TIKEHAU CAPITAL

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Expert insight

DECARBONISATION, DEBT AND THE DEADLINE: PRIVATE DEBT AND THE NET-ZERO TARGET

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Decarbonisation, Debt and the Deadline: Private debt and the net-zero target

Following the last United Nations Climate Change Conference[1] in 2022, governments and businesses worldwide have reacted to the urgent call to accelerate the pace of climate action. In particular, governments and businesses have made further commitments to reduce greenhouse gas (GHG) emissions, and many large corporations have publicly declared their intention to achieve net-zero emissions by 2050. In our view, the decarbonisation of our economy has therefore become a global imperative.

To limit global warming to 1.5°C with zero or limited overshoot, we collectively need to reduce GHG emissions by 43% by 2030, 69% by 2040 and 84% by 2050, compared to a 2019 baseline[2]. Global net-zero CO_2 emissions need to be reached in the early 2050s. As a result, we must emphasise that we are in a pivotal decade for taking sufficient action to have a chance of reaching this common objective. Unfortunately, the race to net-zero at global, national, sector and local levels is delivering incremental progress, and recent estimates suggest we are all falling short of achieving the Paris Agreement targets. According to the Argos-BCG 2023 Mid-market Climate Transition Barometer, only 11% of mid-market companies declare having "strongly invested" to abate their GHG emissions based on a detailed climate strategy built beforehand (consisting of a detailed carbon footprint and a decarbonisation roadmap).[3]

Our view is that there is no way to reach the net-zero target without strong and coordinated action on corporate emission reduction worldwide. The success of a decarbonisation strategy heavily relies on external stakeholders, as the Scope 3 emissions[4] of one company are linked to the Scope 1[5] & Scope 2[6] emissions of another. We believe that the financial sector, which is jointly responsible for GHG emissions and the ecological impacts of these activities, can trigger and coordinate global action to ensure that capital is allocated in ways that help meet these objectives.

This paper therefore explores the case for deploying private market investment, specifically private debt capital, to support the vital contribution of companies in making meaningful and timely GHG reductions at scale.

1 The Conference of the Parties to the United Nations framework Convention on Climate Change – "COP"
2 Table 3.1. https://www.ipcc.ch/report/ar6/syr/downloads/report/IPCC_AR6_SYR_LongerReport.pdf
3 https://argos.wityu.fund/wp-content/uploads/climate-barometer/ARGOS-CLIMATE-ACTION-X-BCG-2023.pdf
4 Indirect emissions linked to the upstream and downstream value chain
5 Covering direct emissions from fixed or mobile sources controlled by the organisation
6 Indirect emissions linked to energy consumption

What is Tikehau Capital's contribution to the decarbonisation effort?

In addition to its commitment to manage €5 billion of assets under management (AUM) dedicated to climate and biodiversity by 2025, Tikehau Capital (the Group) has committed to align its investment portfolio with the long-term decarbonisation trajectory. The Group joined the Net Zero Asset Managers initiative in 2021, and in 2023, defined targets for each of its business lines.

The Group's initial headline target is that circa 40% of total AUM will be managed in line with the global goal of achieving net-zero emissions by 2050 or sooner. The approach to managing assets in line with net-zero consists of interim targets for 2030, which were developed using methodologies developed by the Net Zero Investment Framework (NZIF) and the Science Based Targets initiative (SBTi) for financial institutions. Overall, these targets mean that Tikehau Capital will be shifting towards investing in companies that are actively decarbonising their business models. For the Real Assets business line, these targets should lead to improvements in the energy and carbon-efficiency of buildings.

Beyond the stated decarbonisation objective, we believe that this commitment is a catalyst for awareness, as it should enable not only companies but also other investors to accelerate their decarbonisation efforts.

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

Given the scale and urgency of the climate emergency, we believe that all companies have a role to play in supporting the net-zero deadline. Mid-market companies, the main targets of our private credit platform, collectively play an important role in the global economy. It is therefore unsurprising that 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 GHG contribution of mid-market companies represents up to 63% of the total European emissions[7]. While they may not have the same scale and resources as large corporations, their agility can arguably allow them to (i) embrace change quicker, (ii) innovate (e.g., clean technology innovation), and (iii) adopt a localised position of influence to make them important contributors to achieving neutrality goals at both domestic and global level.

