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TRANSCRIPT

# The Net-Zero Journey for Private Investors

***Featuring:***

***Larry Lawrence,*** *Head of ESG and Climate Products for the Private Assets Segment, MSCI*

***Brian Schmid,*** *Global Head of Product Management and Applied Research, Burgiss*

Jenna Dagenhart:

At the 2021 United Nations Climate Change Conference COP26, BlackRock CEO Larry Fink said we're at risk of the biggest capital arbitrage in our history if private companies are not required to make the same climate disclosures as public companies. Here, with more on this rapidly evolving issue, we have Larry Lawrence, head of ESG in climate products for the wealth management and private asset segment at MSCI, and Brian Schmid, Global Head of Product Management and Applied Research at Burgiss. Well, great to have you both with us and Larry, let's start more broadly by discussing why there's such a need for investors to begin their journey to Net Zero.

Larry Lawrence:

Yeah, absolutely. So, at MSCI, we believe that climate change is the greatest challenge of our time and capital market participants are critical in driving the systemic transformation needed to help deliver solutions and the solutions are to avoid, in a world where we've seen significant impacts from extreme weather patterns, frequent hurricanes, sea level rising that will impact societies built along the coastlines. It's really a world where it will be very difficult to function and live in and we're trying to avoid this. And the interest in these impacts of climate change requires the largest reconstruction of the global economy and investors are essential to helping drive solutions and the discussion around Net Zero in alignment portfolios to a Net Zero economy are absolutely fundamental to helping us achieve our goals. What we've seen as a result of the COP26 Global Conference is that there is still a significant urgency to act. We know, while we've made progress as part of COP26, there's still a significant gap that we need to achieve to keep temperatures well below 2° Celsius. Progress was made but we're still falling very short of that and where governments have fallen short, I think we'll see investors step up to help accelerate the transition to a more sustainable or a Net Zero economy. And the acceleration I think will happen both in the public equity universe and in private equity and the debt universe as well.

Jenna Dagenhart:

On the heels of those comments from Larry, Brian, how is this different for private investors?

Brian Schmid:

Thanks, Jenna. Thanks for the question. So yeah, private asset investors, it is different, right? So, if you commit to a private equity fund or a private debt fund, you're committing capital for, kind of, seven to 15-year horizon. So, almost by definition, private asset investors are long-term investors, and the long-term term nature of private asset investing, kind of corresponds with the, let's call it the longer-term horizon, if you will, of climate risk, right? So, they're aligned in terms of the horizons of private asset investors and their horizons of climate risk. At the same time, investors are increasing their allocations to private assets. So, it's not only aligned in terms of the alignment of the horizons but also, there's an increase in the allocations to private assets. So, therefore, given the kind of increased allocations, given the alignment of horizons, it's important that private asset investors don't ignore climate risk. And the reality is they're not. They're not ignoring climate risk. So private asset investors such as Pensions, Damage Foundations, they're setting targets. They're setting goals for their climate risk and they're Net Zero targets if you will. At the same time the managers who are servicing those asset Investors, they're also working and engaging with portfolio companies and private companies to reduce carbon emissions. So, and then likewise, Fund of Funds are creating products let's call them ESG friendly products, if you will, specific to private asset investors who are focused on those and so, through ways of manager selection, the Fund of Funds are creating products to kind of align with these targets and these goals that are set by the asset owners who invest in the private assets. Now, because Burgiss services over 1,000 private asset investors, we're in a privileged position to be in the kind of the data flow, if you will, of GPU reporting to those LPs and by nature of being in that data flow, we have data on thousands of private equity funds, private debt funds and tens of thousands of the most widely held private companies in the world. And given the data that we have, we see that it's only about let's say, well, it's less than 10% of private companies that are disclosing actual carbon footprint today but given the data that we have in these private companies and given MSCI's research and estimation models, we know a lot about the carbon footprint within private assets.

Jenna Dagenhart:

Yeah, we'd love to hear more about that research. Larry, what is MSCI research shown about carbon exposures in private funds?

