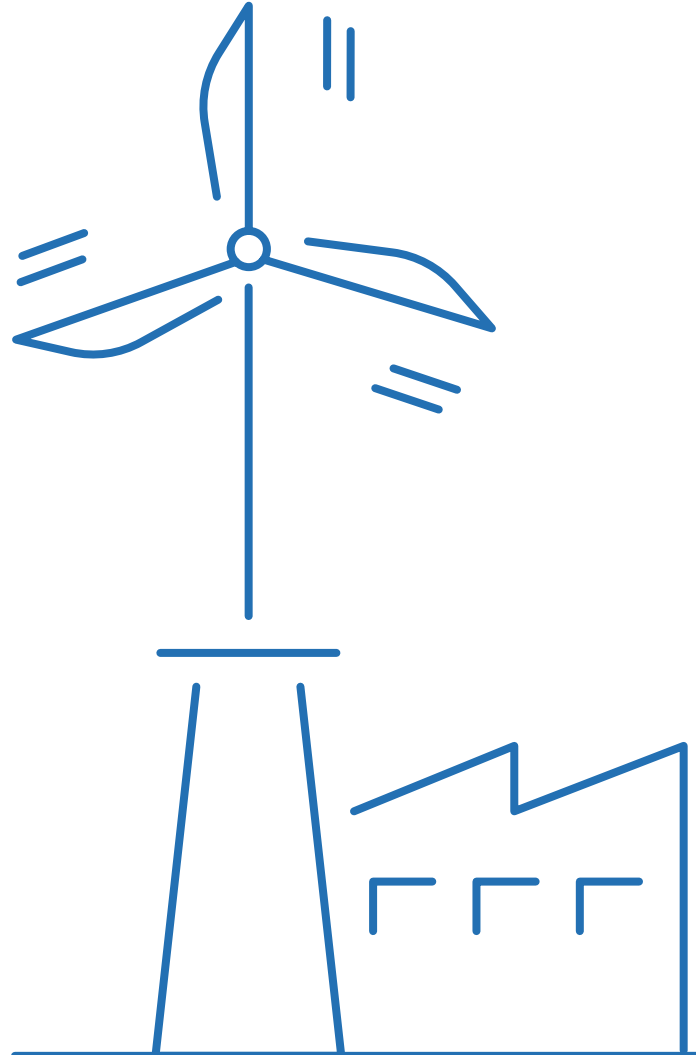




FCLTGLOBAL
FOCUSING CAPITAL
ON THE LONG TERM



REPORT

Grey to Green:

THE OPPORTUNITY FOR PRIVATE
EQUITY TO DECARBONIZE ASSETS

Focusing capital on the long term to support a sustainable and prosperous economy.

Millions of people around the world are saving money to meet personal goals—funding a comfortable retirement, saving for someone’s education, or buying a home, to name a few.

The funds to support these goals are safeguarded by institutional investors—pension funds, sovereign wealth funds, insurers, and asset managers—who invest in companies for the prospect of growth and security. These savers, their communities, and the institutions that support them make up the global investment value chain, and each benefit from long-term decisions in different ways.

Data shows that long-term-oriented investors deliver superior performance, and long-term-oriented companies outperform in terms of revenue, earnings, and job creation. But despite overwhelming evidence of the superiority of long-term investments, short-term pressures are hard to avoid. A majority of corporate executives agree that longer time horizons for business decisions would improve performance, and yet half say they would delay value-creating projects if it would mean missing quarterly earnings targets.

Today, the balance remains skewed toward short-term financial targets at the expense of long-term value creation.

FCLTGlobal’s mission is to focus capital on the long term to support a sustainable and prosperous economy. We are a non-profit organization whose members are leading companies and investors worldwide that develops actionable research and tools to drive longterm value creation for savers and communities.

MEMBERS



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EXECUTIVE SUMMARY

Decarbonization is a generational investment opportunity and, with the right structures in place, private markets can drive investment at scale in the “grey-to-green” transition – that is, investing in high-carbon-emitting sectors with the goal of reducing their emissions over time.

