NET ZERO INVESTMENT FRAMEWORK 1.5°C

PARIS ALIGNED INVESTMENT INITIATIVE

CONSULTATION ON PROPOSED COMPONENTS FOR PRIVATE EQUITY

Produced by:

IIGCC The Institutional Investors Group on Climate Change

Asia Investor Group on Climate Change

Ceres

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1 Background

IIGCC's Paris Aligned Investment Initiative (PAII) was launched in May 2019, with the aim of exploring how investors can align their portfolios to the goals of the Paris Agreement. The PAII is a collaborative forum for investors which aims to:

- Develop definitions of key concepts, terms and clarify pathways relevant to Paris alignment, in order to build understanding and consensus around these concepts.
- Analyse potential methods that can be used to assess alignment of different asset classes.
- Assess approaches for transitioning portfolios, in order to provide practical options for investors to transitioning and assessing alignment to the Paris goals.

The PAII published the Net Zero Investment Framework 1.0 in March 2021, and established the PAII as a global collaboration with 3 other investor networks: the Asian Investor Group on Climate Change (AIGCC), Ceres, and the Investor Group on Climate Change (IGCC).

The Net Zero Investment Framework 1.0 covered four asset classes: Listed equity and corporate fixed income, sovereign bonds, and real estate. In 2021 IIGCC therefore established a working group to develop additional components of the Framework relevant to private equity.

This document includes the proposed components of a Net Zero Investment Framework (NZIF) for private equity (PE) which is published for public consultation.

Acknowledgements

We are grateful to the IIGCC working group co-leads Bryn Gostin, Capital Dynamics and Fabio Ranghino, Ambienta and their teams for steering the work to develop the Net Zero Investment Framework for private equity. We would also like to thank BSR who provided research and analysis to support the work of the group, the members of the IIGCC who contributed to the development of the Framework, and to members of the three PAII Network Partners (AIGCC, Ceres, IGCC) who provided additional feedback on the components.

2 Introduction

The Net Zero Investment Framework aims to provide a consistent basis for asset owners and asset managers to measure and manage portfolios towards the goal of achieving global net zero emissions by 2050 or sooner. It seeks to provide recommendations for methodologies and approaches to alignment that a broad range of investors can utilise. However, it recognises that investors will set their own specific strategies and undertake actions according to their circumstances and legal requirements. Investors utilising the Framework are therefore expected to do so on an 'implement or explain' basis.

The private equity components proposed for the Framework are intended to be relevant to both Limited Partners (LP) and General Partners (GP). To determine the proposed components, the PAII has assessed a range of currently available methodologies and approaches for measuring or undertaking alignment to net zero, based on the guiding principles agreed for the PAII (Box 1). While all methodologies and approaches have some challenges or limitations, the PAII aims to identify practical solutions for investors to take action now, while also highlighting areas that need to evolve to improve investors' ability to align portfolios. In relation to private equity, the PAII recognises that integration of climate considerations is generally at an earlier stage than for some other asset classes, and we therefore expect implementation to be an iterative process as data availability and implementation capability improves over time.

Where asset owners and managers have multi asset class portfolios, the private equity components set out below are designed to be integrated with the broader recommendations of the Net Zero Investment Framework 1.0. For recommendations regarding methodologies, management and strategies that are cross cutting, such as parameters for net zero scenarios, emissions accounting and approach to use of offsets, the PAII has not sought to reproduce this content in this document. Similarly general components of investor action, not specific to private equity as an asset class, such as governance, Strategic Asset Allocation, policy advocacy and stakeholder engagement that should be part of a comprehensive approach to investor action are not reproduced in this document. This document should therefore be read in conjunction with the Net Zero Investment Framework 1.0.

The PAII also notes that if policy and corporate action does not progressively transition towards the net zero goal, it will be extremely challenging for a large number of investors to achieve a portfolio of assets that has net zero emissions in 2050. The Framework is therefore based on the expectation that governments and policy makers will deliver on commitments to achieve the 1.5°C temperature goal of the Paris Agreement.

