Mercer

Positioning for transition

Capturing themes in private markets

welcome to brighter

A world in transition

Investors around the world are faced with the uncertainty of inflation following a sustained period of both fiscal and monetary stimulus. More recently, emerging geopolitical conflicts are adding to volatility, and investors are increasingly concerned about elevated valuations across multiple asset classes. All this is happening at a time when investors are trying to position their portfolios for the transition to a lower-carbon economy.

In this three-part series, *Capturing Themes in Private Markets*, we translate these developments into relevant themes for investors. Private markets are well positioned to help investors address these challenges through a diverse and innovative range of strategies as they seek to unlock portfolio returns.

We have identified three overarching themes that we believe will impact investment decisions, specifically addressing:

Part 1: Inflation Playbook — How Can Private Markets Manage Inflation?

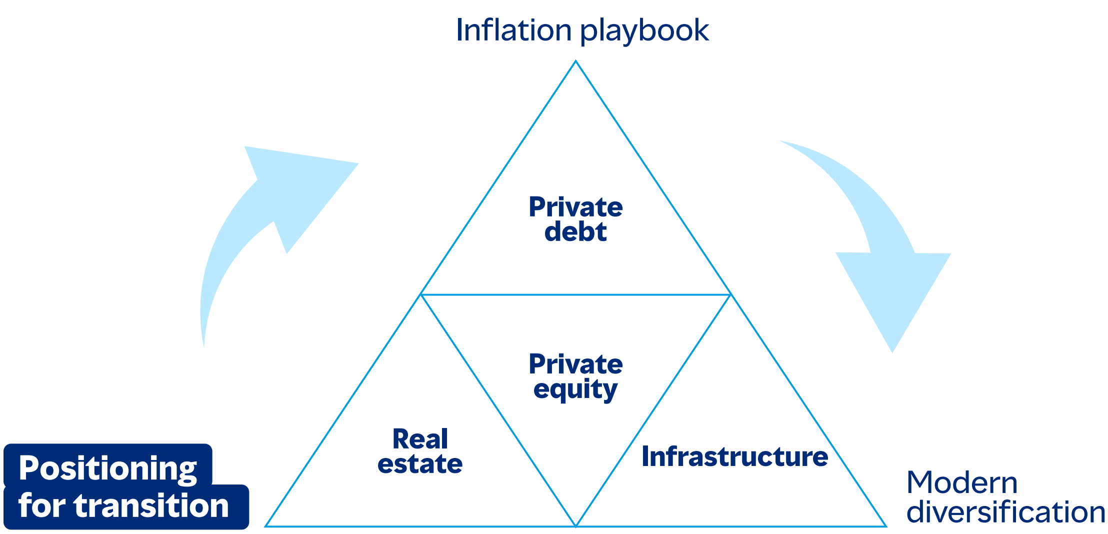
Part 2: Positioning for Transition — How Can Investors Pursue a Sustainable Path Without Missing Out on Returns?

Part 3: Modern Diversification — How Do Investment Themes and Innovative Companies Bring Diversification to a Portfolio?

To meet the sustainability goals set by governments, institutions and companies, many and varied industries need to undergo significant and rapid change. This change will not happen by chance, nor will it come for free, so investment is going to be a vital component of its success. But rather than seeing this investment as pure philanthropy, institutional investors can position their portfolios to benefit from this shift in philosophy and practice across a broad spectrum of sectors.

Instead of a relatively limited range of companies listed on global stock exchanges, private markets offer an array of opportunities across all possible sectors, including some of those with the most pressing need for change.

By supporting the transition most industries and sectors need to make, investors are also positioning their portfolios for a new world of opportunity.



Positioning for transition — How can investors pursue a sustainable path without missing out on returns?

Start to change the world with your investments

Inflation and — more importantly — the causes of the current bout of inflation underscore the need to transition to energy sources that are sustainable and within the control of stable democracies.

The escalation of the war in Ukraine has elevated the debate over solutions on how to balance energy security with long-term sustainability goals. This environment presents a value proposition for private markets investors. The ability to influence how assets are managed, coupled with a long-term investment horizon, attracts new capital and drives the transition to a more sustainable path.