Investing in high-carbon assets can generate long-term value and is crucial for real-world decarbonization. Private markets are well-positioned to lead the grey-to-green transition as they possess the skillset and tools required for the transformation. Spurred in part by a growing limited partner (LP) focus on the climate transition, private equity firms and alternative managers are taking note of this investment opportunity, and as of this report’s publication, many of the largest global private market investors have set climate change goals, are offering climate change funds, and are exploring grey-to-green investments.

However, concerns around returns, metrics, and reputational impacts associated with this novel investment strategy are limiting LPs’ participation in grey to green investment opportunities. LPs want to ensure that the returns are commensurate with the risks, including whether general partners (GPs) have the deep knowledge of relevant industries and credible climate transition pathways that are needed for success. LPs are concerned that high-carbon investing increases the carbon intensity of their portfolios, and the time and turbulence involved in achieving sustained decarbonization puts owners at risk of not meeting their own climate change targets. Finally, the reputational and regulatory risks associated with investing in high-carbon assets pose additional complications.

Capital allocation for grey-to-green investing will require LPs and GPs to put in place mutually reinforcing systems and structures that pursue integrated climate and financial outcomes.

Actions that are needed across the investment value chain towards this end include the following:

-  Clarity from LPs on the role that grey-to-green investing will play in their investment strategy
-  Clarity from GPs on how their investment strategy will integrate competitive returns and decarbonization outcomes
-  Flexibility from LPs that have set net zero goals
-  Asset level metrics supporting portfolio disclosure
-  Innovative incentive structures for integrated climate and incentive success

Development of this area – and participation by leading GPs and LPs – will be critical to an orderly climate transition.

The carbon transition provides a significant investment opportunity

Transforming high-carbon assets is a significant investment opportunity that can generate long-term value and is vital to real-world decarbonization.

As investors consider how to take advantage of these opportunities and generate returns in a market that is affected by climate change impacts, they are paying attention to high-carbon assets. These industries –

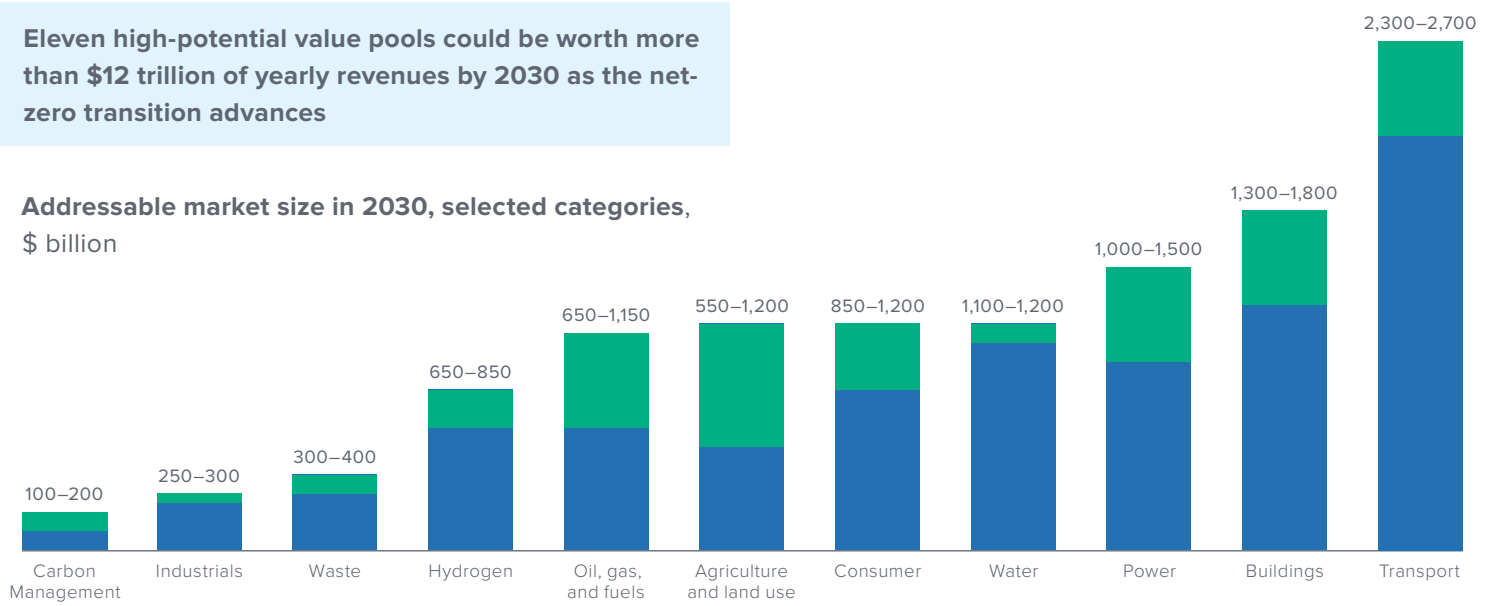
such as energy, transportation, steel and cement – are critical parts of the global economy and vital to geopolitical security. Where the relevant companies and industries can be put on responsible and resilient decarbonization trajectories, the assets in question are positioned to generate value in a carbon constrained future. Capital allocated to such assets to drive the grey-to-green transformation can both reap the investment returns and drive the transition.

