cio investment club

February 2024 Issue #2

Making an impact: why institutional investment is key to achieving the green transition

2023 was a year in which the world set a host of dubious records, including the hottest ever summer, the highest number of wildfires and an unrivalled number of billion-dollar disaster events.

These alarming statistics are attributable to climate change, which left unchecked is on course to see global temperatures exceed 1.5 degrees Celsius by 2050, leading to an even greater number of severe weather-related events.

Avoiding such apocalyptic outcomes requires money – and lots of it – to transform the global economy from one reliant on carbon, to one that harnesses cleaner, sustainable energy.

While estimates vary for just how much the green transition will cost, figures stretch to US$300 trillion by 2050 which equates to three times the current global annual GDP.

While governments have pledged billions of dollars to meet their net zero commitments, the lion's share will need to come from institutional investors, which is proving something of a sticking point.

Financing for climate tech, most of which is made through private markets, saw a significant fall last year.

PwC reports that total venture and private equity investment and grant funding in climate tech start-ups was down 40.5% during 2023, which PwC says "takes climate tech start-up funding back to the level of five years ago".

PwC says that while early-stage investment to drive innovation is no longer needed for more mature sectors including wind and solar, it has implications for newer technologies including carbon capture and alternative food sources.

Like riding a bike

The challenge then is how to keep fanning the financial flames that will power the green transition.

A key component of unlocking investment, according to the Pensions and Lifetime Association (PLSA), is "policy certainty" and clear plans from governments about the future for their economies, for example the UK's Green Transition or through the national infrastructure plan, which will help draw pension fund investments.

Jerome Neyroud, head of infrastructure debt at Schroders Capital, likens the evolution of regulation in the energy transition to a child learning to ride a bicycle.

"When a child is very young, it cannot even walk, so it certainly can't ride a bike. The technology is unproven and there is no market. Regulation at that point is unhelpful. Then the child reaches a stage where they are ready to ride but still need training wheels. That is the role of regulation."

He continues: "It is what we saw with renewables several decades ago and it is the stage we are now reaching with some of these newer technologies, which need regulatory support to make them bankable."

And bankability is essential if investors are to stay on the right side of their fiduciary duty to get the best returns for their members.

There have long been hurdles for responsible investment advocates in demonstrating such strategies deliver on both performance and impact. However, advances in data collation and analysis are making life easier to demonstrate a positive outcome for both the environment and the bottom line.

Shuen Chan, Head of Responsible Investment & Sustainability at Legal & General Investment Management Real Assets, says the metrics around transition opportunities and risks continue to evolve.

"While our current focus is on total invested in low-carbon technology and infrastructure, we are developing ways to measure the climate impact of our investments, which may include consideration of avoided emissions on an investment case-by-case basis. Once operational, we will be able to measure the displacement of carbon emissions annually from our clean energy investments such as solar farms," Chan says.

Taking the long view

For institutions with long-term investment horizons in need of liability-linked cash flows, renewable energy access through private markets looks like a neat fit.

Sam Tufts, Head of New Assets at Phoenix Group, says that renewable energy is well suited to many insurers' profiles.

"We are investing to match our long-term cash flows and we often find we can do that through private markets which are longer duration, often with inflation linkage. You also generally have strong covenants underpinning those physical assets offering stable positions and credit protection."

John Bromley, Managing Director of Clean Energy Strategy & Investments at L&G Capital, adds that directly investing in efficient climate and cleantech solutions with clear end-user benefits presents opportunities for investors to participate in a diverse range of investments with "huge growth potential" over the long term.

"As a patient capital investor, we can take a longer-term view of the sector and partner with investee companies to support their operational and commercial scale-up. For example, our long-term partnerships with ground source heat pump manufacturer The Kensa Group and high-efficiency solar cell developer Oxford PV, both now leaders in their sectors," Bromley says.

But while some institutional investors have the freedom to capitalise on an illiquidity premium, others – like defined contribution (DC) pension schemes – have hurdles to overcome if they are to participate in private markets.

In the UK alone trust-based DC schemes are worth £38 billion while DC Master Trusts have amassed £105 billion in assets but their investing power is set to reach around £800bn in 2030, representing a seriously attractive source of capital to drive the green transition.

No surprise then that last year Chancellor Jeremy Hunt announced a series of reforms designed to make life easier for DC schemes – and Local Government Pension Schemes worth £425 billion - to access private markets.

Phil Dawes, Head of Sales for the UK & Ireland at BNP Paribas Asset Management, says that while those responsible for DC schemes have significant demands on their time, which may see ESG investing fall down the list of priorities, not allocating to clean tech and renewable energy is a missed opportunity.

"We are going through a period of unprecedented reallocation of capital that will be reflected in the [clean energy] markets and industries across the globe. If you're not taking advantage of those investment opportunities on behalf of your DC members, when you look back in 10 to 20 years you might regret it."

Alongside government reform, Dawes says the investment industry is making life easier for investors to access diversified opportunities across private markets.

Dawes says: "None of us really knows which of these clean technologies are going to be the winners. It is critical when investing in these areas - and the same applies for private markets in general - you want to be as diversified as possible."

By way of example, Dawes points to the open-ended diversified private credit fund it runs for the UK's default auto-enrolment DC scheme National Employment Savings Trust (NEST) which includes exposure to infrastructure debt, commercial real estate debt, European mid-market loans, UK Small and Medium-sized Enterprises loans and US mid-market loans.

A complex market

But Angelika Delen, Global Head of Impact Investing at Mercer, warns that incorporating private markets, particularly those involving nascent technologies promising positive environmental impact, relies on extensive due diligence for investors.

"Investors need to focus on companies and managers who have a clear goal and can demonstrate the impact. You need to make sure to understand the tools, the frameworks and what they are really doing to help avoid greenwashing."

Delen adds: "And investing in niche technology requires a lot of research; we talk to the people who have experience, making sure that we capture the full picture on the technology and to make sure that we do not oversee challenges that might arise in a few years' time."

Institutional investors will be paramount to the success of the green transition, but they will need support to help overcome barriers to making the necessary allocation to private markets.

More supportive regulation from government; greater availability and transparency in financial products; and reliable data and analysis to help understand risk and reward must be forthcoming.

With the right tools in place, we might just achieve a successful green transition.

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