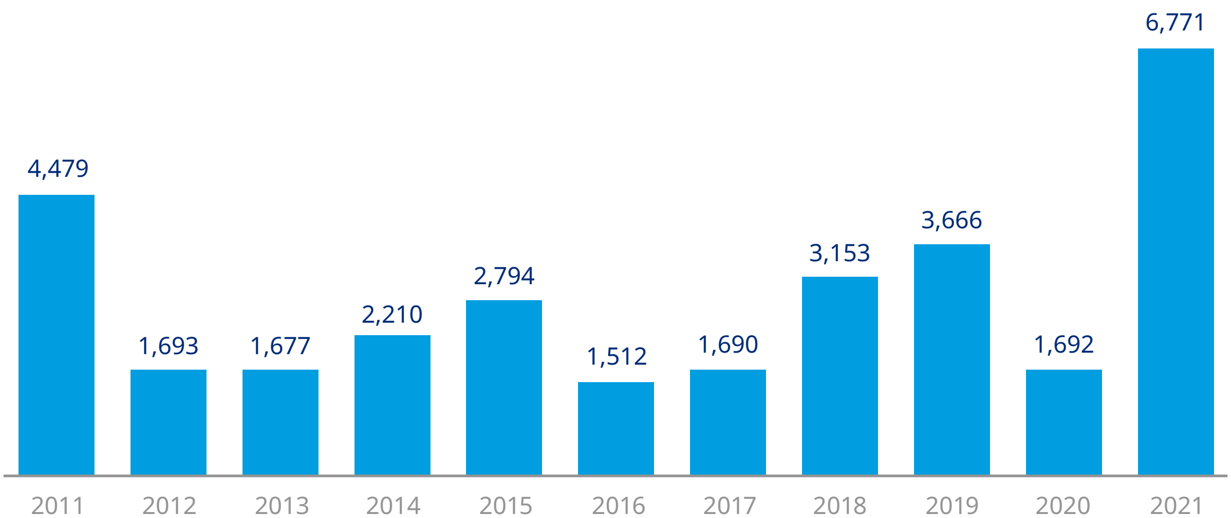
Recent analyses support the trend. In 2021, North American venture capital and private equity invested US$6.8 billion in energy transition companies, reaching a 10-year high. Experts estimate superior returns from carbon capture, green hydrogen and emerging clean technologies.[1]

Private markets can help investors implement their intentions. The range of investment opportunities has changed significantly in recent years. Markets have evolved, enabling investors to build well-diversified portfolios across varied asset classes.

However, investors need to be aware of headwinds with respect to greenwashing. Applying consistent criteria within a risk model is challenging given the lack of standards. In April 2021, the SEC issued a risk alert[2] addressing potential inconsistencies with portfolio management practices and guidelines. Moreover, changing regulations present uncertainties.

Differentiation and sound due diligence is therefore essential to preclude downside risks. We believe the framework in Figure 2 on the following page can help investors build the foundation for a strategic transition.

Figure 1. Record amount of venture, private capital following energy transition in North America ($ million)



As of April, 14, 2022.
Value of venture capital and private equity investment in biomass, biofuels, clean engineering, greentech, renewable energy and smart energy firms.
Source: S&P Global Market Intelligence.

Figure 2. Strategic framework

Attractive market opportunity

Seek to transform the global economy through long-term demand themes, such as:

- Energy transition
- Climate adaptation
- Resilience and social well-being

Value-add portfolio construction

Navigate the complex mix of opportunities through specialized, local researchers focused on:

- Venture capital
- Growth
- Buyout
- Infrastructure
- Real estate
- Natural resources

Impact authenticity

Align investments with long-term demand themes, including:

- Climate
- Resource stewardship
- Social well-being
- Employee goodwill

Private markets managers have the potential to make an impact, either by providing capital or, often, by taking a controlling stake in a company. For example:

- **Infrastructure**

  Investments in infrastructure are central to solving the climate change and energy transition crises. Additionally, infrastructure investments have high entry barriers while offering the potential for alternative sources of income.

  Decarbonization policies are shaping the outlook — Worldwide, countries and companies continue to set net-zero objectives and make decarbonization plans. Infrastructure has been a disproportionate contributor to global greenhouse gas emissions. Power generation and transport together account for nearly two-thirds of total emissions and have been responsible for almost all global growth of airborne pollutants since 2010.[3] As such, decarbonization policies are shaping the outlook for infrastructure investments, broadening the investment pipeline and providing a signification opportunity for alpha generation.

