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ESG-linked carry mechanisms

Aligning fund manager incentives with ESG impact

Setting the rights KPIs and targets

Selection of the right environmental KPI, its detail, and setting a realistic yet sufficient target.

KPIs

Environmental (Climate) KPI

Reduction of the **GHG emissions** in portfolio companies.

CO2 emissions or GHG emissions?

- All GHG emissions (i.e. Carbon dioxide CO₂, Methane CH₄, Nitrous oxide N₂O etc.) are typically included in the Carbon Footprint calculation methodology, in the form of CO₂e (CO₂ equivalent).

What Scope (of emissions) to include in the KPI?

- Standard: **Scope 1 and 2** (direct + indirect)
- It is still challenging to collect good quality information for **Scope 3** emissions (both upstream and downstream), especially from companies with limited experience and underdeveloped data infrastructure/internal procedures.

Targets

Targeted reduction for the KPI

Finding the right balance for the reduced emissions.

Approach to setting targets

- Setting the total aggregate amount of Scope 1 and 2 emission reduction for a certain period (i.e. existence of fund/investment period).
- Setting separate targets at the portfolio level and company level

Portfolio level

- Realistic and achievable targets (e.g., between 10% and 20% GHG total emission reduction during the existence of the fund) - based on the fund plans

(Portfolio) Company level

- Target to be set on the baseline determined at the acquisition of a company.
- Company level targets to be accumulated and aggregated together to feed into the portfolio level target.

Selecting the right model

Setting the model for the compensation structure and deciding on the level of GHG reduction.

Compensation

Compensation structure

Setting the right model for the ESG-linked carried interest

Model options

- **Penalty** for subpar impact by reducing compensation (carried interest) and/or **Bonus** meeting the impact targets by increasing compensation.
- This model is based on a **pass/fail basis** – a predetermined portion of carried interest is forfeited or awarded.
- Another used approach is a “**Sliding scale**” - proportion of linked interest is adjusted based on the degree to which the impact target is met (may add complexity but appears to be quite popular as a risk mitigation measure).

Level

Level of emission reduction

Finding the right balance in a sector agnostic portfolio

Portfolio level

- The portfolio level target to be based on what companies are envisaged to be part of the portfolio and the expected investment period/life cycle.

(Portfolio) Company level

- Target to be set on the baseline determined at the acquisition of each company - based on the size, type, sector and progression in their existing decarbonisation strategy

Setting the baseline

- Existing procedures for CO2e calculations
- GHG emission reduction strategy already in place
- Main economic activities and how carbon intensive they are
- Starting line for operations/circumstances that can be changed (e.g. energy provider).

Creating the right measurement and reporting process

Selecting the right frequency of measurement and the verification process

Measurement

Frequency of measurement

Finding the balance for how often to measure/request information

How often should GHG emissions be measured?

- Frequency for measurement and reporting differs across the funds/firms we have consulted (e.g. quarterly, half-yearly, annually)
- **Annual** = less admin burden / more difficult to track progress
- **Quarterly/Half-yearly** = easier to follow progress based on implemented changes; more data for decisions / more work for the companies

Tools to measure and track progress

- Multiple paid and free options available - depends on the needs/dashboard
- **More sophisticated tools** (e.g. Clarity AI, Persefoni) are frequently used, however, can be an expensive choice – depending on your needs.
- **More cost-efficient** alternatives (e.g CarbonFootprint.com, Microsoft Emissions Impact Dashboard, or Carbon Trust).
- We can create a comparison table for the different available options.

Audit

3rd party verification process

Ensuring the collected and reported data is correct (audit ready)

Verification model and frequency

- A third party assessment (audit) will be needed to ensure credibility and correctness of the reported information.
- When measuring the baseline (**acquisition**) + at the **exit** of an investment (potentially as part of year-end reporting)

Auditor options

- All big four companies offer this service, however, likely a higher price range.
- Smaller environmental consultancies such as EnviTrail or Enviro also offer such services, which are typically the lower price range.
- Auditor must be certified and credible to conduct this type of audit and follows a certain standard do to so, such as for example GHG protocol or ISO 14064.

Thank you!



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