



Private equity in a net zero world:

managing climate risks
and opportunities

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 2026¹, 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 direction¹.

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 investee 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.

We track measures, such as greenhouse gas emissions and published net zero commitments

Part 2: Exploring opportunities

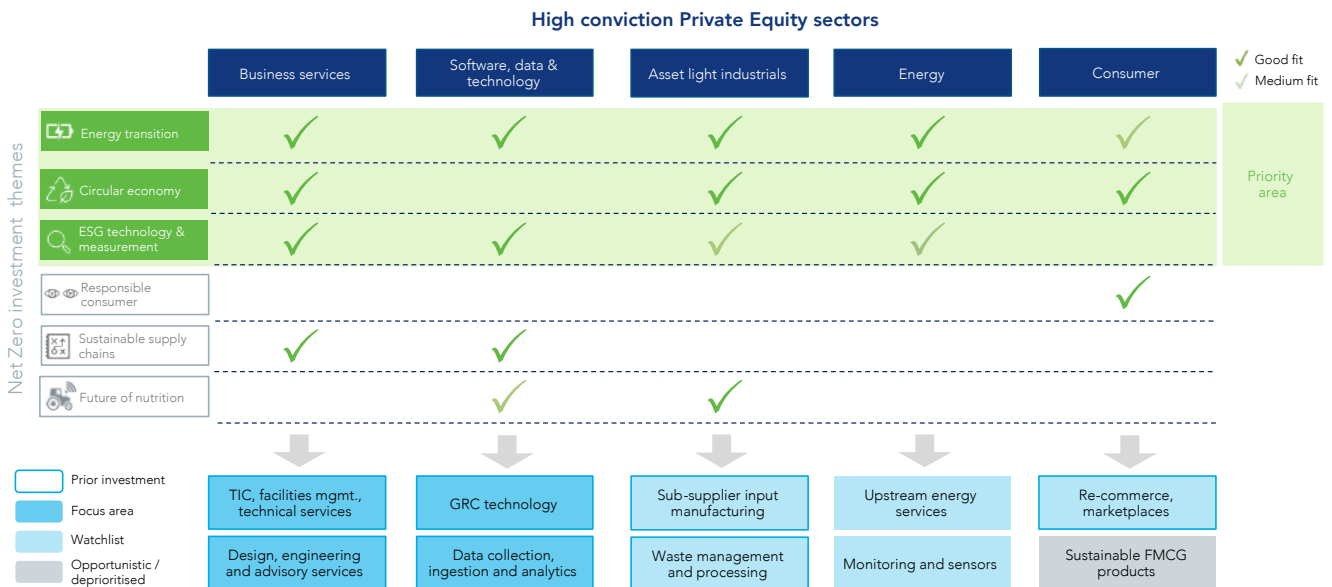
Having limited exposure to the most vulnerable companies in the universe, we turn our attention to identifying the most compelling opportunities. Our thematic framework is the basis for identifying companies that are most likely to thrive as the global economy transitions to a more sustainable growth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



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.

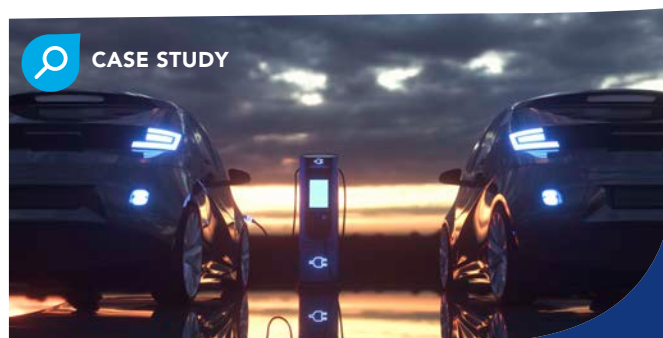
While there are many companies in the market that are vulnerable to climate risk, there are also many opportunities that we believe our funds are well-positioned to tap into. The universal nature of climate risk means that most companies will be exposed in some way. As a result, we do not take a blanket 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 adaptation of EVs.