Exhibit 1: Climate transition investment opportunity

Source: [Accelerating Towards Net Zero: The Green Business Building Opportunity, McKinsey](#)

Eleven high-potential value pools could be worth more than \$12 trillion of yearly revenues by 2030 as the net-zero transition advances

Addressable market size in 2030, selected categories, \$ billion



Carbon Management

- Carbon capture, utilization, and storage
- Carbon-offset markets
- Carbon tracking and measurement

Industrials

- Steel
- Aluminum
- Cement
- Mining
- Chemicals

Waste

- Enablers of materials reuse
- Industrial-and mature-materials processing
- Materials-processing innovation

Hydrogen

- Production
- Transmission
- End use

Oil, gas, and fuels

- Electrification of upstream and downstream
- Efficiency improvements
- Direct emissions elimination
- Sustainable fuels

Agriculture and land use

- Land and forest management
- Agricultural production
- Alternative proteins
- Food waste reduction
- Sustainable agricultural inputs
- Sustainable agricultural equipment

Consumer

- Consumer electronics
- Sustainable packaging
- Sustainable fashion

Water

- Municipal water supply
- Industrial water supply

Power

- Renewable-power generation
- Grid modernization and resiliency
- Flexibility and energy storage
- Power system tech and analytics
- Decommissioning and thermal conversion

Buildings

- Sustainable design, engineering, and construction advisory
- Green building materials
- High-efficiency equipment
- Green building tech/operations

Transport

- Electrification
- Micromobility
- Infrastructure for electric vehicles
- Sustainable aviation

Exhibit 2: “Grey to green” investment potential

Source: [From Brown to Green, McKinsey](#)

Five groups of technologies could attract \$2 trillion of capital per year by 2025 and abate 40 percent of greenhouse-gas emissions by 2050

Electrification

- Electric-vehicle batteries
- Battery-control software
- Efficient building systems
- Industrial electrification

Agriculture

- Zero-emissions farm equipment
- Meat alternatives
- Methane inhibitors
- Anaerobic manure processing
- Bioengineering

Power grid

- Long-duration storage
- Advanced controls
- Software and communications
- Vehicle-to-grid integration
- Building-to-grid integration
- Next-generation nuclear
- High-efficiency materials