Box 1: Guiding principles for developing the Framework

The PAII followed 5 key principles to guide its work, and to assess methodologies and test conclusions:

- **Impact**

The primary objective is achieving emissions reductions in the real economy. While different investors have varying scopes for undertaking action, the Framework should encourage investors to maximise their efforts to achieve the greatest impact possible.

- **Rigour**

Alignment should be based on sound evidence and data, and be consistent with the best available science on meeting the temperature goals of the Paris Agreement.

- **Practicality**

The methods and approaches should be feasible for a range of investors to implement, build on existing work, and be compatible with existing processes or requirements of investors.

- **Accessibility**

Definitions, methodologies and strategies should be clear and easily applied, using publicly available information and assessments where possible.

- **Accountability**

Definitions, methodologies and strategies should allow clients, beneficiaries and other stakeholders to assess whether investors and assets are aligned with the goals of the Paris Agreement.

3 Consultation on the proposed Framework components for private equity

The components of the Framework presented in the following sections of this document are presented as a draft for consultation. IIGCC is seeking feedback from a broad range of stakeholders to strengthen the Framework components for private equity and ensure we have fully considered all issues relevant to alignment with net zero for this asset class. The PAII Network Partners therefore warmly invite stakeholders to provide feedback on the proposed Framework components. There are a number of consultation questions throughout the document which indicates where we would specifically welcome feedback.

Stakeholders can submit feedback on the Framework and responses to questions via the online platform available here.

The deadline for consultation responses is **27 February 2022**.

The PAII expects to publish the final components for private equity as a supplement to the Net Zero Investment Framework 1.0 following the conclusions of this consultation process.

4 Proposed components of the Net Zero Investment Framework for Private Equity

The PAII Net Zero Investment Framework considers that “Paris aligned” investment means committing to a goal of net zero portfolio emissions by 2050 or sooner, and implementing an investment strategy that is consistent with achieving the goal of global net zero emissions by 2050. Delivering a ‘net zero investment strategy’ should focus on achieving two alignment objectives:

- Decarbonising investment portfolios in a way that is consistent with achieving global net zero greenhouse gas (GHG) emissions by 2050 or sooner.
- Increasing investment in ‘climate solutions’ that are needed to meet that goal, such as renewable energy, low carbon buildings, and energy efficient technologies.

Therefore, the following components proposed for private equity are recommended for investors to be able to implement an investment strategy and manage their private equity funds or portfolio in line with this definition of Paris alignment and consistent with requirements of net zero commitments such as the Paris Aligned Asset Owners or Net Zero Asset Managers commitments. The proposals focus on buyout and growth investments. However, recommendations are also made with regard to venture capital. The components proposed do not cover investment in distressed assets, or in mezzanine or other debt investments, although we would expect the metrics selected to measure Paris alignment for private equity investments to be similar to those that can be used for private debt. For clarity, we refer to portfolio companies rather than assets in the remainder of the document.

The following sections propose:

- the scope of portfolio companies to be considered for measurement and management as part of a net zero strategy for private equity,
- the metrics and targets to measure alignment over time, and
- implementation actions to achieve alignment targets and decarbonisation in the real economy.

4.1 Scope

The first stage in measuring the alignment of a private equity portfolio with net zero is to set the scope of portfolio companies to be included in this assessment, and then managed to increase the alignment with the net zero goal.

The optimal situation is that all portfolio companies should be included in scope for measurement and action to increase alignment, to the extent possible. However, it may be relevant to set a minimum scope of portfolio companies for assessment, to ensure an approach that is both practical and robust. In developing the proposal for portfolio companies that should be included in scope, the working group considered:

- The differences between buyout, growth and venture capital, as well as primary, secondary and fund of fund investments.
- Ability to influence a portfolio company’s strategy and operations and build in progress towards net zero alignment into value creation plans.
- Potential different expectations for existing new portfolio companies, and assessing different fund vintages. In the case of new acquisitions, there is more flexibility to establish terms for the investment. However, it is not appropriate to entirely disregard the existing portfolio given the need for many of these portfolio companies to decarbonise rapidly to be consistent with achieving net zero global emissions by 2050.
- Materiality in terms of portfolio company size, stage of development and impact on the transition to net zero. High impact sectors have already been identified in the Net Zero Investment Framework in line with the Transition Pathway Initiative, which could be utilised for PE to support consistency and enable more straightforward aggregation of targets and higher impact on emissions reductions arising from managers’ engagement activities.

