Private equity in a net zero world:

managing climate risks and opportunities

Federated Hermes

Private Markets

www.federatedhermes.com/private-equity

For professional investors only

As climate change reshapes our physical world in stark and visible ways, the impact of rising global temperatures will, ultimately, prove equally disruptive for the corporate and economic landscape. But there are two sides to every disruption: many companies will be adversely impacted by increasingly stringent climate regulation, rising costs and changing consumer sentiment. On the other side of this disruption, will be the companies that will facilitate the net zero transition and thrive in a more climate-aware world.

As investors, it is our role to tell the difference between the climate change winners and losers, aiming to safeguard our partners from the risks while fully participating in the opportunities arising from the new economic landscape.

Why private equity well-placed to address climate change risk

Private equity assets are forecast to surpass $11tn by 2026[1], making it an increasingly significant and influential force in the global economy with the ability to steer large swathes of the corporate world in a more sustainable direction[1].

Given the scale, breadth and influence of the industry, critical issues such as climate change are unlikely to be effectively addressed without the involvement of private equity investors and the companies held within the industry's portfolios. As an asset class, it possesses distinct advantages over the public equity market in its ability to implement and monitor sustainability initiatives. Private equity and its partners are highly influential to the businesses in which they invest, holding unparalleled access to both financial and sustainability data that often goes publicly unreported.

Part 1: Mitigating climate risk

At Federated Hermes Private Equity, we target companies that we believe can thrive as the world transitions towards net zero. As climate change becomes an increasingly critical issue for the global economy, our investment team has taken the decision not to invest in companies that are insufficiently positioned to survive and thrive in a net-zero world.

By minimising our funds' exposure to companies unlikely to thrive, we aim to protect our partners from the most adverse climate change risks. The process of screening out these companies begins with identifying the companies most vulnerable to climate-related disruption. We do this via a two-tiered process.

A two-tiered investment approach

Through our thematic lens, we identify the kinds of opportunities we want to target and then implement a two-tiered approach to assessing the nature of the climate risk that these opportunities may be exposed to.

Our two-tiered approach is predicated on the understanding that some companies are more exposed to climate risk than others, as are some sectors. The first tier of our process, therefore, involves a sector-based risk assessment. We endeavour to have very limited exposure to high-risk sectors, but when we do invest in those sectors, we undertake rigorous additional risk analysis. This begins the second tier of the approach which involves an in-depth review of higher-risk opportunities to identify where those concerns can be further mitigated.

At the core of our overall strategy is the understanding that no two companies will face the same risks where climate change is concerned. The investment team works closely with the sustainability lead to build a clear picture of which risks each potential investment is exposed to and the unique paths these risks might take.

We will also review the lead GPs' sustainability analysis and due diligence (when available), and complement this with additional research where necessary.

While the aim of this work is to screen-out companies that lack the ability to adequately address their climate risk, it does not mean that we will not invest in companies that are exposed to such risks.

> **We approach every investment with the awareness that climate risk is a pervasive economic issue and, in most cases, it cannot be eliminated entirely.**

After all, the universal nature of these issues means that much of the global economy will be exposed to climate risk to a greater or lesser extent. Instead, as investors, we aim to achieve good returns from every investment while effectively managing any risks that cannot be eliminated.

We approach every investment with the awareness that climate risk is a pervasive economic issue and, in most cases, it cannot be eliminated entirely. As a result, our risk assessment and monitoring continues beyond the initial analysis phase, and throughout the life of the investment we support investees companies in adapting to risk conditions as they change over time.

[1] Harvard Business Review 2023

Ownership and ongoing review

A key part of our investment process involves looking for evidence that a company's leadership is open to engagement on addressing the identified risks. We implement a pragmatic, partnership-driven engagement programme across the companies we invest in, leveraging the influence we have as trusted partners of the GPs. All companies in our funds are subject to ongoing reviews in which we look for evidence of progress in addressing the company's climate-risk exposure.

In addition to tracking any specific action plans identified during the investment process, we expect our portfolio to evolve and improve across various climate change risk management milestones.

We track measures, such as greenhouse gas emissions and published net zero commitments, on a yearly basis and engage with our GPs and portfolio companies to encourage progress and drive systematic change.

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Part 2: Exploring opportunities

Having limited exposure to the most vulnerable companies in the universe, we turn our attention to identifying the most compelling opportunities. Our thematic framework is the basis for identifying companies that are most likely to thrive as the global economy transitions to a more sustainable growth model.