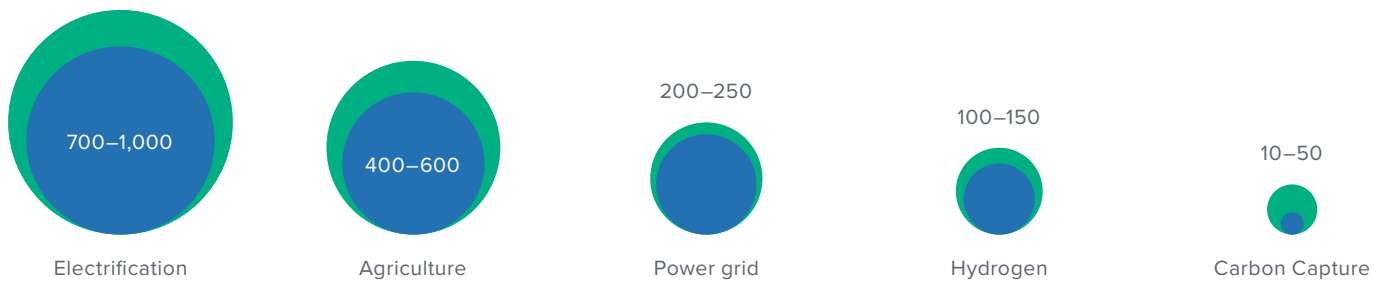
Hydrogen

- Low-cost production
- Road-transport fuel
- Ammonia production
- Steel production
- Aviation fuel

Carbon Capture

- Pre- and postcombustion capture technologies
- Direct air capture
- Bioenergy with carbon capture and storage
- Biochar
- CO₂-enriched concrete

Annual investment by 2025, \$ billion



CO₂ abated per year in 2050, gigaton (1.5°C pathway)



Exhibit 3: Which are the most carbon intensive sectors in the world?

Source: [Emissions by Sector, Our World in Data](#)

Energy, Agriculture and Land Use, Industry and Waste are the most energy intensive sectors in the world

This is shown for the year 2016 – global greenhouse gas emissions were 49.4 billion tonnes CO₂eq.



Energy 73.2%

- 24.2% Energy use in industry
- 17.5% Energy use in buildings
- 16.2% Transport
- 7.8% Unallocated fuel combustion
- 5.8% Fugitive emissions from energy production
- 1.7% Energy use in agriculture and fishing

Agriculture, Forestry & Land Use 18.4%

- 5.8% Livestock & manure
- 4.1% Agricultural soils
- 3.5% Crop burning
- 2.2% Deforestation
- 1.4% Cropland
- 1.3% Rice cultivation
- 0.1% Grassland

Industry 5.2%

- 3.0% Cement
- 2.2% Chemicals

Waste 3.2%

- 1.9% Landfills
- 1.3% Wastewater

Private markets are well placed to lead the grey-to-green movement

While there is significant return potential, investors remain concerned about the financial, transitional, and reputational risks associated with investing in high-carbon assets. These concerns, propelled by [growing divestment pressures](#),¹ are [driving the ownership of these assets from public to private markets](#).² When some portfolios lower their exposure to high-emitting assets simply by transferring ownership to others, the impact of such a shift on real-world decarbonization is negligible.

Owners, therefore, are increasingly focused on the role that private market managers could play in cleaning up high-carbon assets. In November 2022, a group of asset owners representing \$11T in assets called on their managers, [including private equity firms and other alternative managers, to “raise their level of climate ambition”](#).³

The private equity industry is taking note. As of the publication of this report, 7 of the 25 largest global PE firms have set climate change goals. [The industry is already raising billions from climate funds](#).⁴ Some of these funds include ambitions for grey-to-green investing.

The skillset and tools of private markets investors, such as more focused governance structures and longer holding periods, position them well to transform these industries in a way that creates real-world decarbonization and earns the related return in the process. Private markets can lead the grey-to-green transition using strategies that fit within existing investment categories and cater to a range of asset owners’ risk/return appetites (see Table 1).

