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De-risking ESG/ Climate Factors to Enhance Valuations

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This whitepaper draws on the collective reflections of our environmental, social, and governance (ESG)/climate team at Stantec through internal discussions, client interactions, and engagements with institutional investors. As a global multi-disciplinary consultancy firm with decades of track record in planning, design, engineering, and technology enablement across industries and sectors, we frequently interact with finance, investment, and sustainability teams at banks and private equity firms (PE) on feasibility studies, due diligence audits, sustainability disclosures, and ESG/climate programs. We have seen a significant increase in ESG/climate-driven strategies, policies, and disclosures at PE.

The private equity firms (PE) sector has become a major player in the global economy, with $6.3 trillion in assets under management (AUM) compared with about $90 trillion in public equities (2021 figures). The PE sector has $2 trillion in "dry powder", with its assets projected to exceed $11 trillion by 2026. The PE ecosystem includes General Partner (GP), fund manager, high net worth investors (HNWI), and limited partners (LP) that may include institutional investors, pension funds, sovereign wealth funds (SWF), and endowments. Although these funds are not regulated as investment companies, GP/LP require PE to implement policies and programs at their portfolio companies to de-risk ESG/climate factors and enhance performance for better valuations.

Current Headwinds

Given the decline in the number of companies listed on the stock exchanges and the disproportionate impact of large tech companies on the market indexes, PE enables alternative investments in private companies. This creates diversification across sectors, asset classes, commodities, and real estate, resulting in greater annual returns (average of 14%) compared with the conventional securities (MSCI World Index at 7%), over the last 12 years through Q1 of 2022. However, post-pandemic recovery in 2022/23 has been fraught with rising inflation, high interest rates, increasing debt burden, tightness in liquidity, supply chain disruptions, and defining global events that have paused banks from providing leveraged loans, ending cheap debt in buyout markets, and leading to a growth-constrained environment for both private and public markets.

For PE, this has resulted in reduced fund raising, lower valuations of portfolio companies, reduced deal activities, longer holding of assets, and difficulties in meeting LP expectations, especially in the last four quarters compared with the hectic activities in 2021. While some PE has been forced to divest and/or liquidate their holdings in portfolio companies, others have consolidated and sourced funds from private banks and SWF.

To overcome the tightness in conventional sectors, some PE has innovated and specialized in the energy transition, the low carbon economy, and onshoring green supply chains, while others have adopted digital platforms, lowered investment thresholds, and allowed withdrawals. Since the current environment requires PE to hold their portfolio companies for longer periods, pursue organic growth until markets improve, and drive real improvements to enhance earnings before interest, taxes, depreciation, and amortization (EBITDA), the conventional role of PE in restructuring and sale has changed to owner-manager until the economy improves for exiting investments, raising funds, and engaging in heightened deal-making activities.

ESG and Climate Considerations at PE

Although not generally required to disclose ESG/climate performance by law or regulation, PE firms increasingly recognize that these factors are critical to key performance indicators (KPI) and long-term value creation. Typically, PE incorporates them in four stages of the investment process: due diligence, integration, engagement, and reporting.

PE consider ESG/climate integration as an important aspect of the value creation process and for conforming with the overall trend of investor, employee, and other stakeholder's increasing expectations of greater transparency and accountability. These factors are integrated in revenue generation, cost reduction, EBITDA improvements, strategic acquisitions, and digital transformation process, which many PE view as the critical levers for generating returns and successfully exiting investments. Beyond running the ESG/climate programs, GP must satisfy LP requirements on due diligence, ESG mandates, engagement, and greenhouse gas (GHG) reporting.

Many PE have voluntarily applied sustainability frameworks such as the United Nations (UN) Principles for Responsible Investment (PRI), Global Reporting Initiative (GRI), Sustainability Accounting Standard Board (SASB), Taskforce on Climate-related Financial Disclosures (TCFD), the UN Global Compact (UNGC), the Sustainable Finance Disclosure Regulation (SFDR), and Climate Action 100+ in addition to their memberships in sector-specific sustainability associations that provide guidelines on Scope 3 decarbonization and other material topics.

The default standards used by PE for integrating ESG/climate considerations include the following:

- UN PRI standards for PE
- International Finance Corporation's (IFC), Environmental and Social (E&S) Performance Standards (ESPS)
- IFC Equator Principles for Project Finance
- IFC Standards for Environmental and Social Management Systems (ESMS)
- IFC guidelines for ESG, impact investing, and exiting investments

These standards are periodically revised through extensive stakeholder consultations with various UN agencies, various sustainability frameworks, governments, and sector associations.

