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OPINION

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The other climate risk investors need to talk about

The highest carbon-emitting components of businesses could be spun-off to private equity and hedge funds

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The year is 2040. For decades, investors and regulators alike have been encouraging companies across the globe to decarbonise by mid-century.

As a result, MSCI announces for the first time in its 54-year history that every company in its World Index — more than 1,500 publicly traded companies — has achieved net zero. And yet, few are celebrating. Despite the largest companies in the world all having committed to carbon neutrality, a UN report shows that carbon emissions globally have actually gone up.

How could that be? Well, in the rush to be "green" some companies adopted strategies that reduced their emissions or helped them become more efficient, but others simply relied on offsets that delayed the inevitable. Worse, some opted to avoid public scrutiny altogether.

Indeed, while many in the media have seized on "greenwashing" — companies embracing sustainable practices for public relations purposes — a far greater danger is "brown-spinning": selling off the highest-emitting components of businesses to private equity and hedge fund actors at a discount. This can reduce disclosure, shield polluters and marginalise the voice of the investor.

Certainly, the push to net zero is both urgent and necessary. With US President Joe Biden rejoining the Paris Accord, companies across the globe see the writing on the wall, and are setting ambitious net-zero targets. Investors are stepping up as well. For example, the Net Zero Asset Managers Initiative that aims to help big investors strip out damaging carbon emissions now has 87 signatories, representing nearly 40 per cent of all global assets under management

Meanwhile, there is urgency for businesses to respond: today, the failure to address climate concerns comes with increased reputational risks for companies. But pushing companies to set aggressive emissions targets is only half the job when it comes to transitioning to a net-zero future. How will companies get there?

Many will evolve their business models from dirtier sources of energy to incorporate renewables such as wind and solar, as we are seeing in many European oil and gas companies. Some will develop new technology to manufacture products such as "green steel", reducing the largest sources of industrial emissions. Still others may use this moment to reinvent their businesses radically. These would be good outcomes for our environment and for companies — a win-win.

But for others the decisions will be harder, more costly and more complex.

For instance, while carbon offsets may be a financially viable alternative, they do not reduce overall emissions and should probably only be used if there is no choice. Likewise, businesses that have a harder time reducing their emissions outright may invest in carbon capture or take more intermediate steps such as buying carbon credits.

Some companies may simply take the easy path of brown-spinning and sell off their highest emitting assets to the top private bidder who may be less concerned about climate change.

To be sure, some private equity firms have embraced ESG and sustainability and are doing great work in this space. Unfortunately, the public has limited insight into the emission impacts of privately held companies.

That's why the role investors play in holding companies accountable on the journey to net zero is so important. When investors are at the table, we can use our voice urging disclosure of metrics and strategy and, if no action is forthcoming, our vote.

As investors, we must be crystal clear on our expectations for companies, following through on commitments by vetting transition plans, sharing best practices and scrutinising any offsets or spin-offs of portfolio companies. Our goal is to ensure that portfolio companies' transition plans to a carbon-neutral world represent good value for investors over the long term.

We should also push for better, universal disclosure. Public and private investors alike would benefit from more relevant and standardised ESG data that helps us understand companies' capital allocations and the quality of their transition plans.

While much is uncertain, what is not in doubt is that with investors at the table, there will be fewer opportunities to profit off pollution. Public disclosure will increase, not evaporate. And with a focus on the how, there will be far greater accountability to deliver the climate progress we all want to see.

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