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ESG INSIGHTS FOR PRIVATE COMPANIES

Why climate change matters

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What is your strategy for aligning your business with the global low-carbon transition toward net-zero emissions? Have any of your company sites experienced climate-related incidents? Who is responsible for assessing and managing climate-related risks? In our view, private company managements and boards must be prepared to answer these questions and more from their investors.

Climate change is one of the defining investment challenges of our time, causing widespread disruption across many industries. We believe companies across all sectors and stages should develop and maintain thoughtful approaches to building resilience into their business models that consider the accelerating transition to a low-carbon economy and the worsening events exacerbated by climate change. This impacts a broader range of companies than one might expect, for example:

- Deliveries from a key supplier of a *consumer products company* are damaged in transit (or delayed) by an extreme climate-related event. The company, which emphasizes lean manufacturing to control costs, has limited redundancy throughout its supply chain, so an order to a premier customer is delivered behind schedule.
- Higher carbon prices in some operating regions raise electricity prices, resulting in higher operating costs and lower margins for *data center operators* and *substantial data users*. Capital expenditures are required to offset this over time by procuring on-site renewables or securing power purchase agreements.

Many companies overlook and/or underreport climate-related risks and opportunities that can be material and important to disclose to stakeholders. However, we expect disclosure scope and quality to improve in the coming years. In our view, disclosure considerations are particularly relevant for private companies as they approach a public offering, but the material business risks and opportunities presented by climate change warrant consideration at all phases of a company's life cycle.

The evolving regulatory landscape

The Paris Agreement outlines the international community's commitment to limiting global warming to well below 2°C (preferably 1.5°C) compared to preindustrial levels. To meet this goal, greenhouse gas emissions must peak as soon as possible, and we must achieve net-zero emissions by 2050. Each signatory country submits a climate action plan with levers to address its highest-emitting industries.

Regulatory regimes often use disclosure requirements as a tool to promote well-functioning markets, and this includes encouraging more accurate pricing for climate change. For instance, the European Union's (EU's) Non-Financial Reporting Directive (NFRD) requires large companies to disclose their policies around environmental protection, and the European Commission has published guidelines on climate-related information.

While Europe is driving regulatory momentum, we also see jurisdictions like the United Kingdom, Hong Kong, and New Zealand considering implementing climate reporting requirements for listed companies. In the United States, the Securities and Exchange Commission (SEC) has proposed a rule to require public companies to report on material climate-related risks, greenhouse gas emissions, and net-zero targets or transition plans. If adopted, large companies would be required to begin disclosing this information by fiscal year 2024. As the regulatory landscape evolves, these requirements could become increasingly important for both public and private companies to consider.

Market momentum from asset owners and asset managers

Crucially, there is also growing awareness across the globe that climate change and the strategic transition it necessitates matter for returns and the stability of the financial system. This is exemplified in initiatives such as the Net Zero Asset Managers initiative, the International Sustainability Standards Board (ISSB), the Institutional Investors Group on Climate Change's Paris Aligned Investment Initiative, the UN PRI's Net-Zero Asset Owner Alliance, and the Race To Zero Campaign. Importantly, commitments to decarbonization extend across asset classes, so we think investor expectations for disclosure by private companies are likely to catch up to public companies.

In addition, the new requirements in the EU for sustainability-related disclosures in the financial services sector (SFDR) will create mounting market pressure for enhanced disclosure by companies. This progress will be necessary to enable asset managers to measure investments in climate solutions for funds sold in the EU. Since this directive is based on fund domicile, European investor pressure will likely flow to global companies that are not directly subject to these requirements.

Wellington's commitment to climate change research

Wellington is dedicated to expanding our climate research capabilities across public and private markets. We will continue to pursue an aggressive research agenda on the physical and transition risks of climate change and the direct application into our investment processes. In addition to industry initiatives, our ongoing partnerships with Woodwell Climate Research Center and MIT help to deepen and broaden our understanding of the intersections between climate change and capital markets — including through new developments like our climate mapping tool. In our view, these capabilities make Wellington a strong partner for private companies as they consider climate-related risks.

