PEI Alternative Insight
PRIVATE EQUITY INTERNATIONAL

PERSPECTIVES 2013

What matters to private equity investors?

Cinven on leveraged lending
Capital Dynamics on ESG
KKR on value creation
Landmark Partners on secondaries
MVision on fundraising
SL Capital Partners on co-investments
And much more…

PERSPECTIVES

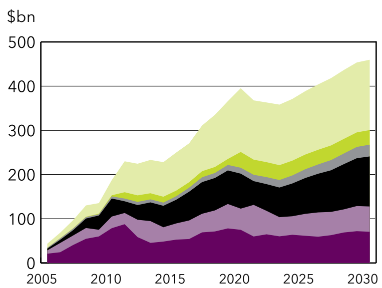
ESG

Keeping it clean

David Scaysbrook, Head of Clean Energy and Infrastructure at Capital Dynamics, in a discussion with PEI says, 'Clean energy investment opportunities are expected to reach record levels in coming years. They can also tick the right boxes for investors focused on environmental, social and governance (ESG) issues'

POWERING UP

Global clean energy investment is poised to increase from less than $50bn to more than $450bn by 2030



Source: Bloomberg, Capital Dynamics, Nov 2011

What's your view on ESG in private equity?

For ESG to be meaningful to investors it has to be measurable, it has to be tangible. There are nefarious notions around ESG, about doing the right thing and what that really means. ESG metrics should, to the greatest extent possible, be just as measurable [as other indicators] so there's no ambiguity for investors.

That's easy for us because it's fundamental to the nature of the investments that we do; because we are investing in projects that abate greenhouse gas emissions, we can quantify the positive environmental impact of our investments in a fairly objective, tangible way. We do that for our investors quarterly, by looking at the aggregate production of our portfolio in each market relative to the existing carbon intensity of that market, whether it be California, Massachusetts or Pennsylvania. We can actually measure emissions abatement and equate that to metrics that many of our investors and LPs will understand, such as cars taken off the road, or Co2 savings. We're increasingly seeing many LPs either participating in carbon disclosure projects or conducting their own sustainability reporting.

Capital Dynamics has a very clear responsible investment policy and ESG framework. How embedded is ESG in your Clean Energy and Infrastructure team's investment process?

Well, at a high level, everything we do is environmentally positive.

If we look at the 'S' in ESG, in our world, that is job creation; it's the deployment of our capital creating meaningful jobs in engineering, in construction, in operations, in maintenance. We're building more and more assets, so we're creating more and more jobs.

And then when it comes to governance, the fundamental criterion is: how strongly is the investment structure aligned with the long-term interests of the investor?

How might ESG policies affect decision making at a portfolio company?

Take the procurement of equipment and, say, solar modules. We have a choice as to whose solar modules to procure. Certain solar manufacturers have appalling environmental track records and have been fined for toxic emissions from their manufacturing process. That's a reputational risk, but more importantly, what it's telling us is that their processes are probably fairly shoddy; that their quality assurance is probably not best practice. To us, it's an indicator of quality and it's an indicator of how diligent the manufacturer is about their processes, which tells us something about whether we really want to buy their kit and keep it producing for the next 25 years.

So ESG is less about being a good corporate citizen and more to do with smart business?

We think it goes hand in hand, because we sell our products based on their fundamental financial attractiveness. But it behooves us to make good business decisions around sustainable best practice. And that means you choose good quality equipment that's going to go the distance; you choose partners that are going to do what they say they're going to do. You do reputational due diligence and reputational risk management, you look at their track record, you look at some of their individuals, their principals and what they've done in the past. Their principles should be fundamentally aligned with the long-term investment ambition of our clients.

Do such decisions come at the expense of returns?

If you go for higher quality, sometimes that costs more, but in our view, you generate a more sustainable investment. So for example, if we only buy Tier 1 equipment from manufacturers with good reputations, we're going to pay a bit more. What tends to go hand in hand with sound business practice is a clean ESG record. That means good partners, reliable production, reliable quality, no scandals, and no misalignment around governance issues.

For our solar fund, for example, it's reasonably straightforward. It's an objective metric – we use Environmental Protection Agency guidelines – we measure it, we report against it and it's auditable. So that means our investors can say, 'as a consequence of our commitment to the Capital Dynamics US Solar Energy Fund we have helped to avoid *'X'* tons of carbon emissions in the US'.

When does ESG present challenges?

A conundrum we're grappling with at the moment is we're looking to invest in projects that utilise unconventional gas, like shale gas, in power generation. This is an unavoidable and extremely prominent new energy source which is – according to the International Energy Agency, who just released a report – potentially going to make the United States energy independent by 2030. This will change the geopolitics in the entire Middle East, but will also create a new significant low carbon energy source in the US. It's an abundant source of new energy but at the same time it has other environmental side effects, potentially.

So when we are analysing those opportunities, then from an ESG perspective it creates certain challenges that we need to get comfortable with. For example, we know the technology is available right now for the recycling and reuse of process water that is deployed in the fracking process. That technology is available, but it makes the process more expensive. There are operators who are choosing to use it, because they believe that, ultimately, that's a better business decision for them, which makes their business more sustainable and less prone to regulatory intervention, or fines or penalties. In other words, it's making their business more sustainable, because they're spending the extra money to deploy the technology, so they can re-use process water rather than let it go into brine ponds with the associated questionable contamination issues of local ground water. So, if we're choosing which particular project or operator to support, we're looking to support the operator who is using that technology, notwithstanding that it may be costing that operator a little bit more money. We're doing that because we believe this business model is more sustainable, because we believe that process will be regulated. In other words, the use of that technology will become standard and mandatory.

Scaysbrook: *ESG integral in clean energy*

What deal would you point to that's helped improve the environment?

If I was measuring emissions, I'd point to the business our clients own and operate in the UK which takes waste mine gas – that's methane – which is 21 times more potent in greenhouse gas terms than Co2. So we take the waste gas from the mining operation, and then, instead of venting it into the atmosphere, we actually use that gas to produce electricity.

How much clean energy infra do you plan to invest in going forward?

The macro projected investment trends in global clean energy over the next couple of years are getting up to about $450 billion* a year, which is twice the size of the entire global luxury goods industry. In terms of Capital Dynamics specifically, so far we've deployed about $500 million. Our plans are to do that on an annual basis, deploying between $500 million and $1 billion per annum in direct clean energy investing, from about 2015 onwards. ■

**Source: Bloomberg, New Energy Finance, Nov 2011*