> ***"WHILE THERE ARE MANY CHECKLISTS FOR ESG/CLIMATE EVALUATIONS, THE SCOPE USED BY PE FOR THEIR DUE DILIGENCE AND INTEGRATION EFFORTS DEPENDS UPON WHICH ESG TOPICS AND KPI ARE MATERIAL TO THE BUSINESS. TOPICS TO CONSIDER ARE OUTLINED ON THE NEXT PAGE."***
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ENVIRONMENTAL: What are the company's GHG emissions, energy and water consumption, and waste generation? Has the company undertaken a GHG emissions target? Is it a science-based target? Has the company expressed support for the goals of the Paris Agreement? Has the company evaluated and disclosed its physical and transition risks associated with climate change? What other environmental risks does the company face, such as regulatory compliance, or natural resource scarcity? Does the company have any environmental certifications or policies in place, such as ISO 14001 or a sustainability policy?

SOCIAL: What is the company's labor force like, and what are the working conditions? Does the company have any labor-related issues, such as discrimination or violations of labor laws? What is the company's policy on gender and racial diversity and inclusion (D&I)? Does the company have a policy for interacting with Indigenous peoples? Does the company have a child or modern slave labor risk in its supply chain? Does the company have community engagement programs or initiatives? What are the company's impacts on society, including its customers and suppliers?

GOVERNANCE: What is the company's governance structure and policies? What is the diversity of the board and management team? Is the company involved in any legal disputes or regulatory investigations? Does the company have anti-corruption or anti-bribery policies in place?

OTHER: Does the company have any ethical or reputational concerns, such as involvement in controversial industries or practices? What is the company's impact on the UN Sustainable Development Goals? Does the company have any partnerships or collaborations in place that support ESG goals?

Against this background, our ESG/climate services to PE differ according to the stages of investment including the pre-acquisition investment phase; and post-acquisition operations and exit phase, which is typically after five to seven years of holding prior to sale via initial public offering (IPO) route, outright sale, buyout by another PE firm, recapitalization, or liquidation to recover proceeds for distribution to investors. We also provide reviews of existing portfolios, strategies for mitigating identified risks, and direct implementation with portfolio companies.

Pre-Investment Due Diligence

Typically business entities considered by PE in the investment screening process have a track record of delivering products/services, revenues, and technology-enabled growth along with permits, approvals, and reporting. They comply with applicable regulations and corporate policies and may already have sustainability programs in place.

From our experience in conducting merger and acquisition (M&A) related environmental and ESG due diligence audits, most companies usually have gaps in their programs that get identified during the audits along with risks, opportunities, and an implementation program for consideration, should the deal go through. Please refer to the pre-investment due diligence audit checklist below.

ESG/Climate Considerations During Due-Diligence Audit

• Manufacturing or services • US-centric, facilities • E&S audit required	• GP has ESG/climate mandate • Any LP have specific ESG standards • Is ESG due diligence audit required	• SASB materiality for sector/sub-sector • Specific social or supply chain issues • Pre-acquisition due diligence checklists
• IFC E&S + ESG standards • Low-carbon or high-carbon • Governance and D&I	• PRI ESG guidelines for PE • Decarbonization plan • Stakeholder expectations	• Additional GP ESG standard • Are ESG/E&S KPIs in place/tracked • Community and value chain
• Divested from listed company • Has GRI, SASB, or CDP reports • Has E&S compliance reports	• Well-established private business • No ESG/climate programs • Has E&S compliance reports	• Recent business enterprise • Basic compliance reporting • No ESG staff/programs

The quality of Environment, Health, Safety, Social & Security (EHSSS), ESG, sustainability, and corporate governance programs at the shortlisted company can be quickly assessed by interfacing with the PE team engaged in the deal. For mature companies with ESG/climate disclosures in place (**shaded green**), desktop ESG assessments are usually sufficient, while for companies with moderate (**shaded blue**) or basic (**shaded yellow**) programs, there is a need for a review of applicable documents and interviews with the leadership at the corporate offices of the portfolio company. Should a desktop study reveal potential material risks, a more rigorous review of exposures is undertaken over the lifecycle.

For pre-acquisition due diligence audits of companies in the low-carbon sectors that have availed government grants, tax credits, carbon offsets, or long-term debts financed by sustainability-linked bonds, reviewing compliance with loan/grant-agreements, ESG/CDP scores, decarbonization programs, carbon/water intensities, and Scope 3 emissions, may also need to be included in the scope of the assessment.

Industrial facilities in chemicals, utilities, and manufacturing sectors operating for many years, may have subsurface contamination and/or legacy issues requiring compliance audits and site assessments at several locations. These can be conducted concurrently with ESG audits at the corporate level so that the results of both can be presented together, saving precious time during competitive bidding, deal-making, and negotiation stages with the owner.

With PE developing deep expertise in specific sectors, we see boutique PE specialized in transitioning high-carbon industries acquiring oil/gas assets to install renewable energy for electrifying production and convert abandoned wells to carbon capture, injection, and storage (CCIS) facilities for producing high-quality carbon credits. Stantec has comprehensive expertise on both ESG and environmental due diligence audits, permitting of renewables, hydrogen, and CCIS facilities, and program management to help these PE build/exit the value-added assets.