Table 1: Private market grey-to-green investment opportunities

Investment type	Risk/Return Profile	Purpose of Investment	Investment profile (example)
Infrastructure & Real Estate	Lower	Accelerating investments in infrastructure for resilience/ decarbonization/ facilitating green energy	Energy efficiency/ Retrofits in real estate Modernizing energy grids Energy storage Transport electrification
Credit	Lower	Capital for specific projects	Converting pipelines from natural gas to hydrogen
Buyouts	Medium	Rapid restructuring of current businesses Adoption of new technologies Leveraging expertise through acquisition	Decarbonizing manufacturing Roll-ups to scale superior management processes Green steel/cement
Growth	Medium	Speed to market Scaling solution uptake Commercialization of new technologies	Combination of transitioning investments with climate solutions to enhance returns Coal/Natural gas to hydrogen
Distressed	High	Winding down/ Decommissioning stranded assets	High-cost fossil fuel reserves
Venture	High	Proof of concept of disruptive technologies	Climate tech Carbon capture/sequestration Green mobility solutions

Concerns over returns, metrics, and reputational impacts

While there is interest from both asset owners and private market managers in this burgeoning investment opportunity, its novelty combined with a still nascent understanding of climate change has slowed LPs' readiness to participate. Discussions between GP and LP members in FCLTGlobal's membership have raised the following issues:

LPs want to ensure that the returns are commensurate with the risk in this novel investment strategy.

Transitioning high-carbon assets is an evolving investment area, and the case, from both a research and returns standpoint, is still being made. GPs that are already engaged in such investing point to the shift in capital towards low-carbon options, evolving regulations globally to support climate change solutions, and the declining cost competitiveness of fossil fuels at large. Yet, many of these trends are still in flux.

Successful investments in these industries will involve transforming high-carbon assets. While GPs have a reputation for being "change agents", the industries in question largely involve dealing with legacy assets and complex regulatory environments. Driving sustained change within these assets may involve longer holding periods, which in turn puts pressure on expected returns, particularly internal rates of return. While there may be easy opportunities to generate value through efficiency, driving sustained and cost competitive change may involve the use of novel technologies, further exacerbating concerns about risk.

Given the newness of such strategies and the complexity of the underlying industries, FCLTGlobal members also stressed the need for capacity building across the investment value chain. To succeed, GPs will need to combine traditional skills with deep knowledge of relevant industries and credible climate transition pathways. LPs in turn require capacity building to be able to assess whether a GP's investment strategy will generate both returns and decarbonization outcomes. Capacity building is also needed at the portfolio company level to ensure that the transformation jumpstarted through GP engagement is sustained after exit.

Given the variables associated with such investments, many LPs are concerned that the potential downside exceeds the opportunity for returns.

LP portfolio climate goals and metrics act as a barrier to investments in high-carbon assets.

LPs who have set climate change goals are concerned that high-carbon investing, even for the purpose of decarbonization, increases the carbon intensity of their portfolios. The time and turbulence involved in achieving sustained decarbonization puts owners at risk of not being able to meet their interim reduction targets, many of which are on a 2030 deadline.

Given LP constraints and the trickle-down pressure on managers, GPs are incentivized to mostly offer investment strategies and pick portfolio companies that already have low emissions, rather than grey-to-green options.

LPs are looking for GPs to disclose the carbon footprint of their investments and are increasingly relying on this metric to make capital allocation decisions. Greenhouse gas (GHG) portfolio metrics are complex, opaque, backward-looking, and do not provide insight into real-world decarbonization outcomes. GPs and LPs in FCLTGlobal's membership called for the use of additional forward-looking metrics that provide insight into the decarbonization and value creation potential of the underlying investments.

LPs are concerned about the reputational and regulatory risks associated with investing in high-carbon assets.

High-carbon investing is reputationally risky to LPs – particularly to asset owners who have made climate change announcements based on emission reductions. [It is also risky for GPs.](#)⁵ Addressing this risk will involve taking on an additional disclosure burden, proactive communication, and stakeholder engagement.

Backlash against investments made based on environmental, social, and governance (ESG) issues in the United States has politicized investments aiming to address climate change, including the decarbonization of high-carbon assets. This puts participating investors in the crosshairs from across the political spectrum. The unpredictable and sometimes contradictory regulatory environment targeted at ESG investing, and climate investing in particular, has further complicated participating in such investment opportunities.