- The working group also noted specific challenges relating to data availability and cost, as well as limitations smaller LPs face in influencing the strategy and actions of GPs, which may affect ability to deliver on the recommendations of the Framework.

The PAII therefore proposes the following approach to setting the scope for portfolio companies to include:

Buyout and Growth

Optimal: All portfolio companies classified as Buyout or Growth for Primaries, Secondaries and Fund of Funds should be in scope for net zero alignment measurement and management.

Minimum: Include Buyout and Growth for Primaries, Secondaries and Fund of Funds ensuring all of the following criteria are met:

- Inclusion of all portfolio companies where a GP has a meaningful influence, which is defined as ≥ 25%of the fully diluted shares of the portfolio company AND board seat(s)[1].
- Inclusion of all portfolio companies that are in a high impact sector (see TPI classification at Appendix B of the Net Zero Investment Framework).
- Inclusion of additional portfolio companies as necessary so that at least 70% of aggregate portfolio companies' NAV or emissions are included, rising to 90% by 2030[2].

Venture Capital

Start-ups to be included once they meet the following criteria[3]:

- >50 persons, and
- more than EUR 10 million annual turnover OR balance sheet, and
- have been in existence for 5 years, and
- the GP has more than 15% of the fully diluted shares of the PC AND board seat(s).

Questions for Consultation

1. **Do you agree with the proposed minimum criteria and thresholds for portfolio companies to be included in scope?**
2. **If not, what amendments to these thresholds do you propose? Please explain how these would ensure an approach that is consistent with the PAII criteria to ensure impact, rigour, and practicality.**
3. **Do you agree with the minimum criteria that at least 70% of aggregate portfolio companies' NAV or emissions are included, rising to 90% by 2030? If not, please explain what alternative criterion or approach can ensure that LPs or GPs are taking action across a significant proportion of their portfolio.**

1 This criterion is consistent with the Science Based Targets Initiative: Private equity sector science-based target guidance https://sciencebasedtargets.org/resources/files/SBTi-Private-Equity-Sector-Guidance.pdf
2 This may be based on % of NAV initially, but is expected to be based on emissions by 2030 at the latest. Where using an emissions coverage %, initially this threshold can be assessed on estimated emissions as necessary in line with timeframes outlined for assessing the carbon footprint of portfolio companies.
3 These criteria are consistent with the Science Based Targets Initiative: Private equity sector science-based target guidance https://sciencebasedtargets.org/resources/files/SBTi-Private-Equity-Sector-Guidance.pdf

4.2 Metrics and Targets

The Net Zero Investment Framework 1.0 recommends that investors should assess the alignment of portfolio companies towards global net zero emissions, and their contribution to climate solutions. Assessment of alignment of portfolio companies should factor in both current and future expected performance, and the likelihood of future alignment. Investors should aim to increase the percentage of portfolio companies that are achieving net zero or aligned to the 2050 goal, and contributing to climate solutions. The NZIF currently recommends methodologies and metrics to assess net zero alignment for four asset classes, and associated targets that investors should set in order to align portfolios to net zero, in line with science-based pathways.

4.2.1 Proposed metrics for measuring net zero alignment of private equity investments

Based on research undertaken by BSR, the working group considered available methodologies and metrics for measuring the alignment of private equity investments. These methodologies included the sectoral decarbonisation approach (Transition Pathways Initiative (TPI) and Science Based Targets initiative (SBTi)); Portfolio Coverage (SBTi); Portfolio Temperature Rating (SBTi); PACTA; and the EU Taxonomy. The working group also reviewed the SBTi target setting guidance for private equity following its publication in autumn 2021.