  Pipeline for large-scale renewables — To reach net-zero emissions by 2050, annual clean energy investment will need to more than triple by 2030 to ~US$4 trillion.[4] Consequently, we expect the pipeline for large-scale renewables projects to continue to grow.

  Energy-efficiency technologies — Beyond power generation, there is a growing opportunity set for required energy-efficiency technologies, such as battery storage, smart meters, efficient boilers and the electrification of heating and cooling systems.

  Increasing investment pipeline — With the growing opportunity set, we anticipate more infrastructure funds to be launched that will contribute to organizations' net-zero pledges or that classify under the European Union's Sustainable Finance Disclosure Regulation (SFDR), Articles 8 and 9.

  – During 2021, global investment in energy transition increased by 27% compared to the prior year.[5] Renewables was the largest sector by investment in 2021 as global economies endeavored to diversify the energy mix.

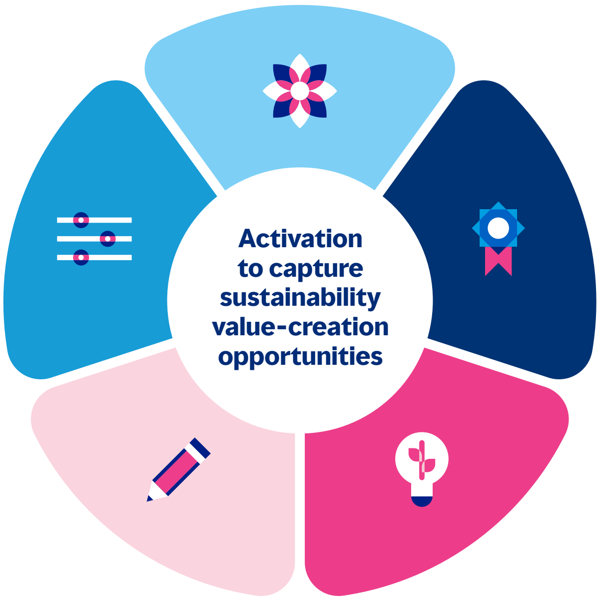
  – Transportation was the sector that experienced the largest shift in investment. Given the sector's major contribution to global CO_2 emissions, we expect investment to continue to increase at an elevated rate.

- **Private equity**

  Many private equity managers focus on venture capital or growth-stage companies, where proof of concept, breakthrough technology and the rate of growth align with the managers' positioning-for-transition themes. S&P Global Market Intelligence data document that renewable energy private equity and venture capital investments increased to approximately US$11.92 billion as of May 2022, up 144% over the one-year period.[6]

  The structure of private equity companies is well suited to facilitate energy-security and energy-transition solutions.

Figure 3. How private equities can drive intentional changes



Drive a cultural shift throughout the organization
Create a culture that actively seeks out and cultivates sustainability opportunities across the organization, extending beyond dedicated functions such as IR.

Install champions with operational expertise
Install senior sustainability champions with the operational experience to understand industry-specific materiality and move beyond "checkbox" exercises.

Integrate sustainability into the full investment life cycle
Create explicit and intentional processes to integrate sustainability into the value-creation plan from sector strategy through diligence, ownership and exit.

Strengthen measurement systems
Join collaborative platforms working toward comparability; develop custom metrics for asset-specific material issues; track progress through regular reviews.

Embrace experimentation
Encourage and enable experimentation to test and refine nascent value-creation opportunities; rapidly scale successful pilots.

Source: World Economic Forum and Boston Consulting Group analysis.

Changing return pattern — Historical returns on investments in renewables have been disappointing, partly due to low energy prices, low interest rates, and a host of technical and cost issues. Surging inflation and supply-chain challenges, along with increasing regulations and incentives supporting the energy transition, open up investment opportunities. Investors may shift their attention from traditional fossil fuels to energy-transition companies.[7] GPs are well positioned to evaluate early-stage companies and actively drive this transition.