Bottom line

We believe it is critical for companies to consider climate change as an enterprise risk in order to prepare for the opportunities and risks climate change presents. Furthermore, firms must also be ready to meet the related disclosure requirements that are likely to increase from both regulators and consumers, especially as they approach a public offering. In our view, companies that demonstrate a high-integrity and principled approach to climate change will be better equipped for these challenges.

To aid in this effort, we have put together a series of resources for companies to consider, including questions to expect from public market investors, suggested reading, and a list of key terms.

Appendix A: 10 questions to expect from public market investors

Every company — whether a consumer company with supply-chain risks or a data-intensive IT company with carbon costs for electricity use — faces its own climate-related risks and resulting oversight and disclosure requirements. We believe boards of directors and management teams will be expected to answer the below questions with the appropriate level of ESG expertise, particularly when climate-related issues arise.

Oversight and disclosure

1. Who is responsible for assessing and managing climate-related risks? Does the board have explicit oversight? How do you ensure that these dedicated resources have sufficient expertise?
2. Have you adopted the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)?

Physical risks

3. Has any company site experienced a climate-related incident? What damage occurred physically and financially? What capital projects have been undertaken since the incident, particularly with respect to resilience planning?
4. Can you explain the company's business continuity planning? Do insurance policies cover both property and casualty (P&C) and business disruption?
5. Do you anticipate that physical climate change will impact the growth or margins of your business as a result of supply-chain shocks or changes in end-market demand?
6. Do your products/services have the potential to help customers adapt to the changing climate?

Transition risks

7. Do you measure and disclose your carbon footprint, including Scope 1, Scope 2, and material Scope 3 emissions? What challenges have you encountered in this process?
8. What is the company doing to mitigate its own greenhouse gas emissions? Are there reduction targets and if so, how do you evaluate year-over-year performance against those targets? How do you measure the business impact of these initiatives?
9. What is your strategy for aligning your business with the global low-carbon transition toward net-zero emissions?
10. What products/services do you offer that benefit from consumer demand related to the low-carbon transition?

Appendix B: Suggested reading and resources

Disclosure

- *Task Force on Climate-related Financial Disclosures* (TCFD) **Final Report** and **Implementation Annex**, a framework with four sections: Governance, Strategy, Risk Management, and Metrics & Targets
- *Assessing and disclosing physical risks*: **Wellington's Physical Risks of Climate Change (P-ROCC) framework**
- ***Understanding the SEC's Proposed Climate Risk Disclosure Rule***, McKinsey & Company

Assessment of risk exposure and management tactics

- *Measuring material emissions*: Greenhouse Gas Protocol (GHG Protocol) **Corporate Accounting and Reporting Standard**, **Scope 3 Calculation Guidance**, and **Product Life Cycle Accounting and Reporting Standard**
- *Setting emissions reduction targets*: Science Based Targets initiative's (SBTi's) development of **sector-specific methodologies** for corporate science-based targets setting
- *Enterprise risk management of physical risks*: ISO 14090, **Adaptation to Climate Change – Principles, requirements and guidelines**

Appendix C: Defining key terms

- *Transition risks versus physical risks*: Transition risks relate to the cause of climate change — emissions in the atmosphere — and the remediation of the cause, referred to as *mitigation*. Physical risks relate to the effect of climate change — acute and chronic climate events — and lessening the impact of these on societies and assets, referred to as *adaptation*.

- *Carbon emissions "scopes"*
  - Scope 1: Direct from operations, such as factories or vehicles owned by the company
  - Scope 2: Emissions associated with electricity consumed by operations
  - Scope 3: Indirect emissions associated with the supply chain and full life cycle of products/services. Measuring Scope 3 helps companies identify opportunities for collaboration and influence across industry verticals and for investing in innovation to evolve product lineups. There are 15 subcategories, divided between two categories:
    - Upstream: purchased goods (think materials, transport, and waste of production inputs/costs of goods sold)
    - Downstream: use of sold products (think automobile emissions post sale), investments
- *Life-cycle analysis (LCA)*: Measurement of the full life-cycle greenhouse gas emissions of a product, including raw materials, manufacturing, transportation, storage, use, and disposal. The results can create competitive advantage by enabling better product design, increasing efficiencies, reducing costs, and responding to customer demand for environmental impact.
- *Science-based targets*: Targets set to be in line with the Paris Agreement and verified by the Science Based Targets initiative (SBTi). The requirements differ by sector in terms of the emissions scopes that must be included and the pace of decarbonization.