Larry Lawrence:

Yeah, absolutely. Let me take a quick step back because there are a few things that I think are important to clarify. So, what we're seeing is that investors are increasingly monitoring whether companies have credible plans to reduce their carbon footprint and are tracking the alignment of their portfolios with the Paris Agreement which aims to limit global temperature rise to well below two degrees Celsius by the end of the century. So, this is driven not just by altruism or environmental state guard concerns but by real portfolio risks, policy risk, physical risk, transition risks, stranded assets risks. So, mitigating all of these is not possible overnight but investors need solutions to be able to do so, to shift to the status quo or to shift the status quo over time. So, what I think we need is pragmatism and urgency need to go hand in hand. As an example, you know, physical risks which estimate exposure of company operations to physical hazards like coastal flooding, extreme heat and cold, and different physical hazards. You know, results from stress testing suggest that large impact on energy companies from these physical risks as capital intensive industries are more vulnerable to extreme weather events and the food and staples retailing companies, for example, are impacted quite significantly from this because extreme weather could impact food productivity. I mean that feeds into other sectors that may be financing or technologically facilitating these industries. So, on the policy side as well, as regulatory pressure mounts, the need for investors to understand how their assets will be impacted by regulatory pressure is also pretty essential and what we're seeing is that investors come to this topic from a different perspective. Some seek to divest from large emitters. Others take a nuanced approach combining, you know, targeted investment with other techniques like, you know, looking at the carbon footprint and allocating towards companies that are contributing to the transition, meaning they're reducing, either reducing their carbon or decarbonizing their operations over time or they're actually providing solutions like renewable energy and their renewable energy produces. And others take stewardship as a key function. And reporting and insights and building portfolios that support all of these activities is really where investors are moving and we're seeing that accelerate especially on the back of the COP26 Conference. Now, when it comes to, you know, the private portfolio, you know, there are a couple of things I've mentioned there. You know, private companies face roughly the same climate transition risk as listed companies, the same transition risks I just mentioned. The private company portfolios also could have substantial exposure to these carbon-intensive companies, you go in gas companies, there's foster fuel-based companies, and the emissions within private portfolios tend to be concentrated in a few companies, so really, what we've seen is understanding your exposure to this high impact, foster fuel sectors are critical and we see that throughout the private asset universe. And carbon footprinting is a good way for private investors to start that understanding measurements is a critical element of all of this. You can't manage what you can't measure, so, that's a great place where we typically see our investors and partners start.

Jenna Dagenhart:

And could you clarify what you mean by carbon footprinting in this context?

Larry Lawrence:

Yeah, absolutely. Great question because this is exactly what MSCI and the Burgiss team have partnered to solve for and that is when we say carbon foot-printing, we're looking at the scope one emissions which are direct emissions resulting from a company's operations, and scope two emissions which are indirect emissions resulting from a company's operations. So what we've done together with Burgiss is to measure the scope one and scope two emissions of 15,000 private companies today and what we're able to do with this is we're able to provide investors with transparency not only on these companies but also on the funds that they allocate to and their portfolio overall that they look at these funds or multiple funds at a time.

Brian Schmid:

And maybe if I could add to that, Jenna, as Larry mentioned, we're providing this estimate on over 15,000 private companies. And we look forward to, kind of, in the next year ahead as the number of portfolio companies that are actually reporting on their actual carbon emissions increases and we look forward to integrating the actual reporting into our data set. At this point in time, it's primarily based on estimates but with that 15,000 most widely held private companies within private assets, we're able to cover something on an order of 85% of the valuation within buyout funds on an order of 70 to 75 of the valuation within venture capital funds and over 50% of the valuation within private debt funds. And given that this estimation methodology is the same that MSCI uses in the public markets, it allows asset owners and private asset investors to be able to look at their total portfolio across both publics and privates through a consistent methodology.

Jenna Dagenhart:

So, Larry back to you, how can carbon footprinting of funds help private investors on their road to Net Zero?

