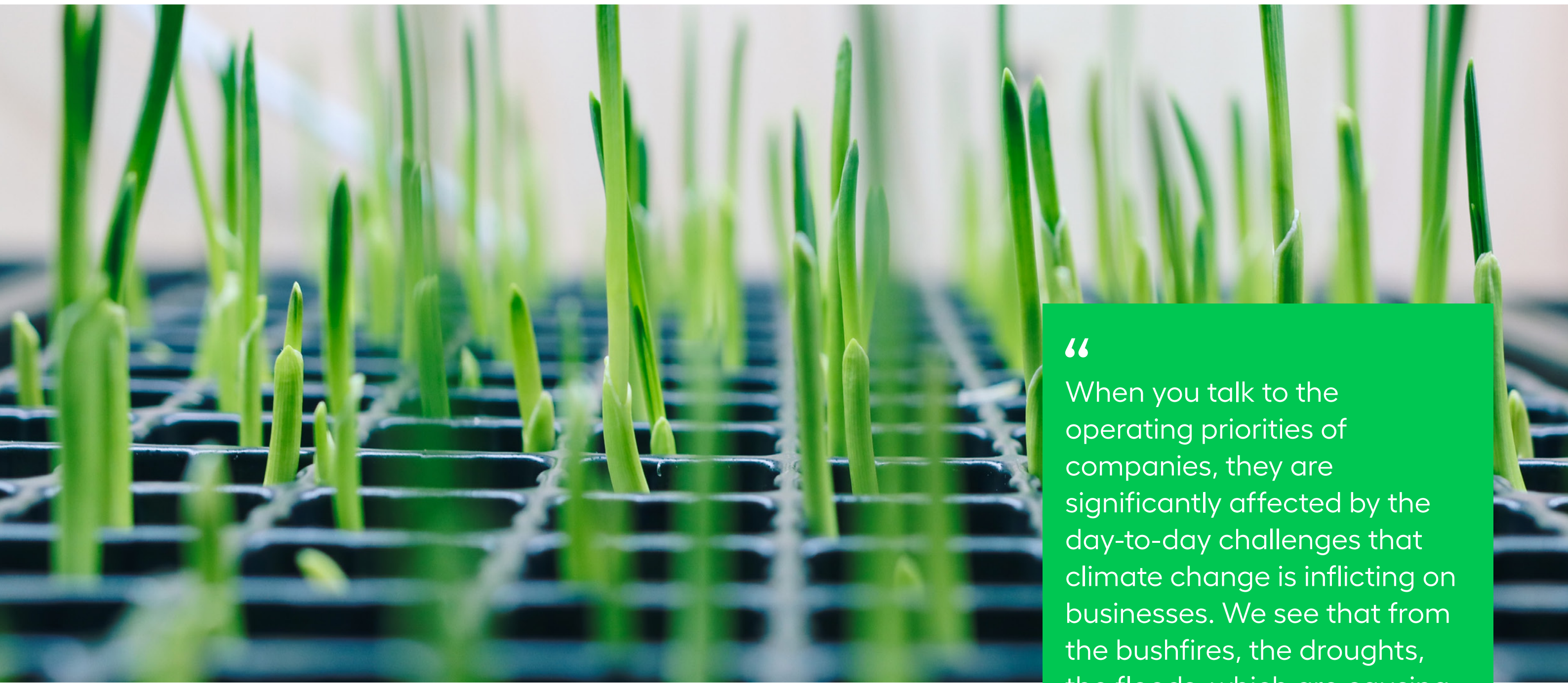
Private equity and the race to net zero emissions

Achieving net zero emissions is becoming the 'new normal' for investors, lenders, customers, and regulators. How can private equity draw on its unique ownership relationships and business transformation skillset to lift the sustainability performance of portfolio companies? And is there a way to convert the net zero transition into a value driver for private equity when it comes to business growth and exit?



Adamantem Capital Fund II

$795m
total fund size

$80m
first CEFC private equity investment

10-year
net zero emissions strategies

Decarbonisation gathers momentum

In Australia and around the world, the race to decarbonisation is gaining momentum. The outcomes of the United Nations COP26 Glasgow climate summit, as well as accelerating investor and consumer preferences for low emissions investment opportunities and sustainable products have confirmed that decarbonisation investment is growing as we move towards net zero emissions.

While there is mid-term focus on achieving net zero emissions by 2050, markets are facing increasing pressure to meet substantial nearer term goals, including halving emissions by 2030. In parallel, regulators across multiple jurisdictions are moving towards mandatory sustainability reporting.

This trend to increased Environmental, Social and Governance (ESG) accountability and transparency is likely to be just as critical for private equity, whether in the capital raising, acquisition, ownership or exit phases. The sector is uniquely positioned to drive the transition at a business level given its ownership stake and governance rights in companies, ability to conduct deep due diligence, board membership and deep strategic engagement with asset managers.