Along with identifying gaps and corrective actions, we provide implementation timelines along with budgeting, phasing, resourcing, strategy and policy preparation, performance assessment, and disclosures of the ESG/climate modules. Our program managers and ESG experts can implement the modules, train the team at the portfolio company, and produce verified GHG and ESG disclosures.

Post-Acquisition and Operations Support

After financial closure, PE teams work closely with the leadership and operations at the portfolio company on various value-building programs including ESG/climate integration initiatives that were identified during the pre-acquisition due diligence study. If the assets are already part of the portfolio, we can provide a similar set of services. Please refer to the post-acquisition and operations support items enumerated below.

Integrating ESG/Climate Programs During the Implementation Phase at Portfolio Companies

Climate Integration	ESG Integration	Special Studies
• Scope 1 & 2 GHG inventory, reporting, and decarbonization	• ESG materiality assessment, strategy, policies, and programs	• Integrated ESG/climate risk assessment and de-risking
• Scope 3 GHG estimation, life-cycle analysis, and decarbonizing value chain	• ESG investing: exclusion, best-in-class, and themed portfolios	• Craft specific programs to improve ESG score and ratings
• TCFD risks and opportunities: scenarios and value at risk	• Benchmarking, scores, and improvement programs	• Assist PE with annual valuation of their ESG/climate programs
• Energy efficiency: utilities, zero flaring, and fuel switch	• Transforming ESMS to ESG using IFC guidance	• Greening of supply chain and pollution prevention plans
• Low-carbon: renewables, hydrogen biofuel, energy storage, and CCIS	• Integrated ESG sustainability reporting and verification	• Biodiversity restoration and forest carbon credits
• Climate vulnerability and resilience assessment	• Stakeholder engagements on ESG programs and clarifications	• Help GP update climate and ESG mandates, policies, and reports
• Carbon credits and offsets in regulated and voluntary markets	• Self-Developing ESG scores of divisions and corporates	• Clarify ESG/climate issues that LP or stakeholders identify
• Feasibility, permitting, and climate financing	• ESG training programs and case studies for workshops	• Conduct ESG/climate due diligence for exit valuations

ESG/climate integration during the operational phase may consist of multi-year programs, often completed before the five-to-seven-year period when the PE typically exits the portfolio company. In the above table, we have enumerated specific services under climate, ESG, and special studies to differentiate the requirements so that they can be conducted separately or grouped together. Typically, the ESG/climate services integration efforts are conducted over several months to enable consistent buildout of the modules, generating decision-useful data for technology and financial innovations.

Although climate and KPI/reports are the main deliverables, the continuous improvement modules in the programs provide many benefits: they improve the ESG/climate competence of the team, sharpen the leadership's engagement with stakeholders, and improve ESG/climate scores with CDP and other external ESG rating agencies.

> ***"THIS MAY IMPROVE THE PORTFOLIO COMPANY'S CREDIT RATING, ACCESS TO LONG-TERM CAPITAL, INNOVATIONS IN VALUE CHAIN, PARTICIPATION IN INCLUSIVE ECONOMIES, AND ULTIMATE VALUE UPON EXIT."***
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> EXECUTIVE VICE PRESIDENT, ENVIRONMENTAL SERVICES

The ESG/climate buildouts demonstrate the risk reduction and value creation components in the portfolio company by transparently tracking performance over the investment/management timelines, making the overall sale proposition more appealing and unique. This opens the field to a wider range of potential buyers with the opportunity to fetch better values and terms at exit.

ESG/Climate Value Addition

The ESG/climate integration process is more than audits, gap analyses, strategies, policies, programs, and KPI – it entails a phased buildout of decision-useful data customized to the business, operations, leadership, resources, value chain, risks, and opportunities at the enterprise level. It needs to build on the enterprise knowledge, enable innovations, embed technologies, transform energy, and onboard expertise at various levels embedded in the portfolio company.

A multidisciplinary consultancy and design firm, our solutions are grounded by our practical implementation experience. Spread across more than 400 offices globally, our planners, scientists, economists, architects, engineers, data scientists, and program managers have decades of experience creating nuanced and layered ESG/climate buildouts that are future-ready and monetizable. We know there are headwinds and changes facing the PE sector, with intense competition to deliver bankable value and de-risked returns to investors.

At Stantec, our approach to ESG/climate integration complements and supports the skills at PE and portfolio companies. Our experience with progressive PE business models can deliver effective sustainability agendas that do not face regulatory requirements for disclosure and are liberated from the quarterly earnings expectation as required by public companies. This can offer significant control over long-term strategies and tactics within their portfolio companies.

Check out Stantec's 2022 Sustainability Report.