It is also a business imperative to build a sound sustainable proposition, starting with a decarbonisation plan, for their development. We believe that the transition to a low-carbon economy will result in a transformation in our economy that will create new business opportunities for those who position themselves as leaders and vice versa. A strong ESG proposition helps companies tap new markets and expand into existing ones. We know that stakeholders such as employees, suppliers and clients are looking at the sustainability practices of the company during the course of business.

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[7] https://europa.eu/eurobarometer/api/deliverable/download/file?deliverableId=81023

Leaders can also earn subsidies and government support, boost employee motivation, attract talent through greater social credibility, better capital with potentially better financial terms, which should result in superior performance and sustainable value creation. It can help them better manage future challenges and enhance the business model resilience for a day when new rules, price signals, scarcity, depletion of resources will be the norm.

There are some businesses that are suppliers to large, listed companies. As many of these said 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, 43% on Italy's MIB, 69% on the UK's FTSE, 70% on Germany's DAX Index, 88% of companies listed on France's CAC Index and 42% of all S&P 500 companies had set or committed to set targets by the end of 2022.[8] We can anticipate further announcements, following Amazon's recent declaration[9] requesting its suppliers to disclose their carbon emissions data and establish concrete emissions reduction objectives, all in alignment with Amazon's objective to attain net-zero carbon emissions by the year 2040.

The European regulator has also incorporated mid-market companies into most of its sustainable agenda, highlighting the significant role they play in the transition. The Corporate Sustainability Reporting Directive ("CSRD") regulation requires both public and private companies to disclose on sustainability, including their carbon footprint and emission reduction targets.[10] The regulation increased the scope of eligibility and it will apply now to approximately 50,000 companies in Europe. It will be mandatory for companies meeting 2 out of the 3 criteria from: > 250 employees, > €40m in annual turnover, > €20m in balance sheet. Listed SMEs are also required to report, while non-listed SMEs will be encouraged to voluntarily disclose using a simplified framework.

[8] https://sciencebasedtargets.org/resources/files/SBTiMonitoringReport2022.pdf

[9] https://www.aboutamazon.com/news/sustainability/amazon-sustainability-report-2022#:~:text=Reaching%20net%2Dzero%20carbon%20by,outside%20our%20direct%20operational%20control

[10] https://ec.europa.eu/finance/docs/level-2-measures/csrd-delegated-act-2023-5303-annex-1_en.pdf

The reporting requirements are staggered - beginning in 2025 for large companies already in scope of the Non-Financial Reporting Directive ("NFRD"), and SMEs have until 2029 to report. We believe that these reporting standards will enable stakeholders (customers, consumers and investors) to choose companies based on their sustainability (including climate) performance, and as this trend is inevitable, we perceive it as an opportunity for mid-market companies who are leading on this topic, and a risk for laggards.

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 5 years[11] 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 with their investments in their portfolios.

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 equipped to deal with the cascade of sustainable finance regulations. It is rare for these businesses to have an internal Corporate Social Responsibility "CSR" department for example. 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 in collaboration with the senior management and sponsors of the business.