> "When you talk to the operating priorities of companies, they are significantly affected by the day-to-day challenges that climate change is inflicting on businesses. We see that from the bushfires, the droughts, the floods, which are causing all sorts of operational disruptions. By getting a baseline of climate risks and carbon intensity we're in a better position to work with management to mitigate those risks, even in a 3-5-year hold period."
>
> **Rob Koczkar**
> Managing Director, Adamantem Capital

The investment

In its first investment in private equity, the CEFC made an $80 million cornerstone investment in Adamantem Capital Fund II, to pursue a strategy of driving ambitious emissions reduction targets across a diverse range of private equity-owned, mid-market companies.

Aware Super, one of Australia's largest superannuation funds, also made an $80 million cornerstone investment in the fund. Aware Super, which manages more than $150 billion on behalf of its 1.1 million members, has committed to transition its investment portfolio to net zero emissions by 2050.

An Australian private equity firm, Adamantem Capital currently has more than A$1.5 billion in funds under management across two funds. It invests in mid-market opportunities in Australia and New Zealand, with a focus on business transformation aiming to deliver outstanding financial returns alongside positive contributions to social and environmental outcomes through a responsible investing approach and portfolio company stewardship activities.

> "Private equity has an important role to play in giving companies the practical support, or 'scaffolding', to take action on climate. There are no established norms on how to address many of the ESG issues we come across, and the requirements are changing rapidly – so it takes an entrepreneurial mindset and a willingness to experiment a bit, using the facts and knowledge that you have at hand."
>
> **Natasha Morris**
> Managing Director, Responsibility and Impact, Adamantem Capital

Australian-first "cradle to grave" approach

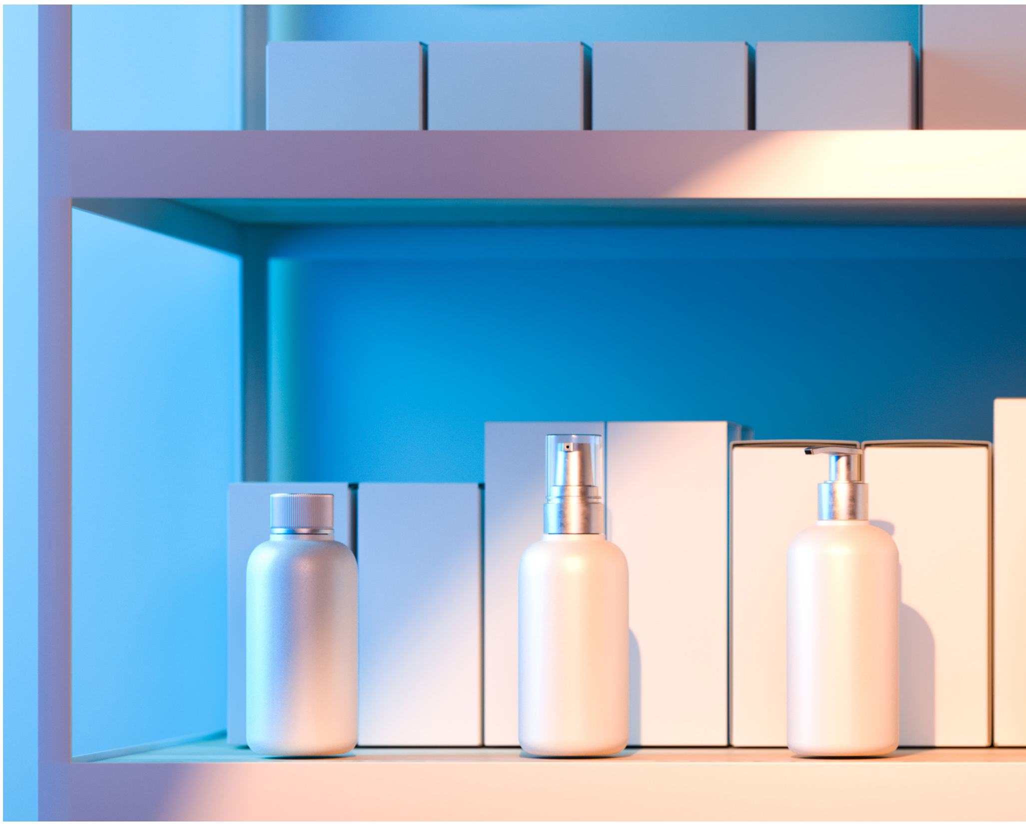
The Adamantem Capital Fund II adopts a "cradle to grave" approach to the emissions impact of its assets – committing to developing net zero emissions reduction strategies for each portfolio company in the Fund targeting net zero in relation to Scope 1 and Scope 2 emissions within 10 years of acquisition.

