstreaming and democratization towards the individual investor.

Value-add strategies will offer the main source of differentiation for GPs, provided they are able to implement a new value creation playbook and ensure the effective conversion of vulnerable assets. This requires:

- Effective integration: Expand in-house sustainability expertise within the investment team to define and implement remediation action plans;
- Dedicated talent: Hire and allocate impact operating partners dedicated to supporting the execution of sustainable transition initiatives for portfolio companies;
- Scaled approach: Define build-up strategies contributing to the accelerated "greening" of the asset.

Chart 1: The new private equity efficient frontier



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