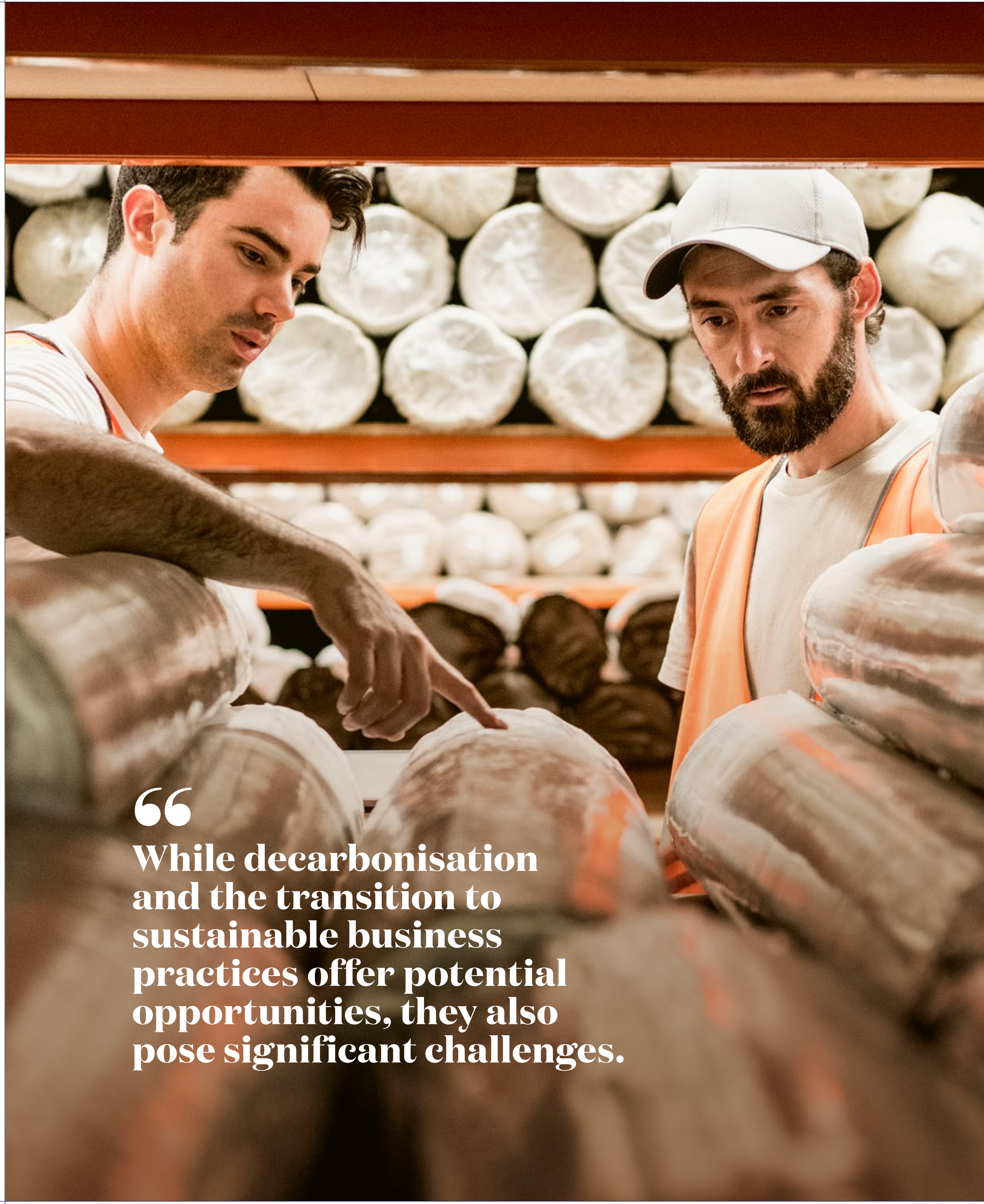
We believe it is our imperative as a private markets asset manager to measure and monitor the climate performance of our portfolio to support the financial interests of long-term investors. We recognise this as a major and necessary part of our fiduciary duty. Managing ESG considerations is a natural 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. These risks can translate into financial costs that can hit a company's financial profile. So sustainable investing 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 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 could

[11] Across our corporate lending and direct lending funds



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.

Deep dive into decarbonisation targets – SBTi (Science based targets initiative), WACI (Weighted Average Carbon Intensity) and NZAM (Net Zero Asset Managers Initiative)

From the portfolio company perspective, science-based targets are the most widespread method to set credible emissions reduction targets that are aligned with the science on what companies need to do to contribute their “fair share” to achieve the goals of the Paris Agreement. Targets should be set for absolute emission reductions on scope 1 & 2 and could be set in absolute emissions reduction or in intensity for scope 3. A typical target is a 42% reduction by 2030 compared to a 2021 or 2022 baseline for scope 1&2 (i.e. a 5.8% or 6.6% y-o-y reduction in emissions depending on the base year selected) and a 25% reduction in absolute emission or 51.6% in intensity for scope 3.

Even though scope 3 targets are not mandatory for SMEs[12], we encourage all SMEs to measure their scope 3 carbon footprint and set scope 3 targets on the most material sources of emissions (e.g. carbon intensive raw material, air travel, etc.). Some difficulties encountered by portfolio companies, especially SMEs, include the lack of supplier-specific information from purchased goods and

