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Opportunities in Sustainability Private Investing

by Ethan Levine and Branden Elkins

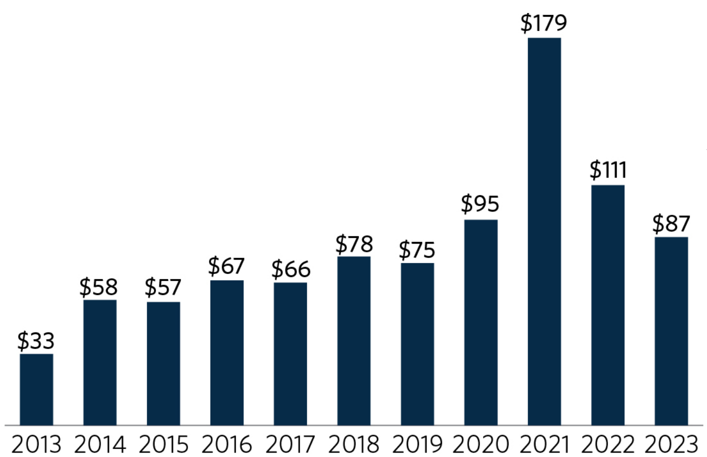
Global macroeconomic trends signal an increased level of investment in the climate and energy transition sectors, despite broader market volatility over the past few years, as investors aim to seize opportunities for risk-adjusted returns in sustainability-themed sectors. The industries, businesses, and technologies that compose the sustainability private investing ecosystem are highly diversified and complex, generating opportunities for a range of investors from early-stage venture capital to buyout-focused private equity. The latter represents an important development, signaling continued maturation of both markets and the resultant investment opportunities. Indeed, such opportunities for institutional-grade investment exist, but it can be difficult to develop a comprehensive portfolio without being embedded in market networks. While challenging, this dynamic presents opportunities for investors to take more collaborative approaches to navigating the complex and rewarding sustainability-themed marketplace.

MACROECONOMIC OUTLOOK FOR SUSTAINABILITY PRIVATE INVESTING

Over the past few years, inflationary pressure and the corresponding rise in interest rates have impacted broader markets, with exit markets declining during 2022 and remaining suppressed throughout 2023[1]. Private markets have not come out unscathed through this market volatility. Since the 2021 peak, the magnitude of growth private capital invested in the US has declined[2], leading to capital scarcity for growth-stage businesses. In addition, both revenue and EBITDA buyout valuation multiples have declined since the 2021 peak[1].

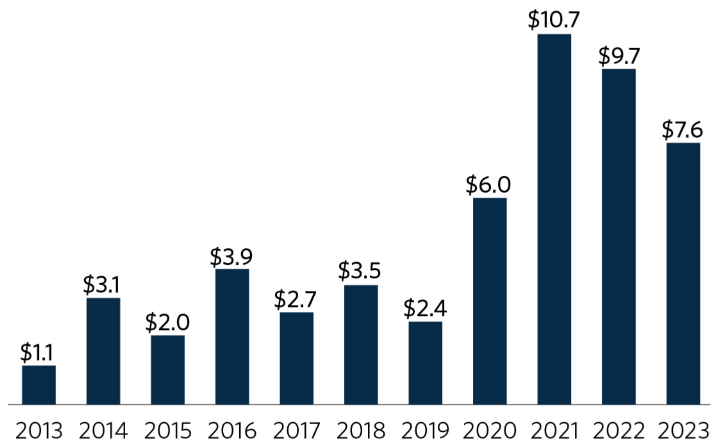
U.S. GROWTH CAPITAL INVESTED[2]

Dollars in billions ($)



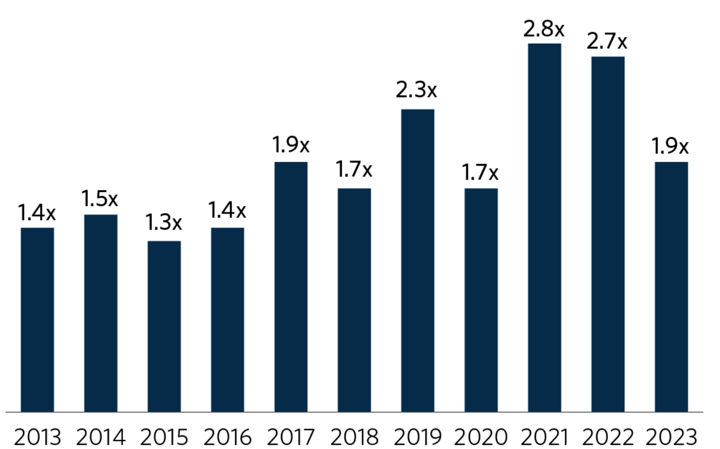
U.S. CLIMATE TECH/CLEANTECH GROWTH CAPITAL INVESTED[2]

Dollars in billions ($)