The $795 million Fund II targets mid-market companies, with a focus on three key sectors; consumer staples, healthcare and business-to-business services.

This approach begins prior to acquisition with an assessment of the physical and transition climate risks and opportunities for each asset during the due diligence period. Following acquisition, the baseline Scope 1 and Scope 2 greenhouse gas emissions of each asset are measured, and a pathway to achieve net zero scope 1 and 2 emissions within 10-years of acquisition is developed.

Adamantem works closely with the management team of portfolio assets to pursue the 10-year target, supporting the identified emissions reduction initiatives to the extent they enhance the value of the portfolio company for the benefit of the Fund during its hold period.

Ongoing measurement and reporting provides transparency and accountability, and endorsement at the asset level ensures long term objectives transcend the life of the asset in the Adamantem fund.



Integrating climate change into risk assessment and due diligence

Adamantem considers climate change risks and opportunities as part of its broader approach to responsible investing across the investment lifecycle.

> We know that climate change poses one of the most significant financial risks to our portfolio and our members' retirement savings in the long term. We believe we can generate strong long term returns while also supporting the economy to transition."
>
> **Jenny Newmarch**
> Senior Portfolio Manager – Private Equity Growth Assets, Aware Super

Supported by an underlying responsible investing theory of change, Adamantem integrates ESG considerations into its investment decision making process and portfolio company stewardship activities to support its aim of delivering outstanding financial returns and positive contributions to environmental and social outcomes.

Climate change is one of the most important components of the Environmental Sustainability pillar of the Adamantem responsible investing strategy, which is defined as "reduced impact on the natural environment and contribution to climate solutions to avoid deterioration of natural resources."

Since 2020, Adamantem has used a framework aligned with the Task Force on Climate-Related Disclosures to assess both transition and physical climate risks for each potential investment that reaches the final stages of the investment evaluation process.

These climate risk assessments, supported by an expert climate consultant, use scenario analysis to enable Adamantem to analyse how climate-related risks and opportunities might impact an investment under a range of possible climate scenarios. The analysis may be qualitative or quantitative, depending on the nature of the investment, the level of climate risk exposure and the data available.

As well as being an important tool for ensuring robust consideration of climate risk to support better investment decision-making, the climate risk assessment results provide a useful baseline for managing and mitigating climate risk within portfolio companies during Adamantem ownership.

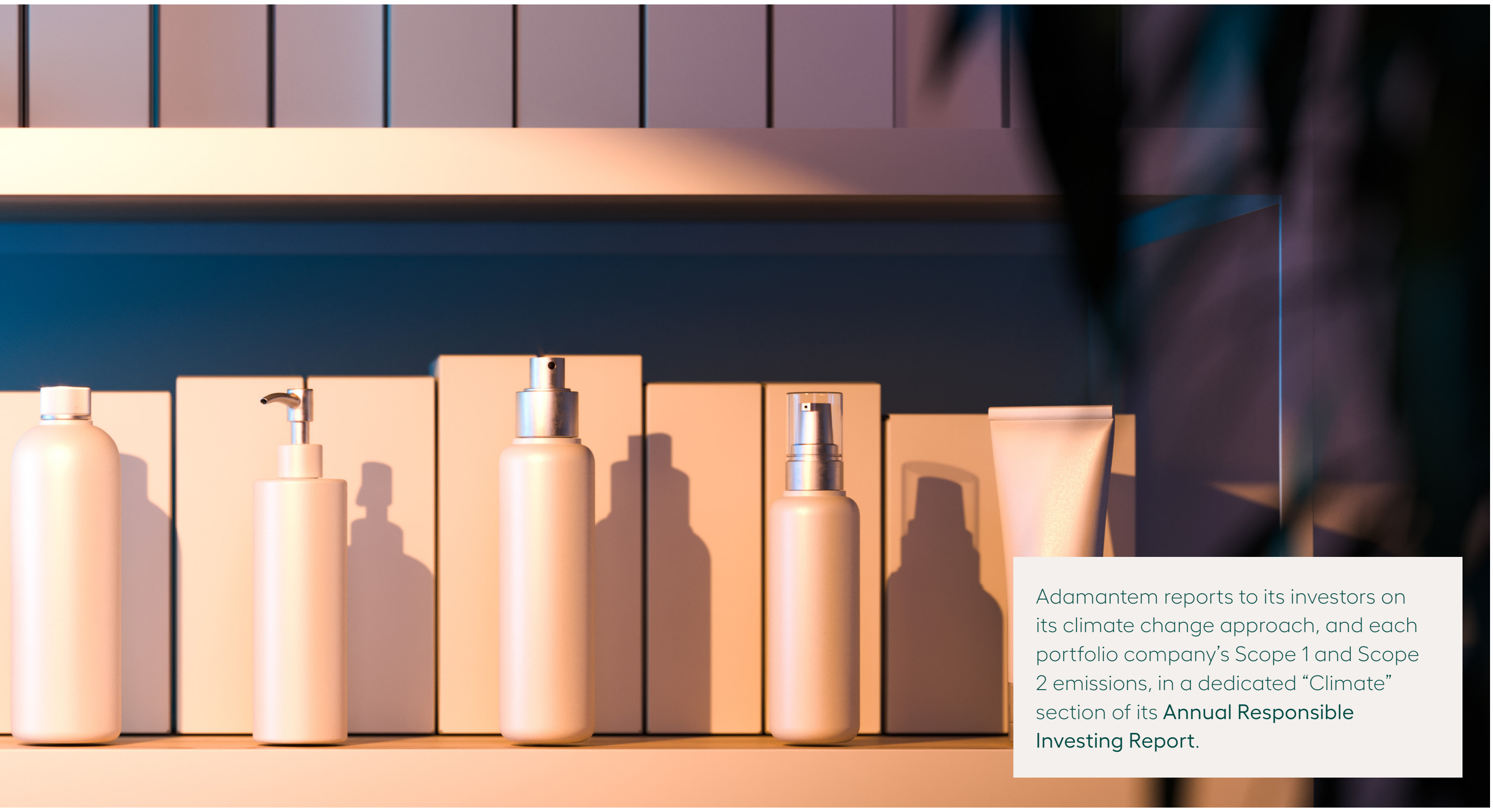
A minimum of two scenarios are used to assess both transition risks and physical risks, based on global climate models:

Transition Risk Scenario

A high transition risk and low physical risk profile

Physical Risk Scenario

A high physical risk and low transition risk profile



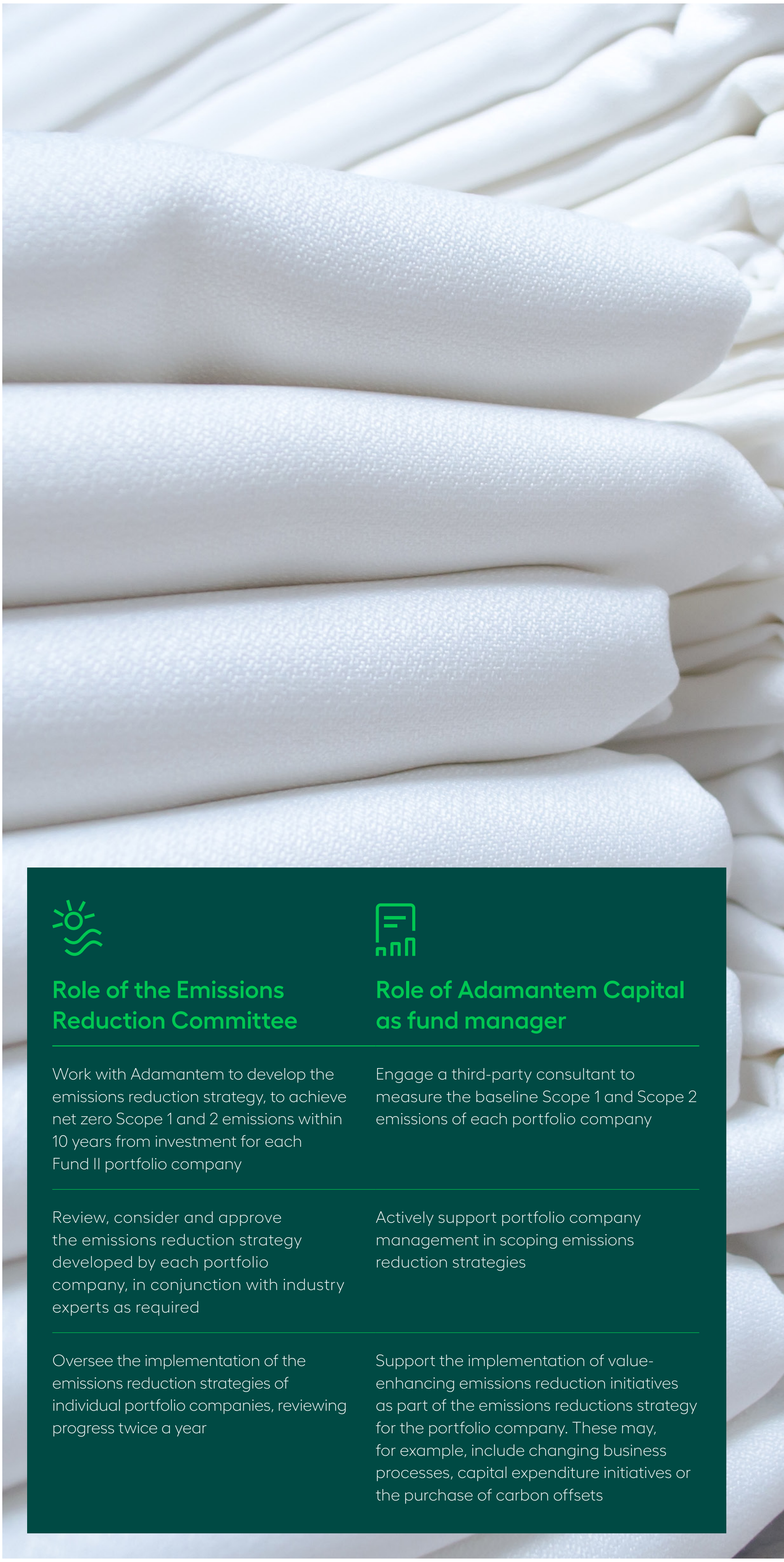
Adamantem reports to its investors on its climate change approach, and each portfolio company's Scope 1 and Scope 2 emissions, in a dedicated "Climate" section of its Annual Responsible Investing Report.