Solution: Strategies and structures that integrate returns and climate outcomes

Mutually reinforcing actions from LPs and GPs that clarify the nature and purpose of grey-to-green investing as a part of their overarching investment strategy will drive capital allocation to these opportunities. Actions that are needed across the investment value chain towards this end include the following:

-  Clarity from LPs on the role that grey-to-green investing will play in their investment strategy
-  Clarity from GPs on how their investment strategy will integrate competitive returns and decarbonization outcomes
-  Flexibility from LPs that have set net zero goals
-  Asset level metrics supporting portfolio disclosure
-  Innovative incentive structures for integrated climate and incentive success



LPs who have clarified the role of climate change investing in their overall investment thesis will be better able to capitalize on grey-to-green investing opportunities.

Long-term LPs that are clear about why and how to factor in climate change as a part of their overall investment approach are better positioned to make smart decisions on whether, how, and the extent to which they should participate in grey-to-green investing.

FCLTGlobal’s [Decarbonizing Long-Term Portfolios](#)⁶ (2022) provides investors with an adaptable “top-down” approach to decarbonization that uses multiple levers to address portfolio climate risk while fulfilling returns objectives and capitalizing on new opportunities. Climate change investment approaches that could be adapted for grey to green investing are identified in Table 2.

Using a variety of approaches could identify opportunities across asset classes, including public equities, infrastructure, real estate, PE funds, and co-investments (as illustrated in Table 1), allowing for risk diversification rather than concentration in one bucket

Table 2: Four top-down decarbonization approaches

Source: [Decarbonizing Long-Term Portfolios, FCLTGlobal](#)

Investment approach	Examples of how this approach is applied to portfolios
Silent approach	<p>Extrapolation: assume the future will mirror the past</p> <p>Discount: discount the potential for future investment losses from climate change</p>
Principles-based approach	<p>Impact: employ a combination of investing and philanthropy</p> <p>Divestment and exclusion: remove and/or exclude specified companies or industries (may be combined with carbon offsets)</p>
Analytical approach	<p>Reweighting: overweight underpriced assets and underweight overpriced assets based on different views of future carbon pricing or the value of stranded assets</p> <p>Innovation: employ an options pricing or a venture capital mindset for investing in long-shot technologies that could have a significant return and an effect on the climate.</p>
Catalyst approach	<p>Solutions: invest in known solutions to drive scale—e.g., green infrastructure, regenerative agriculture, electrification of transportation, carbon sequestration, emissions reduction technologies,</p> <p>Engagement: influence companies to transition from high-carbon to low-carbon intensity through active ownership.</p>

For instance, in December 2021, CPP Insights Institute released a [white paper](#)⁷ that detailed how CPP Investments is looking to generate risk-adjusted return by financing emissions reduction and supporting the decarbonization of high carbon assets.. In making the case for such investing, the Institute notes:

“CPP Investments sees an opportunity to create value and pursue new investments by adopting a decarbonization investment approach, which seeks attractive returns from enabling an economy-wide evolution to a low-carbon future. This investment approach is premised on identifying, funding and supporting high emitting companies that are committed to lowering their emissions in a way that will allow CPP Investments to capture attractive risk-adjusted returns. We believe that high-emitting companies that navigate this evolution successfully will preserve and surface embedded value for patient investors.”

Decision-maker education (covering board directors and trustees, CIOs, heads of asset classes, investment

teams, and risk and portfolio construction professionals) will facilitate informed decision making. Governance structures (such as goals or incentives for asset allocators) that create a culture of innovation for this emerging investment area could also be important.



GPs that provide visibility into how their investment strategy can provide competitive returns and support climate outcomes will be better positioned to raise funds in this emerging investment area.

Effective dialogue between GPs and LPs will clarify how the pursuit of transition outcomes in these high carbon industries will generate the anticipated fund returns. Such discussion will improve LP readiness to participate in these investment opportunities. Table 3 includes illustrative questions for such discussion. When these conversations take place across the investment due diligence process and involve the right stakeholders, they will drive informed decision making.