Larry Lawrence:

Yeah, that's a great question and just to add on to what Brian said, I think he made a great point and we've you know, leading up to the launch of this collaborative solution, we engage with a number of our clients around the globe as part of a consultation and one thing that was fundamentally important to all of them was that consistency across the asset classes was critical because at the end of the day what our clients, you know, asset owners and others are trying to accomplish is, what Brian said, which is that total portfolio measurement. You need to understand where you are holistically to start to think about where you need to make decisions or where you need to take action to help meet your goals to decarbonize your portfolio or even facilitate engagement with managers so they can interact with those companies. So what we are helping accomplish is, you know, essentially taking a bottom-up approach to carbon footprint and what it helps you do is not only measure and understand what the carbon intensity of your portfolio is, it also helps you understand how much of those emissions that you as an investor are responsible for. So, let's say you're an investor and you're allocating, you know, 10 million in a $100 million-dollar fund, you may not be responsible for all the emissions in that fund but you are responsible for 10 million of the emissions based on your allocation or your investment into that fund. So providing clarity around what you're responsible for, providing clarity around your impact, and also answering the fundamental question, how intensive are the companies that I have exposure to and how many of those companies are in these high impact foster fuel sectors that are most likely impacted by the transition to a Net Zero economy and the transition that we're starting to see accelerate especially as a result we believe of the COP26 Conference.

Jenna Dagenhart:

Finally, is there anything else that either of you would like to add about what private investors need to consider?

Brian Schmid:

Well yeah, listen, in the arena of climate risk, we're looking forward to increasing the coverage, if you will, based on estimates. So, we talked about those percentage coverage based on estimates that MSCI is able to provide based on the data that Burgiss provides, we're looking forward to getting those estimates to 100% coverage of portfolios with additional data in order to do estimates. At the same time, we look forward to seeing actual reporting from private companies and from GPs based on their carbon footprint and integrating that into the offering. So, just like today, in the public markets, there's a certain percentage based on actual reporting and a certain percentage based on estimation, the same will be true of private markets and the percentage based on the actual reporting will just increase over time similar to what it has done in public markets. So that's in climate risk. In the areas of the E, the S, and the G, Burgiss, and MSCI look forward to delivering solutions across the full spectrum for private markets, you know, not regulatory reporting requirements but acronyms such as SFDR, SDG (Sustainability Development Goals) and EU taxonomy. We look forward to providing solutions for the private markets in all of those areas and maybe the bottom line is this, that Burgiss and MSCI are working together to provide the same kind of tools that are available for ESG in public markets to those private asset investors as well.

Larry Lawrence:

Yeah and to add to that, I think there are a couple of things that are converging quite quickly, especially as a result of all of the interactions we've had with the market just this year alone. I think the need to go deeper in the climate is absolutely essential. As Brian said, we've introduced the estimation model but in addition to that, we've seen a lot of interest from private equity investors who really are going to go not only deep but wider in very comprehensive climate analysis on their portfolio companies. So, when you look at climate scenario analysis, physical risk assessments, how much my company's valuation is at risk of different climate scenarios in the future. Whether it be sea level rising, we know, we've built society, along the coastlines in most continents and those are the most susceptible to one of the biggest hazards of climate change which is sea level rising, so the need to understand this risk is absolutely essential and so we're going to, you know, I think that the need to go deeper will grow. We started with scope one and two, which I think are great places to start but scope three emissions which take into account all of the residual emissions from the use of your products upstream and downstream in terms of your inputs into your production and your manufacturing, that's highly thought after as well in that scenario where we'll need to make progress. And when it comes to more holistic, we're looking at E, S, and Gs, it's really partnering with our clients both GPs and LPs and alike, to really round out information, additional information about environmental issues, social issues like diversity and inclusion and governance issues and really delivering more holistic E, S, and G ratings beyond just climate. So, we see all of those things starting to materialize especially with interest from our clients and when we think about total portfolio reporting, you know, there's a spectrum of things you can do, the scope on a scope two emissions and the emissions measurements are a great place to start. But I think, you know, clients would want to go deeper and especially in the context of what the regulators are asking for in terms of reporting that scenario where we'll spend a lot of time as well.

Jenna Dagenhart:

Well, Larry and Brian, thank you both for sharing your thoughts and research on carbon footprinting and ESG on the heels of COP26. Thanks for being here.

Larry Lawrence:

Thank you so much for the invitation.

Brian Schmid:

Thanks for having us, Jenna.

Jenna Dagenhart:

And thank you for watching. Once again, I was joined by Larry Lawrence, head of ESG and Climate Products for the Wealth Management and Private Assets Segment at MSCI, and Brian Schmid, Global Head of Product Management and Applied Research at Burgiss. I'm Jenna Dagenhart with Asset TV.

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