Fund II Emissions Reduction Committee

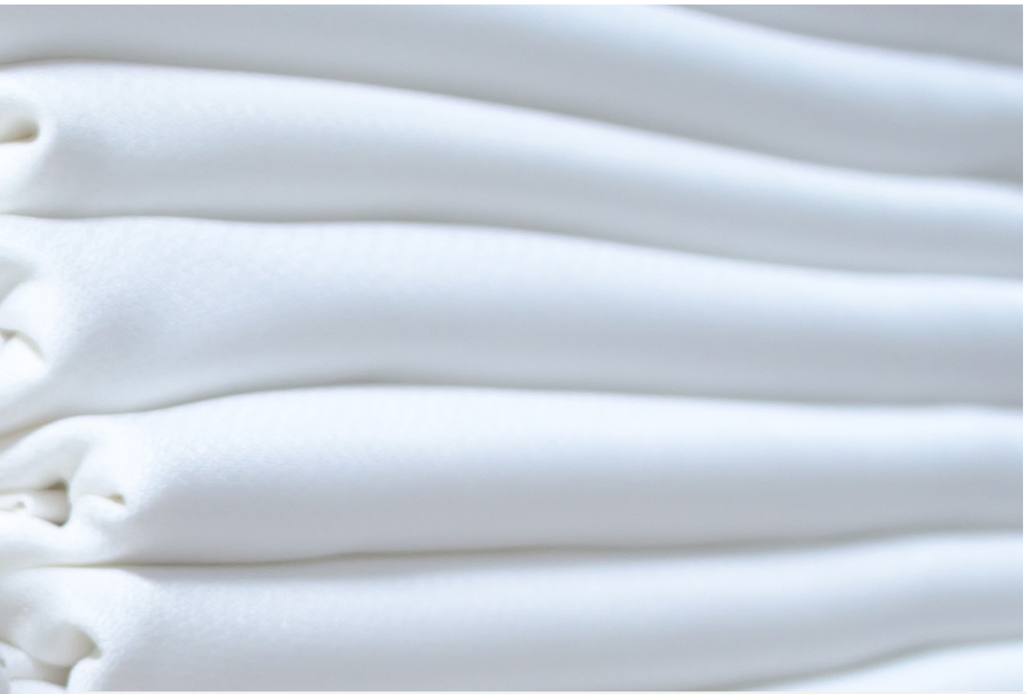
Adamantem has established a Fund II Emissions Reduction Committee to work with Adamantem on the net zero strategies developed by the portfolio companies within the Fund. The committee is driven by Adamantem and comprises representatives from Fund II investors.

PwC has forecast the value of global private equity assets will grow by as much as 40 per cent to more than US$8 trillion by 2025. In Australia, latest Australian Investment Council figures show that private equity investment contributes about $47 billion to the economy across a wide range of sectors, including healthcare, consumer goods and retail, financial services, energy and the environment.

> "For superannuation funds and institutional investors generally, the transition to net zero emissions by 2050 has become the new normal for us. You have to be thinking about what levers you can pull in your listed equity strategies, your credit strategies, your private and unlisted market strategies, and there needs to be a connection across the whole of the portfolio around achieving those objectives. And it's not easy. It's a path we were hesitant to get started on several years ago. Now it is effectively front and centre of our investment strategies as we go forward."
>
> **Andrew Major**
> Chief Risk and Compliance Officer, HESTA



Role of the Emissions Reduction Committee	Role of Adamantem Capital as fund manager
Work with Adamantem to develop the emissions reduction strategy, to achieve net zero Scope 1 and 2 emissions within 10 years from investment for each Fund II portfolio company	Engage a third-party consultant to measure the baseline Scope 1 and Scope 2 emissions of each portfolio company
Review, consider and approve the emissions reduction strategy developed by each portfolio company, in conjunction with industry experts as required	Actively support portfolio company management in scoping emissions reduction strategies
Oversee the implementation of the emissions reduction strategies of individual portfolio companies, reviewing progress twice a year	Support the implementation of value-enhancing emissions reduction initiatives as part of the emissions reductions strategy for the portfolio company. These may, for example, include changing business processes, capital expenditure initiatives or the purchase of carbon offsets



Fund II portfolio companies

Adamantem Fund II has invested in three portfolio companies, deploying approximately $240 million of capital to 30 June 2022.