Table 3: GP-LP Conversation Guide on Grey-To-Green Investment Opportunities

Theme	Question
Integrating climate and financial goals	What is the GP’s strategy on pursuing both financial and climate outcomes? How will the GP’s efforts to transition high-carbon assets lead to value creation in those investments?
Policy and price on carbon	What is the assumption on the role that public policy will play in driving value creation? What is the price on carbon that the GP has assumed? What are the assumptions of how the price on carbon will increase over time?
Transition investments	Which high carbon companies/ industries will the fund invest in? What is the proportion of high-carbon assets compared to others in the investment vehicle? Is there a difference between how the GP will engage with carbon intensive assets versus other?
Holding period	What is the anticipated investment holding period? Is this holding period sufficient to achieve the identified climate and financial goals? How is the GP considering term extensions, continuation funds, or capital recycling as a part of its strategy to achieve impact?
Influence strategy	How will the GP incorporate decarbonization into portfolio company business plans? Who on the board will have specific responsibility for the transition plan? Does the GP’s strategy align with transition pathways identified by SBTi or other groups?
Offsets	Will the GP use offsets to achieve needed decarbonization?
Exit strategy	How does climate change factor into the exit strategy of assets? What is the GP’s strategy to ensure that the decarbonization strategy of the asset will continue post exit?



LPs who balance approaches, such as using transition carve outs, with rigorous transparency, will have the flexibility to invest in grey-to-green options.



GPs who combine portfolio metrics and goals with asset-level metrics will be able to demonstrate progress towards value creation in a decarbonizing future.

Where LPs are constrained by previously set climate change goals, creative but credible approaches and rigorous transparency could provide flexibility to engage in grey-to-green investing. To this end, some LPs are experimenting with putting in place clearly ringfenced “carve outs” of their portfolios that are explicitly focused on investing in grey-to-green opportunities and do not count towards their climate change goals.

Where an LP adopts a carve out, robust communication about strategy, intended financial impacts, and anticipated real-world decarbonization outcomes will provide important credibility. This includes:

- Clear definitions of “transitioning assets” that are pegged to external definitions, such as GFANZ or EU taxonomy.
- Clarity that the purpose of the investment is to decarbonize the asset or support ongoing decarbonization efforts in question.
- Transparency on how decarbonization is being pursued and the impact of the efforts in question.

For instance, Ontario Teachers’ Pension Plan (OTPP) has been working towards its ambitious climate change target, pledging to reduce portfolio emissions intensity by 47% by 2025 and 67% by 2030. In 2022, the organization [announced](#)⁸ that it was planning to allocate up to \$5B over several years towards High Carbon Transition Assets (HCT) with a view to “actively invest in select emissions-intensive assets with the goal of helping them decarbonize faster”. OTPP notes: “*High Carbon Transition (HCT) assets will allow us the opportunity to achieve our plan to make a significant real-world impact while also making good returns*”.

OTPP's HCT assets will be tracked separately from the rest of portfolio's climate footprint and interim emissions reduction targets will not apply to HCTs. However, HCT investment emissions will count towards net zero goals by 2050. OTPP has also committed to rigorous transparency for its HCT investments. Specific and rigorous measures will be developed for each HCT asset which is separate from but complementary to interim targets.

Many LPs and disclosure frameworks call on GPs to disclose the GHG emissions associated with their investments. However, GHG metrics are complex, do not lend themselves easily to valuation, and showcase the current rather than future carbon profile of the asset. Most important, such disclosure from GP to LP tends to be aggregated and provided at the portfolio level.

However, given the various opportunities and strategies for grey-to-green investing, asset-level metrics often provides more useful insights. Combining portfolio carbon metrics/goals with specific asset level details allows GPs to demonstrate the work that they are doing to position the asset for value creation in a low-carbon world.

To be most useful to the LP, the asset-level metrics should have the following characteristics:

- Financial or operational, providing insight into asset valuation.
- Forward-looking, providing insight into how the company is positioned for short and long-term performance.
- Comparable, providing insight into how the asset is performing relative to its peers.
- Contributing to credible decarbonization progress that is aligned with climate science.
- Verifiable by an independent third party.

Options of metrics for GPs to consider are identified in Table 4 (page 12).