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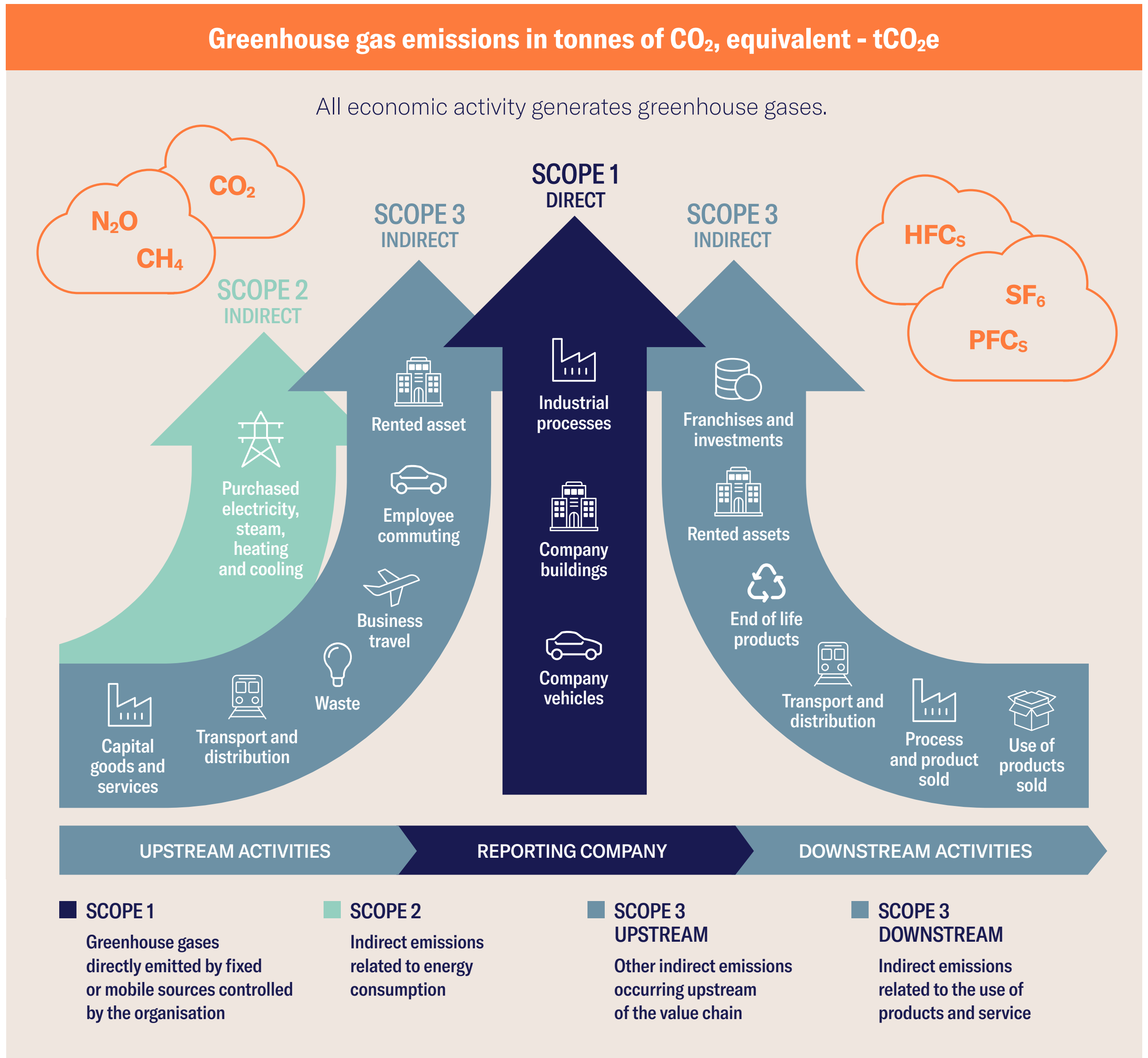
services and capital goods (upstream sources of scope 3 emissions), as well as issues with accurately calculating the emissions related to the use of sold products (upstream sources of scope 3 emissions). Engagement with upstream / downstream supply chain is essential to addressing this challenge. Increasing transparency through disclosure regulations will also improve the data situation.

In terms of our contribution, Tikehau Capital has formalised its climate commitments under the Net Zero Asset Manager (“NZAM”) initiative, with an initial commitment to manage circa 40% of AUM[13] in line with the global goal of achieving net-zero greenhouse gas emissions by 2050. For our private debt and private equity portfolio, this commitment translates into an interim target for 2030[14] of achieving a 50% reduction in the (“WACI”) of the assets that are in scope compared to a 2021 baseline. This is the equivalent to an 8.3% y-o-y reduction.

We believe the WACI metric is most suitable for private companies as the denominator is based on revenue, which is a commonly reported financial metric. The metric demonstrates that the portfolio is decoupling emissions from revenues. Other carbon metrics attribute greenhouse gas emissions to investors via enterprise value which can be more subjective and more complex to calculate annually.