It is aiming to fully invest the remainder of the fund during the 5-year investment period, to June 2025.

	Linen Services Australia	Climate Friendly	NAK Hair
Business focus	Specialist provider of healthcare linen and garment laundry services	Leading developer of land-based carbon offsets	Australian formulated and vegan haircare products
	~4,500 customers across Australia and NZ	>130 registered carbon projects	Australia's leading professional haircare company
	>110m textile items processes annually	>11m hectares nationwide	~$40m annual sales
Scope 1 and Scope 2 emissions baseline	55,318 t CO_2-e (FY21)[1]	140 tCO_2-e (CY19)[2]	To be developed
Scope 1 and Scope 2 key emissions sources	Natural gas, electricity, transport fuels, steam and LPG	Transport fuels and electricity	To be developed
Identified emissions reduction initiatives	A range of initiatives across energy efficiency measures, capital investment initiatives, renewable energy procurement, monitoring of future technology and fuel switching opportunities and procurement of carbon offsets	Annual organisational carbon neutral certification through the Climate Active Scheme, with a Sustainability Working Group overseeing improvements to organisational sustainability practices	To be developed
Alignment with business objectives	The Linen Service Australia approach to sustainability within its operations and the increasing focus of its customer base on the sustainability credentials and actions of suppliers are supporting greenhouse gas emissions reduction.	A focus on their own greenhouse gas emissions footprint is aligned with Climate Friendly core business. By the end of 2020 Climate Friendly had supported the generation of more than 15m carbon credits to farmers and delivered ~20m tonnes of abatement through supported projects.	NAK Hair has a continually evolving approach to sustainability, including in relation to the ingredients it uses, the packaging of its products and the sustainability of its operations. This approach, and its customers' increasing awareness of environmental issues, are aligned with emissions reductions.

1 As estimated by an independent consultant in the HT HoldCo – FY21 Baseline emissions summary report 20 August 2021.

2 Based on Climate Friendly Climate Active Public Disclosure Statement

The changing climate for private equity

Global analysis from CERES and the SustainAbility Institute confirms private equity expectations that future investment performance will be significantly impacted by climate risk.

The Institute's Changing Climate for Private Equity report assessed private equity readiness to integrate climate matters in investment practices. The report reflected the views of 18 leading General Partners with more than US $1.9 trillion assets under management (AUM), as well as nine Limited Partners, with a collective US$1.3 trillion AUM.

It recommended the private equity sector prioritise consideration of climate-related risks and opportunities, while accelerating climate-related disclosure and transparency activities, drawing on science-based targets and standardised data, metrics and tools.

In addition, the sector should increase investment in companies offering low carbon solutions and technologies, and capture value by investing to lead decarbonisation of high emitting companies.

Climate drivers	Priority actions	Adamantem approach
Increased awareness of investment returns and opportunities	Support the implementation of emissions reduction opportunities that enhance the value of portfolio companies	"Cradle to grave approach" from initial due diligence to 100-day and then 500-day plans
Growing pressure from Limited Partners	Develop financially-feasible baselines, pathways and net zero plans	Emissions Reduction Committee involving all investors to provide transparency on decarbonisation pathways
Increased understanding of the systemic nature of climate impacts	Climate considerations integrated across the full investment lifecycle	External consultants engaged to develop baselines, pathways, capital expenditure requirements and payback metrics
Changing stakeholder expectations	Identify and capture value from investment opportunities	Educate investors on the payback/impact on exit multiples and resulting Internal Rate of Return
Regulatory change	Promote industry alignment with and adoption of existing and emerging ESG climate-related frameworks	Peer-to-peer discussions on challenges at an asset level and at an industry level

ESG reporting trends

Analysis of 120 ESG reporting instruments in 2022 by the UN Principles for Responsible Investment identified four significant reporting trends across nine jurisdictions including Australia:

1

Investment-related ESG reporting requirements are growing

with more than 90 per cent of reporting instruments requiring reporting that is either publicly accessible or directly reported to investors in a financial product, reflecting increased concerns about "greenwashing".