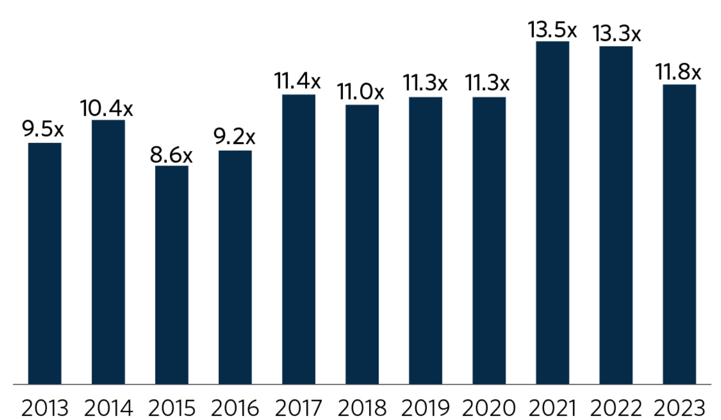


While the broader public and private markets declined in 2022 and 2023, sustainability-themed capital markets demonstrated greater resilience, declining to a lesser degree than the broader market and remaining elevated relative to pre-2021 investment levels[2]. When viewed globally across public and private investment, clean energy investment continues to increase annually[3]. Even with elevated investment levels, market observers, such as Goldman Sachs, forecast that an additional $2.8 trillion of annual investment is needed this decade to meet decarbonization, clean water, and infrastructure targets[4]. The private sector is currently expected to only supply about one third of the incremental investment needed[4], suggesting that there is a significant market opportunity for additional capital in this space.

MEDIAN PE BUYOUT REVENUE MULTIPLES | NORTH AMERICA[1]

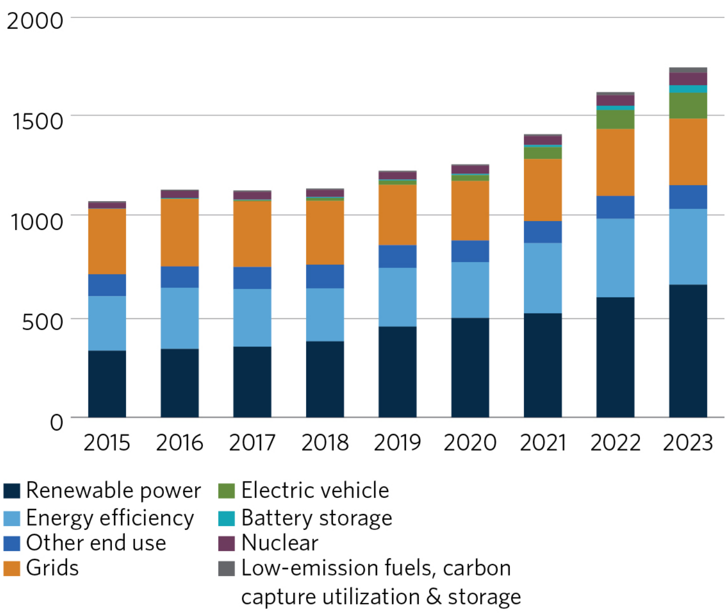


MEDIAN PE BUYOUT EBITDA MULTIPLES | NORTH AMERICA[1]



ANNUAL GLOBAL CLEAN ENERGY INVESTMENT[3]

Dollars in billions ($)



DOW JONES SUSTAINABILITY WORLD INDEX PRICE RETURN[5]

The combination of market maturation, capacity for further investment, and the expanding pool of investment opportunities in the sustainability sphere create an attractive value proposition that draws return-seeking investors to the sustainability private investing corner of the market.

FINDING SUSTAINABILITY PRIVATE INVESTING OPPORTUNITIES

Perspectives on how to allocate capital to sustainability themes vary by investor. While some investors may view sustainability from an impact lens, focusing on the degree of environmental or social impact that will be generated from their investments, the overwhelming majority of investors prefer to approach sustainability as a fiduciary. These investors refuse to offset impact benefits with financial results and will only approach non-concessionary, return-generating strategies. They may allocate to sustainability through a more focused view—via a Real Assets or Natural Resources bucket, targeting more granular themes, such as renewables infrastructure or agriculture. Others, who may not have such allocations or take a more comprehensive view, allocate to sustainability out of a broader (private or public) equity bucket. Generalist private equity investors may consider sustainability-focused investments as a piece of a diversified portfolio, while other private equity investors may raise a sustainability-focused fund that is diversified across sustainability-themed industries. Choosing one's execution approach in the sustainability market depends on an investor's strengths, experience level, and networks.

The opportunities for investment in the sustainability-themed market are present across both well-established and emerging industries. Whether working to meet decarbonization goals, consumer demand, or both, many highly mature industries have entered the sustainability sphere, spurring the development of new sub-sectors across the value chain. For instance, efforts to electrify transportation have led the highly mature automotive industry to shift its production focus from gasoline-powered vehicles towards electric vehicles. In addition to new electric vehicle-focused manufacturers arising out of this transition, sub-sectors such as fleet management, EV charging, and battery production have emerged and are expanding rapidly. Depending on investors' risk and return focus, opportunities for investment could range from focusing on the early-stage, emerging opportunities in the value chain to the more well-established mature ends of the market.