It was noted in the BSR analysis that there was no 'off the shelf' methodology directly applicable to private equity. However, the analysis identified the sectoral decarbonisation approach (SDA)[4] and portfolio coverage[5] methodologies as most appropriate to consider, based on their fulfilment of the PAII criteria (see Box 1). While the SDA approach has strong scientific rigour it was noted that it was most relevant for high impact sectors, and may not provide the coverage of sectors common in private equity investment. However, for PE investments in high impact sectors, target setting based on these sectoral pathways is relevant. In relation to the SBTi portfolio coverage approach, it was also noted that target setting as the key metric may be insufficient to fully capture progress towards alignment and likelihood of achieving these targets, particularly considering shorter time horizons of private equity investment. Therefore, the working group concluded that a portfolio coverage approach, including additional criteria to target setting, would be relevant to measuring progress of portfolio companies towards alignment.

The PAII therefore proposes that alignment for portfolio companies in scope should be assessed based on the fulfilment of the following criteria:

4 The sectoral decarbonisation approach involves investors setting emissions intensity targets for key sectors within the portfolio which are consistent with science based sectoral pathways in line with a specified temperature outcome.

5 The portfolio coverage approach involves increasing the proportion of underlying investments e.g. portfolio companies which have themselves set science based targets over time.

	Criteria	Net Zero	Aligned	Aligning[6]	Early progress[7]
1	Ambition: A long term 2050 goal consistent with achieving global net zero GHG emissions by 2050 or sooner	*Company with emissions intensity required by the sector and regional pathway for 2050 and whose ongoing investment plan or business model will maintain this performance.*	X		
2	Targets:				
2a.	Short- and medium-term science based GHG emissions reduction target (scope 1, 2 and material scope 3)[8] OR		X	X	
2b.	Immediate emissions reduction target set in line with at least a global net zero decarbonisation pathway[9] (Scope 1 &2)				X
3	Disclosure: Annual disclosure of scope 1, 2 and material scope 3 absolute GHG emissions, and capex or revenues related to climate solutions as defined by the EU Taxonomy mitigation or adaptation criteria, or equivalent assessment		X	X	
4	Emissions performance: Current emissions intensity performance (scope 1, 2 and material[10] scope 3) relative to targets provided to GPs and disclosed publicly		X		
5	Climate strategy: A proportionate plan, with clear governance, setting out the measures that will be deployed to deliver GHG targets, assess and manage climate risk, and achieve value creation through climate related opportunities. For high impact sectors this plan should be quantified and include Capex and Opex expenditures (potentially agreed by the GP) to achieve targets		X		
6	Strategy on track to meet exit criteria that a) the company is in a position to be profitable in a net zero future b) the company has the potential to continue to align to relevant net zero decarbonisation pathway over time		X		
7	Governance: A named director on the board with responsibility for climate risk, and other relevant management responsibilities for climate change defined; Climate risk management discussed by board at least once a year		X	X	X

6 Beyond the respect of the indicated criteria an actual carbon footprint is conducted and a timebound process for strategy development and implementation underway.
7 Carbon footprint estimate also conducted (at least on Scope 1&2) and timeframe for achieving other criteria established.
8 TPI or SBTi SDA pathways; Carbon Risk Real Estate Monitor Pathways for real estate.
9 For example, 4.2% / year absolute emissions reduction as defined by SBTi absolute contraction approach.
10 IIGCC is currently undertaking analysis to support identification of material sources of Scope 3 GHG emissions for a range of sectors and improved consistency in estimation and reporting of Scope 3 GHG emissions.

Portfolio companies can therefore be assessed on their progress towards alignment in the following categories:

Net Zero: A company which is already achieving the final emissions intensity level required by the sector and regional pathway for 2050, and has ongoing disclosure of emissions and performance, and whose ongoing investment plan or business model will maintain this performance.

Aligned: Meeting criteria 1-7, including 2a above.