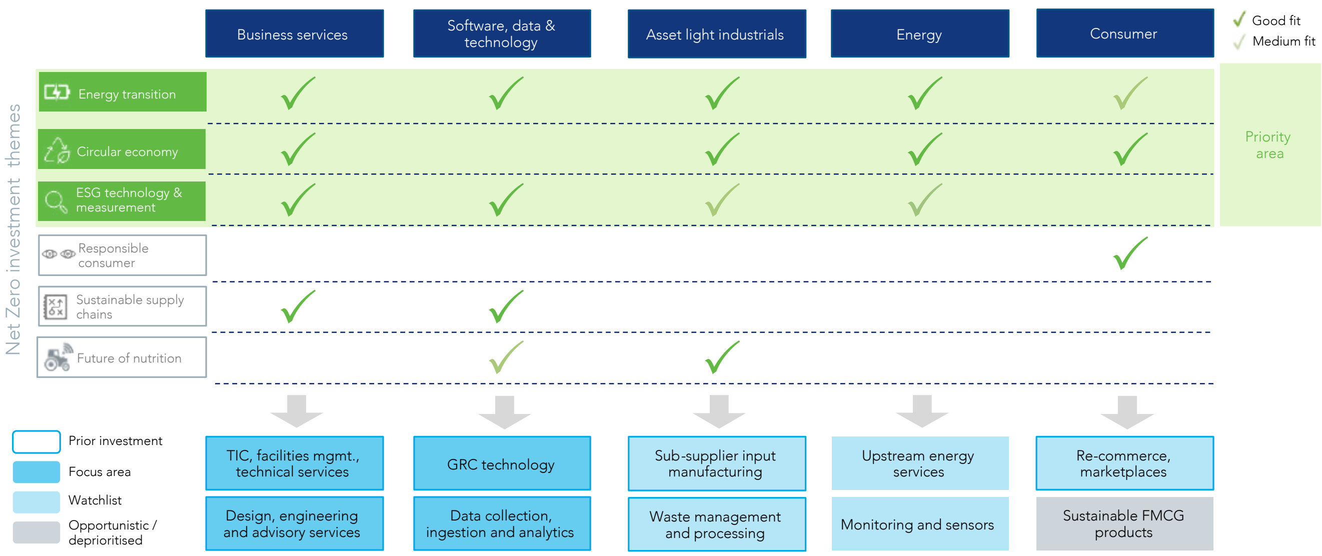
The net zero economy is one of the megatrends that we believe will drive global growth, crossing industries and borders to impact all areas of the market. Via this theme,
we seek to access opportunities to invest in much-needed climate-change innovation and solutions.

We segment the net zero economy into six sub-themes – listed below – which are accessible through proven private equity sectors with equivalent risk-rewards:

- Energy transition
- Future of nutrition
- Circular economy
- Responsible consumer
- Sustainable supply chains
- ESG technology and measurement.

We then use a targeted investment approach to hone in on the highest-potential opportunities in the universe, accessible through proven private equity sectors, as outlined in the chart below.

High conviction Private Equity sectors



Accessing a comparable risk-reward profile to other private equity opportunities

With the universe assessed through the lens of these company-level risk factors, we implement a disciplined and focused approach to mitigating these risks by taking the following actions:

- Taking exposure via growth buyout and buyout approaches with a focus on proven businesses that have market leadership.
- We take an institutional-grade underwriting approach focused on validating core commercial tenants and a consumer-value proposition.
- Deprioritising B2C and B2B2C investments.
- Focusing on companies selling into corporate wallets with clear proposition built around ROI and/or risk mitigation.
- Avoiding 'hype' sectors and undisciplined business plans, particularly on the growth equity side.
- Prioritising asset-light business models, taking on capex intensity in cases where business maturity supports this.
- Taking partner-selection as seriously as asset selection. We seek to invest behind seasoned investors with proven board and value-creation capabilities only.

While there are many companies in the market that are vulnerable to climate risk, there are also many opportunities that we believe our funds are well-positioned to tap into. The universal nature of climate risk means that most companies will be exposed in some way. As a result, we do not take a blanket exclusion approach but look at each company's ability and willingness to address any identified risks. This is where our ownership and ongoing review processes come into focus.

Conclusion

The private equity net zero market is experiencing accelerated growth with rising demand from investors who see private equity as an attractive asset class to deliver on their climate solutions commitments.

Federated Hermes has invested in this theme for over a decade. We believe that success in this space will be underpinned by a clear thesis around where to invest, in terms of sub-segment and business model. We have developed a system that enables our investment team to effectively identify and assess sustainability risks and opportunities from sector level down to company level.

As early adopters of sustainability in private equity, we have seen first-hand the impact that sustainability factors can have on an investment over its lifetime. As a result, we believe it is important to integrate these factors as part of the fundamental analysis in any investment process.

CASE STUDY

Sustainability driven investing: Project Electric

The sustainability tailwinds for Project Electric are a key component of the investment rationale

Project Electric is a UK-based specialist engineering company focused on the roll-out of electric vehicle (EV) charger stations. The company offers turnkey solutions for designing and installing EV connection points across the UK primarily in B2B settings.

Investment rationale

- Growing market opportunity with strong sustainability tailwinds, the company is a key contributor to the infrastructure development required to transition the UK to net zero
- The company is positioned as a market leader in a supply-constrained market with growing barriers to entry
- Attractive transaction characteristics, including valuation with outsized returns potential

Vehicle charging is an essential element of EV infrastructure, with anticipated growth at approximately:

20% per annum to 2030

Sustainability tailwinds

- In the transition to EVs, the UK has banned sales of new internal combustion engine vehicles from 2035, and car sellers need to comply with minimum percentage EV sales
- Charging infrastructure for electric vehicles is necessary with installation of electric vehicle chargers to grow approx. 20% per annum to 2030
- Lack of infrastructure remains a barrier to adaption of EVs.

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Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

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