2

There is a move from "tell me" to "show me" reporting

with product providers increasingly expected to explain how ESG considerations or objectives are reflected in the fund's holdings or its sustainability performance.

3

ESG issue-specific reporting is growing

extending from fiduciary duties to voluntary reporting around climate action plans, targets and progress.

4

Global consensus on investment-related ESG reporting is slow

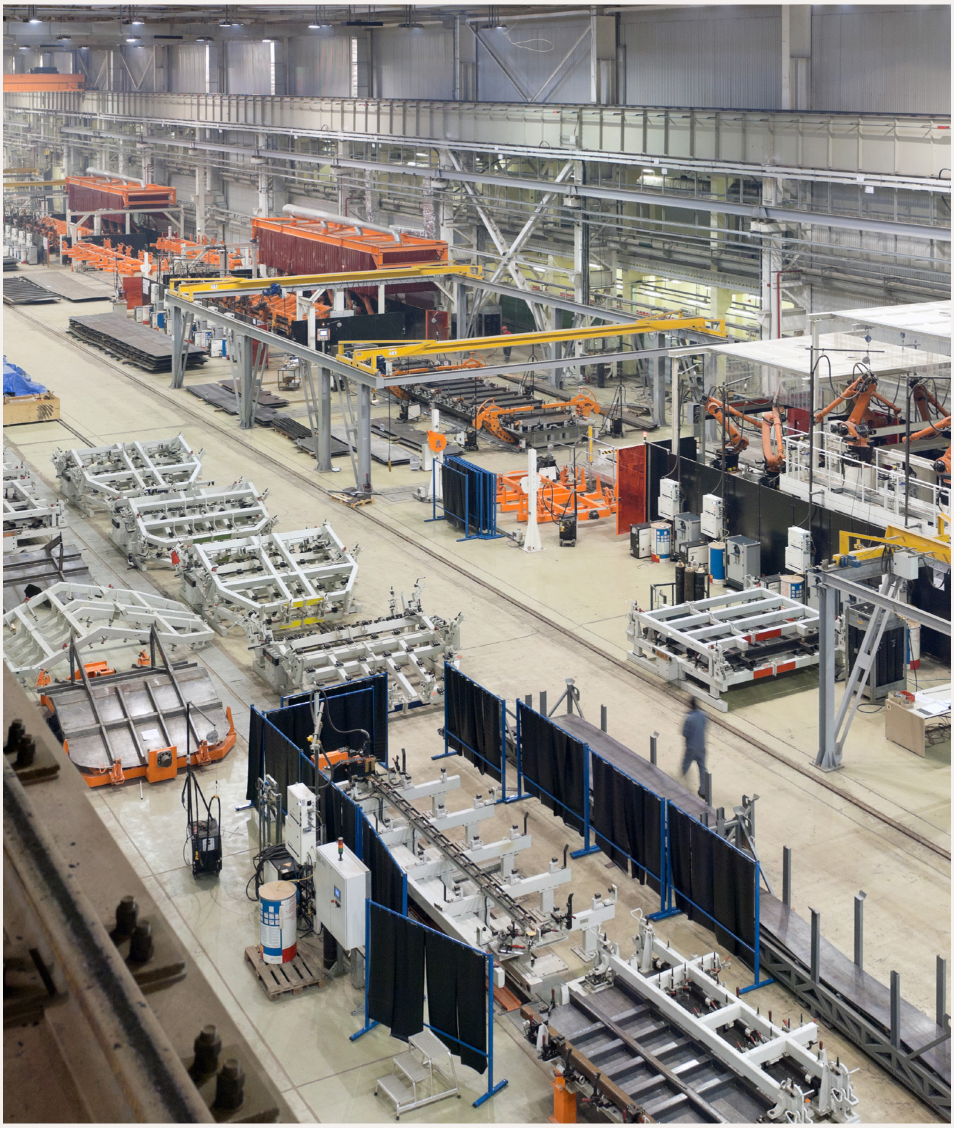
while there are some near-universal reporting requirements, such as proxy voting, ESG reporting remains subject to a range of different national legal, market and political factors.

In the Green Room with the CEFC

The Green Room | Clean energy conversations with the CEFC

We are seeing a heightened focus on net zero emissions, whether from investors, regulators or businesses. With record levels of capital to invest, what are the implications for private equity funds, and for their portfolio companies?

We considered these questions as part of a special CEFC Green Room webinar on private equity. The Green Room is a popular CEFC webinar series connecting investors and the broader market to discuss relevant topics. Highlights of the discussion are included here.



The investable universe

Private equity is ultimately rewarded by its financial returns to investors. This requires active management of the risks inherent in every business, including climate risk. If investments are limited to businesses with limited environmental and social exposures, private equity will see its investable universe shrink.