Aligning: Actual carbon footprint conducted, and meeting criteria 2a, 3 and 7 above, with a timebound process for strategy development and implementation underway.

Additional measure of early progress: Meeting criteria 2b, 7, carbon footprint estimate conducted (at least Scope 1&2), and timeframe for achieving other criteria established.

Third party verification of portfolio companies' disclosures, targets and compliance with the criteria is recommended, and should be annual to the extent possible.

Box 2: Investment in climate solutions

The working group noted that increasing investment in climate solutions is relevant for PE as an industry, and within LPs portfolios as a whole. However, the relevance of climate solutions within investment strategies will depend on the sectoral profile of a GP or fund.

The EU taxonomy was noted by BSR as the relevant metric for assessing investment in climate solutions. However, it was noted in discussions that GPs are not advanced in measuring investment in climate solutions using the taxonomy. Therefore, in the short term more basic assessments of green investment may be relevant to report to LPs while the practice of measuring in line with the taxonomy develops. IIGCC is undertaking further work on relevant climate solutions metrics and has a simplified approach for assessing investment in climate solutions which may be used in the short term.

In addition to disclosing taxonomy compliant revenues and setting goals to increase revenues associated to activities compliant with the taxonomy, it may be relevant to have 'process based' metrics or criteria. For example, it could be considered relevant for some types of portfolio companies to conduct an assessment of business opportunity in relation to climate solutions.

Question for Consultation

4. **Are the proposed alignment indicators, thresholds and additional recommendations relevant to assessing and ensuring alignment of portfolio companies to a net zero pathway, and measuring progress towards alignment? If not, please describe the amendments or additions to the proposals that you recommend?**

4.2.2 Net Zero target setting for private equity

The portfolio coverage approach recommended, and measurement of portfolio companies' Scope 1, 2 and material Scope 3 GHG emissions, would facilitate investors to set the following targets for PE portfolios and funds.

All of the following (Target 1a, 1b, 2, and, as relevant, 3) are proposed to be set by GPs and LPs to be considered "Net Zero Aligned", and is recommended to be set by an asset manager or owner making a net zero commitment (e.g. Net Zero Asset Managers (NZAM); Paris Aligned Asset Owners).

These targets also align closely to the existing asset level alignment targets, and portfolio level emissions reduction targets, of the Net Zero Investment Framework allowing aggregation across asset classes and portfolios for multi-asset managers, and at portfolio level for asset owners.

Box 3: Portfolio Coverage (asset alignment)

Target 1a: A year-on-year alignment target for increasing % of current net asset value (NAV) of assets in scope that is achieving the criteria to be considered i) net zero, or ii) 'aligned', or iii) 'aligning' to net zero. The year-on-year increase should indicate a target for the following 5 year period, and is expected to demonstrate an increase consistent with reaching 100% net zero, aligned or aligning by 2040.

Target 1b: As a subset of target 1a, for all **new** assets **where the GP has a meaningful influence**, criteria should be achieved progressively, reaching 100% of assets 'aligned' or 'net zero' by 2030, or for acquisitions after 2025 within 5 years of investment. (New assets refer to assets acquired by existing funds that are still in their investment period, and all assets in future new funds).

Climate Solutions

Target 2: As relevant, set a goal or target for each fund (GP) or portfolio (LP) taking into account the sectoral profile of the fund or portfolio, to increase investment in climate solutions (% revenues or capex/AUM invested associated to climate solutions as defined by the EU Taxonomy or alternative relevant criteria such as the forthcoming UK taxonomy).

Fund of Funds

Target 3: Where investing in fund of funds, the GP or LP shall aim to ensure that as soon as possible and by 2030 at the latest to only invest with firms or fund managers who themselves are setting portfolio coverage targets and undertaking relevant actions in line with those recommended in Section 4.

It is expected that GPs will set and report on these targets on a fund-by-fund basis. GPs and LPs may update targets and re-baseline to reflect changes in the holdings. Targets should be reviewed and updated at least every 5 years, in line with the existing NZIF guidance and net zero commitments (NZAM and Paris Aligned Asset Owners).