"Gray-to-green" transformation[8] — Private companies usually have full operational and management control over their businesses and are less exposed to reputational and regulatory scrutiny. The management consulting experience of GPs, coupled with the longer time horizon of private equities, is particularly effective in the transformation of so-called "gray" assets. In general, private markets have a much stronger impact as they are often injecting new capital into the system rather than simply participating in the repricing of capital in the listed markets.[9]

Ranges of themes — GPs can take advantage across a range of themes, such as circular economy, energy efficiency, environmental support and waste management, financial and digital inclusion, and pollution prevention and control. Examples include:

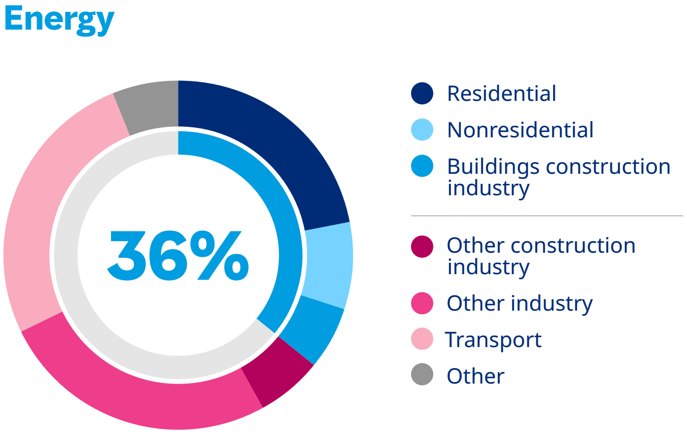
- **Circular economy** — A circular economy focuses on matters that involve consumption reductions, reuse and recycling. From companies that rent bicycles and e-scooters to firms that extract high-value plastics from end-of-life vehicles to companies that provide an online marketplace for the resale of various products — each of these types of businesses extracts greater value from the assets and allows it to be monetized.

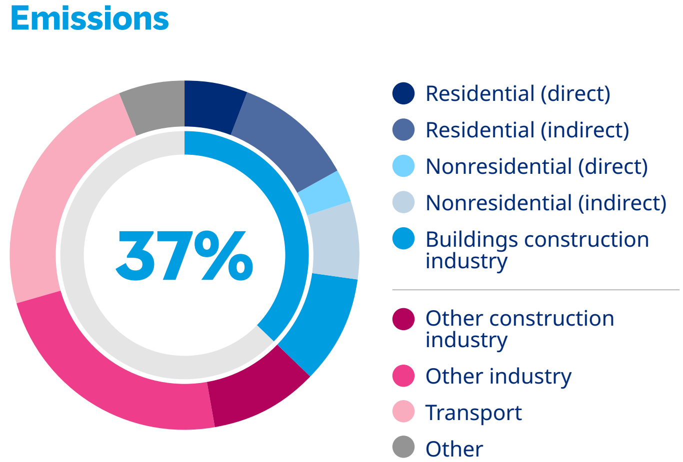
- ## Real estate

Portfolio markets are driven by the following transition drivers:

Emission reduction — The building sector has a massive carbon footprint when indirect emissions are considered. Technical innovations, specifically in heating/cooling and lighting, have contributed recently to more efficient operations. Despite these reductions, the global share of energy-related CO_2 emissions from buildings and construction compared to other sectors stood at 37% in 2020[10] (see Figure 4).

Figure 4. Buildings and construction's share of global final energy and energy-rated CO_2 emissions 2020





Note: "Buildings construction industry" is the portion (estimated) of overall industry devoted to manufacturing building construction materials, such as steel, cement and glass. Indirect emissions are emissions from power generation for electricity and commercial heat.

Source: IEA 2021a. All rights reserved. Adapted from "Tracking Clean Energy Progress."

Innovations — Global building construction continues to grow at a fast pace, amplifying the need for innovative solutions to meet net-zero targets for new buildings and renovations. The market is expected to grow from US$6.5.trillion in 2021 to US$7.4 trillion in 2022 at a compound annual growth rate of 12.7%.[11] Examples of new technologies include smart appliances; efficient water, heating or cooling systems; electrochromic smart glass; the use of biodegradable materials; and solar-powered homes. In many countries, governance supports the upgrades, offering a variety of benefits, from tax deductions to subsidies.

Greater focus on environmental, social and governance (ESG) concerns — More managers are getting serious about reducing emissions and fighting climate change, although large variations persist. In March 2021, the EU's SFDR and Taxonomy came into force, which spurred managers — mainly in Europe — to make their ESG objectives known. We also see more impact strategies focused on social programs, food production and affordable housing.