Geography is another critical pillar for investors to consider when developing their sustainability investment strategy. The maturity of sustainability-themed industries can differ across geographies. Opportunities exist to take technology and business models that have been proven in one region and implement them in a more emerging market to capture higher returns. Moreover, there lies an element of competition between regions that can drive additional returns. Many countries aim to develop greater domestic production capabilities to support the energy transition and reduce risk in their supply chains. Government initiatives aimed at bolstering domestic production of energy transition technologies, such as the Inflation Reduction Act in the U.S., can create powerful incentives that provide a boost to the level of returns to be gathered from investments.

The sustainability-themed market ecosystem is highly diversified across industries, geographies, and investment stages, providing opportunities for early-stage, growth, and buyout investors. While opportunities clearly exist, they can be difficult to access without a developed network in the sustainability space. Additionally, new entrants may find it challenging to assess and discern winners in these industries without experience in the market. These dynamics lay the groundwork for a more collaborative approach to private investing to better navigate the complexities of the sustainability market.

IMPLEMENTING A SUSTAINABILITY PRIVATE INVESTMENT STRATEGY

As the net zero transition progresses, short-term market shifts will affect sub-sectors of the sustainability-focused market. Private equity is better positioned than public markets in the sustainability space due to its longer hold, illiquid position, which enables private investors to attune their investments to the long-term tailwinds and growth trends of the sustainability sector. Some volatility is to be expected across industries and the degree of dislocation that occurs will reward investors with the network and expertise to identify the market winners.

Given the depth of sustainability-themed industries, sourcing interesting opportunities can prove a significant challenge. Many niches exist within the market, and investors will naturally have greater levels of expertise in certain industries versus others. Across industries, it can be difficult to gain access to and sift through the investment opportunities that do exist. Some sustainability themes are self-evident and present themselves in a concentrated way in certain industries like renewables or electric vehicles. Other sustainability themes may be more nuanced and can be found across broader industries like agriculture and industrials, incorporating benefits such as waste reduction, water usage, and lower carbon footprints. Collaboration on sourcing can enable investors to augment their investment teams and gain an extended network that grants access to opportunities that would otherwise be inaccessible. Therefore, it can be beneficial to have investment teams with a broad reach alongside sector expertise to widen a team's sourcing funnel and adequately evaluate such opportunities.

Investors must consider how they will approach measuring the sustainability impact of an investment. An investment in the sustainability market does not always mean that the investment must strictly fit the criteria for the most rigid designation (e.g. an EU SFDR Article 9 sustainability investment[6]). There are opportunities with measurable positive environmental impact that may fall outside that criteria and be suitable for investors that are not investing with such a rigid lens. However, expertise is needed within the investment team to discern greenwashing from actual positive environmental impact and draw out benefits in a genuine, concrete way. This requires an experienced team to work on sourcing, diligence, and monitoring while accounting for both the financial and environmental benefits of an investment.

Another key pillar of success in private sustainability investing is investors' ability to be flexible in their approach. Generalist investors can benefit from the expertise of those embedded in the sustainability market to make thoughtful investment decisions and help better assess the value-add of sustainable benefit creation. And vice versa—more specialized experts can learn analogous lessons from generalists who have seen themes play out in other industries. The challenges of accessing capital in today's market environment and the evolving growth in the space, create growing opportunities for more collaborative and creative approaches to private investment, such as co-investments, secondaries, strategic fund commitments, and direct operating platform investments. Being nimble and approaching opportunities via partnerships can provide benefits for all parties and a path to success within the sustainability investing market.

CONCLUSION

Despite recent volatility in broader markets, sustainability-themed sectors have maintained a high and growing demand for private capital with capacity for significant additional investment levels. The niches within the climate and clean energy market vary in their maturation, which creates both challenges and opportunities for investors in this space. An approach focused on collaboration can prove a winning strategy in this environment as investors work together to navigate the complexities of the energy transition.

Endnotes

1 Pitchbook, 2023 Annual US PE Breakdown (Jan 2024)

2 Pitchbook (Jan 2024)

3 IEA, World Energy Investment 2023 Report (May 2023)

4 Goldman Sachs GS SUSTAIN: Green Capex "What's on track and spare capacity" (May 2023)

5 S&P Global Dow Jones Sustainability World Index (https://www.spglobal.com/spdji/en/indices/esg/dow-jones-sustainability-world-index/#overview)

6 SFDR = Sustainable Finance Disclosure Regulation; An Article 9 Fund under SFDR is defined as "a Fund that has sustainable investment as its objective or a reduction in carbon emissions as its objective." Article 9 Funds must meet a number of different requirements that promote a sustainable investment objective Source: https://www2.deloitte.com/content/dam/Deloitte/ie/Documents/Audit/IE_SustainableFinanceDisclosureReg_Article9.pdf

Important Notes

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