In addition:

To allow LPs, or multi-asset class managers, to incorporate private equity in the overall top-down portfolio level emissions reduction and climate solutions reference targets expected as part of net zero commitments in the NZIF, **GPs should also report to LPs annually** on:

a. current emissions of portfolio companies and funds (portfolio company reported, or estimated initially)

b. forecast future emissions based on targets

c. current and forecast (or target for) investment in climate solutions

LPs should incorporate PE into the scope of the portfolio level emissions reduction and climate solutions reference targets, as set out in the NZIF and supplementary guidance on target setting.

4.2.3 Additional recommendations for measuring and assessing alignment

With regard to other aspects of measurement such as emissions accounting approaches, appropriate use and accounting for offsets etc, it is expected that GPs and LPs would apply the approaches currently set out in the Net Zero Investment Framework. Similarly, investors should refer to recommendations regarding avoidance of new investment in unabated thermal coal and oil/tar sands exploration set out in the NZIF which should also be applied by funds, GPs and LPs for portfolio companies and funds to be considered net zero aligned.

Question for consultation

5. **Do you consider the proposed targets appropriate for GPs and LPs? If not, please describe amendments or clarifications you would recommend and describe how these ensure targets are science based, support achieving impact in the real economy, and are practical for a range of LPs and GPs to use.**

4.3 Approaches for transitioning a portfolio and increasing alignment

Given the ownership and control model involved in private equity investments (compared to listed companies), GPs will often have considerable influence over companies in the portfolio. The controlling GP's role in business strategy, budget and board positions will often place them in a strong position to support achievement of the metrics and criteria set out above, and ensuring companies are set for success in the net zero transition. LPs generally have more limited influence and the blind pool risk means ability to directly assess companies ahead of investment is limited. LPs may therefore have most leverage for influencing the transition to net zero for private equity through their asset allocations within PE fund strategies, manager relationships and the selection, appointment and monitoring of GPs.

The following elements set out recommended actions identified by the working group that can be applied by LPs and GPs respectively, and at different stages of the investment cycle, to increase the alignment of their portfolios. A LP or GP with a net zero commitment would be expected to implement relevant actions set out below.

4.3.1 Limited Partners

A. Portfolio Assessment and Management

- Inclusion of private equity assets in Net Zero commitments, climate-risk governance and TCFD reporting including monitoring and reporting on aggregated carbon performance and achievement of milestones/actions of portfolio companies and funds based on requested reporting from GPs.
- Climate risk mapping and carbon footprinting of existing PE portfolios, to prioritise GP engagement strategies e.g. review TPI high-impact sector exposures (by NAV) where sector data for underlying portfolio companies is available; or establish priorities using estimated carbon footprint data and modelling (if available) to identify the most exposed funds.
- Inclusion of net zero and climate risk assessment in investment committee sign-off processes/memos to approve commitments to new funds and GP co-invests.
- Asset allocation decisions to increase exposure to PE funds with a focus on climate solutions and net zero alignment targets.
- Use of ILPA's Climate Assessment Framework or the TCFD framework to increase allocation to GPs who are more mature in their response to climate risk management.
- Introduction of appropriate fossil fuel investment policy e.g. avoid new investment in thermal coal and tar sands (per the NZIF recommendation).
- Training and guidance for in-house and external legal counsel to represent Net Zero alignment within side letters and deal terms.
- Work with industry bodies to advance best practice and standards to facilitate Paris alignment in the PE sector.

B. GP Selection

LPs should select GPs, based on GPs fulfilling the following criteria:

- Appropriate screening / exclusion policy in side letter terms (or in place for the whole fund) to ensure that portfolio companies not permissible according to net zero pathways (e.g. new coal power generation) are not acquired.
- GP compliance with the recommendations of the TCFD in relation to climate-related financial risk.
- Disclosure of carbon performance of portfolio companies/funds on an annual basis (estimated initially if necessary).

