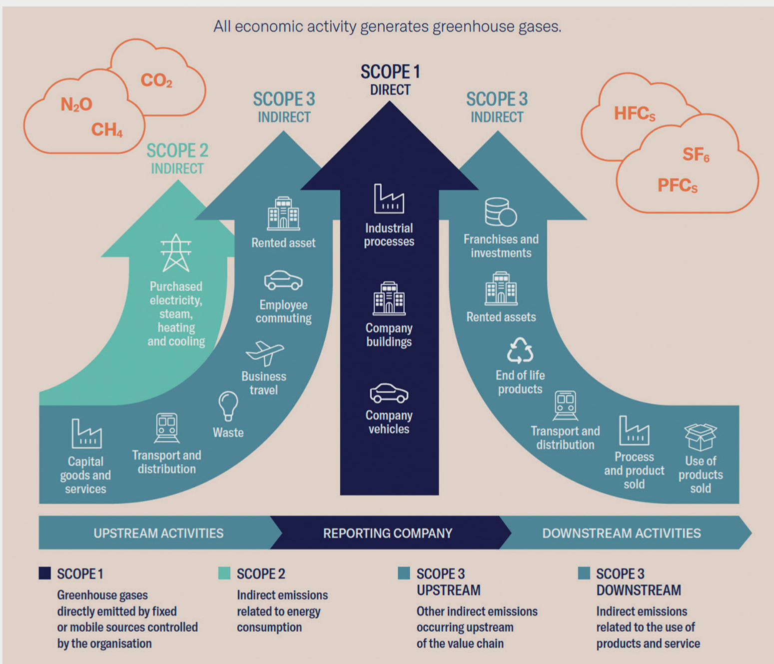
Decarbonisation, debt and deadline: private debt and the net zero target

Private debt capital can be deployed successfully to support the vital contribution of companies in making meaningful and timely greenhouse gas reductions at scale.

By *Lindee Wong* and *Vincent Lemaitre*

Following the last United Nations Climate Change Conference in 2022, governments and businesses worldwide have reacted to the urgent call to accelerate the pace of climate action. Our view is that there is no way to reach the net zero target without strong and coordinated action on corporate emission reduction. The success of a decarbonisation strategy heavily relies on external stakeholders, as the Scope 3 emissions of one company are linked to the Scope 1 and 2 emissions of another.

FIGURE 1: GREENHOUSE GAS EMISSIONS IN TONNES OF CO_2, EQUIVALENT – TCO2E:



Source: Tikehau Capital

Embrace or increase risk: the role of mid-market companies in decarbonisation

Mid-market companies, the main targets of our private credit platform, collectively play an important role in the global economy. They have a significant impact on climate change outcomes, both as a source of emissions today and as an enabler of the decarbonisation solution. According to the European Commission, the greenhouse gas (GHG) contribution of mid-market companies represents up to 63% of the total European emissions.[1] While they may not have the same scale and resources as large corporations, their agility arguably allows them to (i) embrace change quicker, (ii) innovate (for example clean technology), and (iii) adopt a localised position of influence, to make them important contributors to achieving neutrality goals at both a domestic and a global level.

It is also a business imperative to build a sound sustainable proposition, starting with a decarbonisation plan. We believe that the transition to a low-carbon economy will create new business opportunities for those who position themselves as leaders. A strong ESG proposition helps companies tap new markets and expand in existing ones. We know that stakeholders such as employees, suppliers and clients are looking at the sustainability practices of a company during the course of business. Leaders can also earn subsidies and government support, boost employee motivation, attract talent through greater social credibility and better capital with potentially better financial terms, all of which should result in superior performance and sustainable value creation.

There are some businesses that are suppliers to large, listed companies. As many of these large companies have Scope 3 reduction targets, middle market companies are pressured to reduce their own GHG emissions accordingly, or risk being excluded. As evidenced by the SBTi 2022 report, companies need to take significant steps towards decarbonisation to meet their commitments. Indeed, 40% of companies listed on Japan's NIKKEI Index, 69% on the UK's FTSE, 70% on Germany's DAX Index, 88% on France's CAC Index, and 42% of all S&P

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500 companies had set or committed to set targets by the end of 2022.[2]

The European regulator has also incorporated mid-market companies into most of its sustainability agenda, highlighting the significant role they play in the transition. The Corporate Sustainability Reporting Directive (CSRD) requires both public and private companies to disclose on sustainability, including their carbon footprint and emission reduction targets.[3] The CSRD has increased the scope of eligibility and it will apply now to approximately 50,000 companies in Europe. It will be mandatory for companies meeting two out of the three criteria from: more than 250 employees, more than € 40 million in annual turnover, or more than € 20 million on their balance sheet.

Private debt: a well-placed asset class to mitigate the climate crisis

Meeting decarbonisation goals requires funding long-term strategies and access to portfolio company management, which is inherent to the activity of private debt. At Tikehau Capital, we invest in mid-market companies on average for five years, which gives us time to implement and monitor changes. The long-term nature of many private debt investments allows for a deeper relationship than most shareholders and bondholders have.

While decarbonisation and the transition to sustainable business practices offer potential opportunities, they also pose significant challenges. Mid-market companies generally have small administrative capacities and are less well equipped to deal with the cascade of sustainable finance regulations. Private lenders can act as a catalyst for change, plug the gap with their expertise, and act as an advisor on developing a clear decarbonisation proposition.

We believe it is our imperative as a private markets asset manager to measure and monitor the climate performance of our portfolio to support the financial interests of long-term investors. We recognise this as a major and necessary part of our fiduciary duty. Managing ESG considerations is a natural way to preserve the downside protection of portfolio returns. ESG quantifies risks that can’t be measured by traditional financial metrics. ESG factors could affect the long-term financial performance of borrowers as well as refinancing risk. Sustainable investing therefore is not just about driving positive change, it also makes investment sense.

ESG ratchets: a powerful tool for accelerating climate action of financial participants

The big focus of our approach in private debt to net zero is engagement through contractually embedding ESG ratchets, which are debt instruments that provide the potential to drive transition through financial incentives, upwards and downwards. They are designed to generate positive outcomes on specific points of the transition, to support borrowers in achieving their sustainability objectives. By doing so, we try to influence the company’s activity by conditioning its cost of borrowing on its climate performance. ESG ratchets have become an efficient tool to engage more proactively with portfolio companies, accelerate change and increase the monitoring of improvement as they are based on quantifiable and measured data.

In the context of our net zero commitment, we aim to align the yearly decarbonisation objectives of our portfolio companies to the Paris Agreement using SBTi methodology. The portfolio companies can benefit from a lower cost of capital if they meet their annual objectives, but also commit to higher potential penalties in case of failure to adequately reflect the financial materiality of decarbonisation activities. We also believe that by contracting an ESG ratchet, mid-market companies can better communicate their ESG proposition and use this as a tool to differentiate themselves from peers. ■

1 https://europa.eu/eurobarometer/api/deliverable/download/file?deliverableId=81023
2 https://sciencebasedtargets.org/resources/files/SBTiMonitoringReport2022.pdf
3 https://ec.europa.eu/finance/docs/level-2-measures/csrd-delegated-act-2023-5303-annex-1_en.pdf

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SUMMARY

The transition to a low-carbon economy will result in a transformation in our economy that will create new business opportunities for those companies who position themselves as leaders.

Mid-market companies play an important role in this development.

Due to its ability to incorporate emission reduction-based incentives for businesses in loan offerings, private debt will become a vital allocation for investors looking to construct net zero portfolios.

PHOTOS: ARCHIVE TIKEHAU CAPITAL