An eye on the exit multiple

Managers who do not anticipate the net zero commitments of future buyers are likely to face a discount on the exit multiple, particularly when it comes to attracting international capital. To create value for their investors today, private equity also needs to address the medium to long term risks.

Capturing early wins

Decarbonisation, the energy value chain, carbon measurement and monitoring are increasingly seen as value accretive, and not just in the long term. Active managers are capturing short term operational gains as part of longer-term decarbonisation initiatives, demonstrating that performance and low emissions can co-exist in the relatively short hold period.

Shifting sands

Climate risk is creating an inherently unstable environment for investors. Many businesses are seeing rapid changes in the economics of production, supply chain implications, the cost of carbon and the sensitivity to Scope 1 and 2 emissions versus Scope 3. Private equity cannot avoid addressing these, even with the short-term nature of its investments.

Consistent reporting

The increasing number of climate risk tools and reporting frameworks poses challenges for investors. The development of a more consistent reporting framework, including carbon intensity, inherent carbon risk and climate risk, will be essential as decarbonisation gathers momentum.

You can view the webinar via cefc.com.au/insights

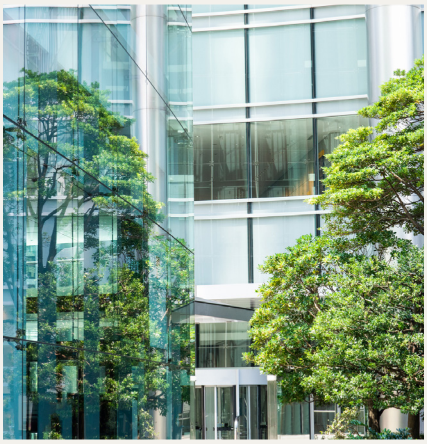
Mid-market private equity and the carbon challenge

For a purpose-driven investor like the CEFC, private equity offers exciting potential to fast-track decarbonisation. Increasingly, private equity is in a position to drive significant change across global economies.

PwC has forecast that its total global assets will grow by as much as 40 per cent to more than US$8 trillion by 2025 and in Australia, latest Australian Investment Council figures show that private equity investment contributes about $47 billion to the economy across a wide range of sectors, including healthcare, consumer goods and retail, financial services, energy and the environment.

While private equity is still in the early stages of climate transition, encouraging more private equity firms to commit to a cleaner, greener profile in their acquisitions and management is just the starting point. A more significant step change can be achieved if these firms also push companies within their portfolios toward higher sustainability ambitions.

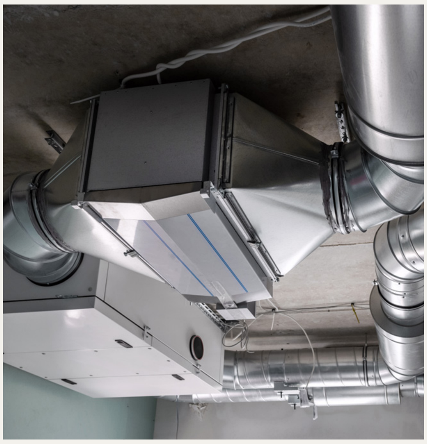
CEFC finance in action



Net zeroing in on PE growth companies

$80m CEFC cornerstone investment

The IFM Investors Private Equity Growth Partners Fund invests in and supports Australian-based mid-market growth companies. Established by industry super owned IFM Investors and managed by the IFM Investors private equity team, the new fund aims to invest in companies with high growth potential, resilient and profitable business models and strong management.



Fast tracking decarbonisation enablers

$50m CEFC cornerstone investment

The open-ended Ellerston Capital 2050 Fund invests in companies fast-tracking decarbonisation, including listed and unlisted small to mid-sized companies which actively help reduce carbon emissions in the wider economy. These include companies with low carbon products, technology and services that enable energy efficiency or facilitate the accelerated adoption of low emissions technologies.

About the CEFC

The CEFC is a specialist investor at the centre of efforts to help deliver on Australia's ambitions for a thriving, low emissions future. With a strong investment track record, we are committed to accelerating our transition to net zero emissions by 2050. In addressing some of our toughest emissions challenges, we are filling market gaps and collaborating with investors, innovators and industry leaders to spur substantial new investment where it will have the greatest impact. The CEFC invests on behalf of the Australian Government, with a strong commitment to deliver a positive return for taxpayers across our portfolio.

"Increasingly, private equity is in a position to drive significant change across global and national economies, by pushing companies within their portfolios toward higher sustainability ambitions. In a sector that understands how quickly non-financial risks become financial risks, it is critical that calculation of climate risk in a company's outlook becomes business as usual."

Rory Lonergan,
Executive Director, CEFC

Private equity in Australia

$47b

Australia-focused private capital assets under management

$10b

'Dry powder' available for PE investment

17%

Net annual return on a 10-year basis

Australian Investment Council