- Adoption of portfolio coverage approach for measuring the alignment of relevant portfolio companies in the fund/portfolio and setting targets for increasing the proportion of portfolio companies aligned over time.
- Commitments on climate performance and management integrated into the fund Limited Partnership Agreement (LPA), or side letters.
- LP Advisory Committee (LPAC) consultation on climate-related performance issues integrated into fund reporting, including progress on carbon footprinting of portfolio companies and setting targets.

C. GP Engagement

- LPs should engage with managers and legal counsels regarding GPs creating new funds to promote inclusion of appropriate terms in relation to climate performance and management (targets, disclosure, governance etc for portfolio companies).
- LPs should request information from the GP on climate risk management in pitch book materials e.g. the ILPA Due Diligence Questionnaire (DDQ) 2.0[11] includes questions that managers should address on climate in fund marketing materials.
- Work with LPACs, and individually, to monitor GPs to ensure achievement of net zero metrics and criteria for the fund.
- Where commitments have yet to be made by a GP, engage with the manager to encourage adoption and share examples of industry frameworks and good practice (within the bounds of confidentiality agreements).
- Work alongside other LPs, GPs and industry bodies to advance best practice and standards to facilitate Paris alignment in the PE sector.
- If necessary, where the LPA does not yet adequately cover climate related performance and management requirements, larger LPs in particular can seek side letters which include the requirements to achieve KPIs noted above (targets, disclosure, governance etc for portfolio companies).

D. Co-investment

Generally, a co-investment by an LP will involve increasing exposure to an existing holding within a fund, and therefore no additional specific considerations may need to be applied if the fund is already implementing a 'Paris aligned' strategy. However, an LP may wish to independently underwrite Net Zero assumptions as part of their commercial due diligence; and where Paris alignment is not the case, and LPs are making a separate investment from the GP directly in a portfolio company, the LP should:

- Not co-invest in portfolio companies that cannot be aligned to net zero.
- Consider "positive screening" to increase allocation to companies which represent 'climate solutions'.
- Seek representation on the board of the portfolio company, for larger co-investors, to influence climate integration and net zero transition.
- Ensure LPA contains relevant provisions regarding alignment and reporting.
- Co-invest with a majority shareholder meeting the above GP selection criteria and consistent with any overarching target the LP is trying to achieve.

11 https://ilpa.org/due-diligence-questionnaire/

4.3.2 General Partners

A. Portfolio assessment and management

- Build skills and capacity to better understand and value climate risk and Net Zero pathways and commercialise net zero intellectual property.
- Implement TCFD recommendations, including scenario analysis, and disclosures in relation to climate-related financial risk as a firm.
- Develop Net Zero aligned fund terms for LPs, including:
  - Commitment to the goal of a net zero aligned portfolio in fund strategy and pitchbook materials
  - Commitment to carbon accounting data and performance measurement reporting to LPs in LPA
- Be open to side letter terms regarding climate risk management and Paris alignment.
- In asset management, develop capacity and resource to support portfolio companies in the delivery of Net Zero.
- Deliver 'climate-literacy' programmes for investment teams and portfolio company board directors.

B. Pre/During acquisition

- Screening/exclusion of portfolio companies not permissible according to net zero pathways (e.g. new coal power generation).
- Due diligence including scenario analysis to inform valuations, exit strategies and identify opportunities to increase investment in climate solutions.
- Inclusion of Net Zero and climate risk assessment in investment committee sign-off processes/ memos.
- Ensure shareholder agreement includes appropriate terms in relation to climate risk governance, performance, management and reporting.
- Consider inclusion of climate risk management KPIs in leverage for the deal. Details can be agreed at a later date in a competitive/ time constrained deal situation.