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URL References

- **Paris Aligned Investment Initiative** (https://www.iigcc.org/our-work/paris-aligned-investment-initiative/)
- **Net-Zero Asset Owner Alliance** (https://www.unepfi.org/net-zero-alliance/)
- **Race To Zero Campaign** (https://unfccc.int/climate-action/race-to-zero-campaign)
- **Final Report** (https://assets.bbhub.io/company/sites/60/2020/10/FINAL-2017-TCFD-Report-11052018.pdf)
- **Implementation Annex** (https://assets.bbhub.io/company/sites/60/2020/10/FINAL-TCFD-Annex-Amended-121517.pdf)
- **Wellington's Physical Risks of Climate Change (P-ROCC) framework** (https://www.wellington.com/en/wellington-news/physical-risks-of-climate-change-p-rocc)
- **Understanding the SEC's Proposed Climate Risk Disclosure Rule** (https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/understanding-the-secs-proposed-climate-risk-disclosure-rule)
- **Corporate Accounting and Reporting Standard** (https://ghgprotocol.org/corporate-standard)
- **Scope 3 Calculation Guidance** (https://ghgprotocol.org/scope-3-technical-calculation-guidance)
- **Product Life Cycle Accounting and Reporting Standard** (https://ghgprotocol.org/product-standard)
- **sector-specific methodologies** (https://sciencebasedtargets.org/sectors)
- **Adaptation to Climate Change – Principles, requirements and guidelines** (https://www.iso.org/standard/68507.html)

Related Insights

- **Diversity, equity, and inclusion: FAQ** (https://www.wellington.com/en-nl/institutional/insights/dei-strategies-private-portfolio-companies)
- **Governance best practices in public markets** (https://www.wellington.com/en-nl/institutional/insights/corporate-governance-best-practices-private-companies)
- **Mid-2022 Alternative Investments Outlook** (https://www.wellington.com/en-nl/institutional/insights/alternative-investment-outlook-2022-mid-year)
- **From autopilot to active pilot: How investors can navigate the future** (https://www.wellington.com/en-nl/institutional/insights/future-active-management)
- **Closing the return gap: A new set of "stepping stone" ideas** (https://www.wellington.com/en-nl/institutional/insights/target-return-investments-stepping-stones)
- **How the public market correction is affecting the late-stage private equity market**

(https://www.wellington.com/en-nl/institutional/insights/market-correction-late-stage-private-equity)

- **Cybersecurity in 2022** (https://www.wellington.com/en-nl/institutional/insights/esg-cybersecurity-growth-cybercrime-private-companies)
- **Diversity, equity, and inclusion: FAQ** (https://www.wellington.com/en-nl/institutional/insights/dei-strategies-private-portfolio-companies)
- **Governance best practices in public markets** (https://www.wellington.com/en-nl/institutional/insights/corporate-governance-best-practices-private-companies)
- **Mid-2022 Alternative Investments Outlook** (https://www.wellington.com/en-nl/institutional/insights/alternative-investment-outlook-2022-mid-year)
- **From autopilot to active pilot: How investors can navigate the future** (https://www.wellington.com/en-nl/institutional/insights/future-active-management)
- **Closing the return gap: A new set of “stepping stone” ideas** (https://www.wellington.com/en-nl/institutional/insights/target-return-investments-stepping-stones)
- **How the public market correction is affecting the late-stage private equity market** (https://www.wellington.com/en-nl/institutional/insights/market-correction-late-stage-private-equity)
- **Cybersecurity in 2022** (https://www.wellington.com/en-nl/institutional/insights/esg-cybersecurity-growth-cybercrime-private-companies)
- **Five key ESG topics for private companies** (https://www.wellington.com/en-nl/institutional/insights/esg-investing-private-equity-5-considerations)
- **Ten more “what if” scenarios for 2022** (https://www.wellington.com/en-nl/institutional/insights/2022-investment-scenarios-what-ifs)
- **2022 Alternative Investment Outlook** (https://www.wellington.com/en-nl/institutional/insights/alternative-investment-outlook-2022-annual)
- **ESG in 2022: Insights for private companies** (https://www.wellington.com/en-nl/institutional/insights/esg-private-equity-2022-insights)