Riskier climate — The physical consequences of a changing climate are becoming more pronounced as higher temperatures lead to more extreme weather systems, bringing storms, floods, fires and extreme heat. In addition to increased flood risk and property damage, climate change may increase mortgage default rates, increase the volatility of house prices and possibly produce climate-related migration patterns.[12] CoreLogic estimates the property damage from the largest natural catastrophe events for US residential properties at US$56.92 billion in 2021.[13] The numbers present a challenge to managing property costs and driving the transition naturally.

- **Private debt**

Private debt has lagged other private markets asset classes in terms of sustainable or impact investment strategies. This is partially a function of the limited ability to engage from a noncontrol perspective. However, capabilities and the product set have expanded in the past 12 months. ESG issues represent material risk factors when it comes to underwriting a loan, and private debt asset managers have bolstered their resources across the board to help identify such risks. This coincides with a definitive shift in the preference of investors to seek managers with these capabilities.

We also see greater scope for ESG-related engagement with private debt portfolio companies compared to publicly issued and traded corporate bonds. Recent trends include:

Direct lending — Specifically in Europe, we have seen the emergence of loans that offer borrowers the ability to incrementally lower their interest payments once they have met predetermined ESG-related reporting or metrics.

Impact — Managers are launching impact-focused funds in which they finance private-equity-sponsored companies with impact-driven strategies; for example, financing the transition to clean energy.

Solving the energy transition puzzle — According to the modeling of the Net Zero 2050 scenario from the Network for Greening the Financial System,[14] sustainable infrastructure and real estate debt has a key role to play.

Figure 5. Opportunities across industries and sectors

Renewable and alternative energy
Solar, wind, wave, biofuels and geothermal technology

Water infrastructure and technologies
Irrigation, storage, treatment, drainage and flood protection

Environmental support services
Consultancies, carbon trading, data and reporting management

Energy efficiency
Storage plus power network, industry, building and transport efficiency

Health, housing and social services
Positive impacts for social development; e.g., affordable housing and healthcare

Pollution control
Pollution control solutions and environmental testing

Sustainable resource management
Soil management, sustainable farming and forestry

Waste management and technologies
Recycling processing, hazardous and general waste management — circular economy

Consumer services with impact
Financing and affordable consumer staples for people currently underserved

Private markets are most commonly associated with transformational investing since investors have a greater ability to drive change and convert global systemic risks into sustainable returns. According to a World Economic Forum report, there is an annual investment gap of US$6.27 trillion.[15] New project and capital needs emerge across industries and sectors (see Figure 5) and offer asset owners a rich universe to drive change and identify return opportunities.

Key takeaways

Traditionally, investors turn to private markets to seek return opportunities and diversification.

As investors continue to increase their allocations to private markets, they are also finding added benefits. Private markets investments provide elements of inflation-protection hedging in investors' portfolios. They also offer a diverse range of opportunities to meet investors' sustainable and impact goals while aiming to deliver a higher return profile than with public markets. In addition, investors can achieve enhanced diversification by investing in managers with innovative strategies at companies that are leading change in their sectors.

The opportunity set in private markets is deep. It is therefore important to diversify across a range of managers using a variety of strategies. The starting point is an effective portfolio construction process to identify the themes and opportunities that investors plan to capture. Investors should also apply a rigorous due diligence process to ensure a balanced blend of strategies diversified across geographies, sectors and vintage years.

Despite recent market volatility, future growth in private markets looks strong. Experts predict that private equity assets under management (AUM) will grow at 16% per annum (p.a.) between now and 2025 to US$10 trillion, with private debt expected to grow by 11% p.a.[16] Similarly, strong AUM growth is expected in infrastructure equity and real estate.

Macroeconomic headwinds, such as inflationary pressures and more modest growth prospects, are foremost on investors' minds. The transformational investing approach of private markets, which combines thematic sourcing with value creation, can help investors navigate this environment.

In parts one and three of this three-part series, *Capturing Themes in Private Markets*, we look at:

Inflation Playbook — How Can Private Markets Manage Inflation? Inflation Reaches a 40-Year High in 2022

Modern Diversification — How Do Investment Themes and Innovative Companies Bring Diversification Into a Portfolio? Beyond Beta: Private Markets — The Roadmap for Modern Diversification

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