C. During holding period

- Support portfolio company to establish a carbon footprint to set baseline for performance and targets. This should cover Scope 1 and 2 GHG emissions as a minimum and include material Scope 3 emissions over time. Where reported or estimated data specific to a portfolio company is not available, use of public market proxy estimates could be used in the short term (first 1-2 years) to estimate carbon footprint. Engagement with specialist carbon footprinting firms is also encouraged.
- Identify key decarbonisation levers that reduce carbon emissions in order to develop PC strategy for decarbonisation, including as part of 100 day plans and value creation plans.
- Define governance/management responsibilities for climate change in each company, including establishing remuneration linkage to delivering on targets/climate strategy as relevant.
- Education / operational support for company management on managing climate performance and implementing a net zero strategy.
- Establish timebound KPIs related to alignment metrics to be met by each company over time:
  - Ongoing disclosure – carbon performance plus TCFD (as relevant)
  - Setting a science based target
  - Developing a strategy for achieving targets
  - Implementing strategy milestones/actions
  - Developing performance frameworks to incentivise/ acknowledge delivery
- Track KPIs through regular reporting from portfolio companies to GPs, and incorporate KPI review into board and / or management committee meetings.

- Monitoring and reporting on carbon performance and achievement of milestones/actions defined in company strategies to LPs. Reporting should be consistent with the requirements set out in any LPA or private placement memorandum (PPM). Optimally, reporting should be disaggregated for portfolio companies and include data tags to allow for the calculation of intensity metrics and peer benchmarking. The inclusion of identifiers e.g. Legal Entity Identifiers (LEIs) ISINs, DUNS number will allow service providers and LPs to understand double counting across an LP's portfolio, populate missing data and to monitor discrepancies where an LP may have exposure to the same portfolio company through different managers or capital structures.
- Consider inclusion of climate risk management KPIs in credit facilities for the firm.

D. At Exit

- Aim to meet the following "exit criteria":
  - The company is positioned to be profitable in a net zero future
  - The company has the potential to continue to align to relevant net zero decarbonisation pathway over time
- Seek to measure value-add arising from climate initiatives undertaken by the GP over the hold period.

Box 4: Recommendations for addressing net zero alignment for venture capital (VC)

Many GPs will also manage venture capital investments or funds, in addition to buyout and growth investments. VC investments tend to be very asset light during the initial investment period, and suffer a relatively high failure rate. Therefore, applying the measurement and management recommendations above to VC investment may not be a practical or useful approach. Therefore, as set out in section 4.1, start-ups should be in included in scope once they meet the following criteria:

- >50 persons, and
- more than EUR 10 million annual turnover OR balance sheet, and
- have been in existence for 5 years, and
- the GP has more than 15% of the fully diluted shares of the portfolio company AND board seat(s).

However, it was noted that climate considerations should nonetheless be integrated into planning and the evolution of business models to ensure longer term consistency with achieving net zero, particularly as some investments e.g. in tech may have large energy emissions over time.

Therefore, investors are recommended to take the following actions in relation to all VC investments:

- For any VC investment in a high impact sector, a GP should seek to ensure climate risk and alignment strategy is considered within the governance structure and a proportionate climate strategy developed to ensure the business model aligns to net zero over time. Given the group of investors in VC is usually quite evenly distributed and there is not a controlling position which also affects the ability to influence company behaviour, GPs should consider collaborating with other investors to achieve this outcome.
- Given VC has the potential to be an important and necessarily growing aspect of achieving the goals of the Paris Agreement in relation to investment in climate solutions, LPs can seek to adopt a strategy, asset allocation or investment decisions as relevant to increase exposure to climate solutions through VC opportunities.
- As for buyout and growth investments, LPs and GPs should adopt screening/exclusion of potential investments whose growth or business model would not be consistent with alignment to net zero pathways (e.g. new coal power generation).

Questions for consultation

6. Do the recommended actions for GPs and LPs capture the key activities that should be undertaken to manage climate risk/opportunity, increase net zero alignment of portfolio companies and funds/portfolios, and to achieve net zero targets?
7. If you consider any actions listed as not relevant or a lower priority for supporting the transition to net zero, please list which these are and reasons for your assessment?

NET ZERO

INVESTMENT FRAMEWORK 1.5°C

IIGCC The Institutional Investors Group on Climate Change

Asia Investor Group on Climate Change

Ceres

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