Table 4: Asset level metrics to demonstrate grey-to-green transition

Insight ⁹	Metric	Source ¹⁰
Investments in decarbonization potential	Amount or % of capital expenditure, financing or investment deployed towards climate-related risks	ISSB, GFANZ
	% of annual revenue invested in R&D for low-carbon products/services	TCFD
	One-off restructuring costs to align to a low-carbon target operating model including investing in new systems, resourcing, training.	FCLT
Investments in upside value creation potential	Amount and percentage of assets or business activities aligned with climate-related opportunities	ISSB
	% of revenues from products/services that support the transition to a low carbon economy;	TCFD
	Number of patents for low carbon solutions	GFANZ
	% of technology mix that is low carbon	GFANZ
	% of products/ services that are low carbon	GFANZ
Ringfencing downside risk	Amount and percentage of assets or business activities vulnerable to physical or transition risks	ISSB
	Expected impacts of the transition plan on financial performance (changes to revenues and costs), financial position (changes to assets and liabilities) and cash flow (changes to working capital).	TPT



Innovative incentive structures allow GPs to be compensated for integrated climate and investment success and ensure LPs will pay for performance.

Fund incentive structures provide an opportunity for experimentation in this evolving area. Incorporating climate and financial outcomes into traditional private market incentive structures build LPs’ confidence that

the GPs will pursue both return and climate outcomes in an integrated manner. Such incentive structures also reward GPs for innovative investment approaches that allow for joint climate and investment success.

Table 5 features opportunities to integrate emissions or climate goals into incentive elements across private market financing structures.

Table 5: Illustrations on how climate can be integrated across private market incentives.

Incentive elements	Illustrations of climate outcome integration
Hurdle rate	8% returns plus a 50% reduction in emissions as hurdle rate
Carried interest	Step up or step down in carry rate; For example, carry goes to 25% if 50% reduction in emissions is achieved; Carry goes to 10% with no reduction in emissions
Expenses	GP buys offsets for emissions reduction targets not achieved out of management company funds, rather than LP refunded expenses
Catch ups	Emissions target must be achieved to trigger catch up, even if return hurdle met
Base fee	Additional 25 bps base rate to employ or build climate industry or management expertise

Most of the experimentation to date on climate integration in incentive structures has centered around carried interest. For instance, in EQT’s Futures Fund, [up to 20 percent of the organization’s total carried interest is linked to achieving the portfolio-level KPIs](#)¹¹—one of which is the reduction of GHG emissions using the Science Based Targets. Just Climate applies a “climate impact factor” to carried interest. Achievement of carried interest “fills up the bucket”. The application of the climate impact factor could potentially “empty the bucket”, where the intended climate outcomes are not achieved. As a result, the GP is equally incentivized to deliver attractive market returns and highest positive climate impact.¹²

Conclusion

Decarbonization is a generational investment opportunity, and with the right structures in place, private markets can drive investment at scale for the grey-to-green transition. Though attractive, the novelty of such opportunities and reputational concerns are limiting investments. LPs who have considered and clarified their grey-to-green investment approach, and are transparent about their efforts and impacts, will be able to participate in those opportunities. GPs who launch credible transition funds backed by appropriate incentives will have a competitive advantage. Development of this area – and participation by leading GPs and LPs – will be critical to realizing a lower-carbon future for companies and more importantly for society as a whole.

ACKNOWLEDGEMENTS

FCLTGlobal's work benefited from the insights and advice of a global working group of subject matter experts drawn from FCLTGlobal's Members and other organizations. This final document is our own, and the views expressed here do not necessarily represent the views of our working group participants. We are grateful for the insights of all our project collaborators:

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- ¹¹ “EQT Future: EQT launches impact-driven longer-hold fund” EQT Group, October 2021. <https://eqtgroup.com/news/2021/eqt-launches-impact-driven-longer-hold-fund/>
- ¹² Although Just Climate seeks to deliver the highest positive climate impact and attractive market returns, this is an aspiration and there is no guarantee this goal will be achieved.

**FOCUSING CAPITAL
ON THE LONG TERM**