[12] SMEs under SBTI are companies with less than 500 employees
[13] AUM as of 31 December 2022
[14] Unlike science-based targets, the NZAM commitment requires targets set for 2030 to be achieved by the 31.12.2029.



With portfolio-level carbon metrics, the challenge is that we also consider changes in the portfolio composition, which means that it could be possible that a reduction in WACI is achieved without any ‘real world ’ decarbonisation. We are working on attribution analysis and are considering approaches to revising the target, e.g. revising the baseline, so that we are able to disclose metrics that represent our portfolio companies’ contributions to real world decarbonisation.

We fully recognise that the WACI metric is a backward-looking indicator as it looks at the carbon footprint of a company the year before (i.e. it is a lagging indicator). That is why, in order to achieve the WACI target, strategies in scope of the Group target also have forward-looking targets based on the share of portfolio companies with validated science-based targets.

A final word

Decarbonisation is now widely recognised as the investment megatrend of the decade. With six of the nine Planetary Boundaries now exceeded[15] and the 2030 target of halving emissions becoming increasingly difficult to attain, there has never been a more urgent time to take meaningful action. A disorderly transition caused by delayed action will not only miss the goals of the Paris Agreement but directly work against the financial interests of pension funds and other long-term investors and their beneficiaries.

Asset managers have an important role to play in driving the transition and, with growing bank retrenchment from lending to mid-market companies, they are more reliant than ever on non-bank lenders to finance their ambitions.

We see that sustained demand from mid-market companies and a rising rate environment has underpinned the continued success of private credit as a stand-alone asset class. Smaller private companies are also incentivised to leverage on sustainability linked loans to access new business opportunities to tap new markets and expand into existing ones.

Having passed its first real stress test in the form of the global pandemic, allocators have been increasingly drawn to contemplate the asset class that we see has continued to generate solid, risk adjusted returns and stable income generation in the context of the biggest crisis facing humanity today: the climate emergency.

Due to its inherent long-term view, and ability to incorporate emission reduction-based incentives for businesses in loan offerings, it is possible to see how private debt can become a vital allocation for investors looking to construct net-zero portfolios.

Tikehau Capital has a long-standing track record in private debt, having invested over €16.2bn AuM in this space (as at 30 June 2023) and has served as a pioneer in the use of ESG ratchets. We believe that Tikehau Capital's private debt teams are among the most experienced in Europe. With 35+ professionals, as at September 2023, we aim to structure, finance, participate in and implement a variety of financing deals, from €10m to €300m, particularly in senior debt, stretched senior, unitranche financing, mezzanine debt and preferred equity. This also includes securitisation activities dedicated to collateralized loan obligations ("CLOs"), a specialised product consisting of obligations backed by a portfolio of leveraged loans. In the context of decarbonisation and energy transition, the Group expects to continue to build on its successful track record of implementing fast, flexible and reliable funding for medium-sized companies looking to make acquisitions, innovate or expand their operations.

[15] Stockholm Resilience Centre, Stockholm University, https://www.stockholmresilience.org/research/planetary-boundaries.html

Wong
LINDEE

DIRECTOR OF CLIMATE AND BIODIVERSITY

Lindee joined Tikehau Capital in 2022 as Director of Climate and Biodiversity in the ESG team and is responsible for the implementation of the Group's climate and biodiversity strategy across the Group's business lines.

Prior to joining Tikehau Capital, Lindee was environmental business manager at Allianz Trade, responsible for the ESG integration in insurance activities. Previously, she worked for 7 years as a climate change consultant for ERM and Ecofys advising financial, corporate and public sector clients on climate change strategy, the low-carbon energy transition and international and national climate policy. Lindee started her career as a nuclear analyst at the Australian Nuclear Science and Technology Organisation and the French Atomic Energy Commission.

Lindee holds a Master of Science in Environmental Technology from Imperial College London and a Bachelor of Science (Mathematics and Physics) from the University of Sydney.

Lemaitre
VINCENT

HEAD OF ESG FOR PRIVATE DEBT

Vincent works to design and implement Tikehau Capital's ESG strategy within the private debt platform. He serves as the main contact with investors, investment teams, and portfolio companies, helping to integrate various ESG factors across the investment cycle. His responsibilities go from engaging with the portfolio companies about ESG or impact practices, structuring ESG ratchets, fund raising, impact funds management, reporting to train the investment team. Vincent has more than 7 years of experience in ESG and 14 years in the finance industry. In June 2022, Vincent was appointed as member of the UN PRI Private Debt Advisory Committee.

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