The value of investments and income from them may go down as well as up, and you may not get back the original amount invested. Any investments overseas may be affected by currency exchange rates. Past performance is not a reliable indicator of future results and targets are not guaranteed.

For professional investors only. This is a marketing communication. The views and opinions contained herein are as of the date indicated above, are those of author(s) noted above, and may not necessarily represent views expressed or reflected in other communications, strategies or products. These views are as of the date indicated above and are subject to change based on market conditions and other factors. The information herein is believed to be reliable, but Federated Hermes and its subsidiaries, does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This material is not intended to provide and should not be relied on for accounting, legal or tax advice, or investment recommendations. This document has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient.

This document is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities, related financial instruments or advisory services. Figures, unless otherwise indicated, are sourced from Federated Hermes. Federated Hermes has attempted to ensure the accuracy of the data it is reporting, however, it makes no representations or warranties, expressed or implied, as to the accuracy or completeness of the information reported. The data contained in this document is for informational purposes only, and should not be relied upon to make investment decisions.

Federated Hermes shall not be liable for any loss or damage resulting from the use of any information contained on this document. This document is not investment research and is available to any investment firm wishing to receive it. The distribution of the information contained in this document in certain jurisdictions may be restricted and, accordingly, persons into whose possession this document comes are required to make themselves aware of and to observe such restrictions.

United Kingdom: For Professional investors only. Distributed in the UK by Hermes Investment Management Limited ("HIML") which is authorised and regulated by the Financial Conduct Authority. Registered address: Sixth Floor, 150 Cheapside, London EC2V 6ET. HIML is also a registered investment adviser with the United States Securities and Exchange Commission ("SEC").

European Union: For Professional investors only. Distributed in the EU by Hermes Fund Managers Ireland Limited which is authorised and regulated by the Central Bank of Ireland. Registered address: 7/8 Upper Mount Street, Dublin 2, Ireland, DO2 FT59.

Australia: This document is for Wholesale Investors only. Distributed by Federated Investors Australia Services Ltd. ACN 161 230 637 (FIAS). HIML does not hold an Australian financial services licence (AFS licence) under the Corporations Act 2001 (Cth) ("Corporations Act"). HIML operates under the relevant class order relief from the Australian Securities and Investments Commission (ASIC) while FIAS holds an AFS licence (Licence Number - 433831).

Japan: This document is for Professional Investors only. Distributed in Japan by Federated Hermes Japan Ltd which is registered as a Financial Instruments Business Operator in Japan (Registration Number: Director General of the Kanto Local Finance Bureau (Kinsho) No. 3327), and conducting the Investment Advisory and Agency Business as defined in Article 28 (3) of the Financial Instruments and Exchange Act ("FIEA").

Singapore: This document is for Accredited and Institutional Investors only. Distributed in Singapore by Hermes GPE (Singapore) Pte. Ltd ("HGPE Singapore"). HGPE Singapore is regulated by the Monetary Authority of Singapore.

United States: This information is being provided by Federated Hermes, Inc., Federated Advisory Services Company, Federated Equity Management Company of Pennsylvania, and Federated Investment Management Company, at address 1001 Liberty Avenue, Pittsburgh, PA 15222-3779, Federated Global Investment Management Corp. at address 101 Park Avenue, Suite 4100, New York, New York 10178-0002, and MDT Advisers at address 125 High Street Oliver Street Tower, 21st Floor Boston, Massachusetts 02110.

Issued and approved by Hermes Investment Management Limited, which is authorised and regulated by the Financial Services Authority.
BD015188 0018403 02/25

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

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.

Federated Hermes Private Markets

With a Private Markets track record spanning four decades, we have developed capabilities that bring investors closer to the companies, assets, communities and environments in which they invest.

Through a combination of heritage and innovation, we seek to connect investors to the industry's leading Private Markets opportunities in pursuit of delivering relevant, resilient investment returns over the long term.

Since our first Private Markets investment in 1983, our close connections, partnership mindset and deep understanding of client needs continue to define our client-focused approach across the asset classes and capabilities.

Private Equity | Private Credit | Real Estate | Infrastructure

Closely Connected

For enhanced outcomes

For more information, visit www.federatedhermes.com/private-markets or connect with us on social media:  