BENORI

Sustainable **Investments**

by Private Equity/ Venture Capital Firms in India

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Foreword

"Sustainability has to be a way of life to be a way of business" – Anand Mahindra[1]

Sustainable investment is an approach that considers environmental, social, and governance (ESG) factors in portfolio selection and management. Sustainable investing, on the other hand, is about investing in progress and recognizing that companies that are solving the world's most threatening challenges are in the best position to grow and bring positive impact in society. There is an increased demand for organizations that can withstand the severe impact of any crises and constantly incorporate ESG factors in their daily operations.

In this context, Benori Knowledge conducted a survey and in-depth interviews with professionals in private equity (PE) and venture capital (VC) firms for their expert opinions and valuable insights on the landscape of sustainable investments in India.

The survey seeks a deep understanding of the current and future share of fund allocation, plans of the investor community, and the most attractive sectors for sustainable investments. The survey outcomes and insights generated through our in-depth interviews are presented in this report.

Finally, through this report, we have tried to present different scenarios of sustainable investing by PE and VC firms in India. The report revolves around the following four major themes:

- Identifying key sectors that are attracting majority of sustainable investments and the laggards
- Fund allocation to ESG-based sectors/portfolio out of the total available funds
- Major challenges that these institutional investors are facing for sustainable investments
- Preferred approaches and strategies adopted by investors for these sustainable investments

**Our analysis has been mostly based on PE/VC firms that have higher focus on sustainability*

2. Executive Summary

As one of the fastest growing economies, there is a big opportunity for India to tap into the growth prospects in sustainable investments. In the past, PE/VC investors have played a limited role in sustainable investments. However, with increased global recognition of the implications of sustainability risks on the performance of portfolios, several global PE/VC players investing in India as well as domestic investors have begun to consider sustainability risks of companies. To invest in emerging markets and raise capital, sustainability and ESG must be considered as important factors. ESG is a tool that investors use to characterize company behavior better and estimate the financial future, which starts with governance.

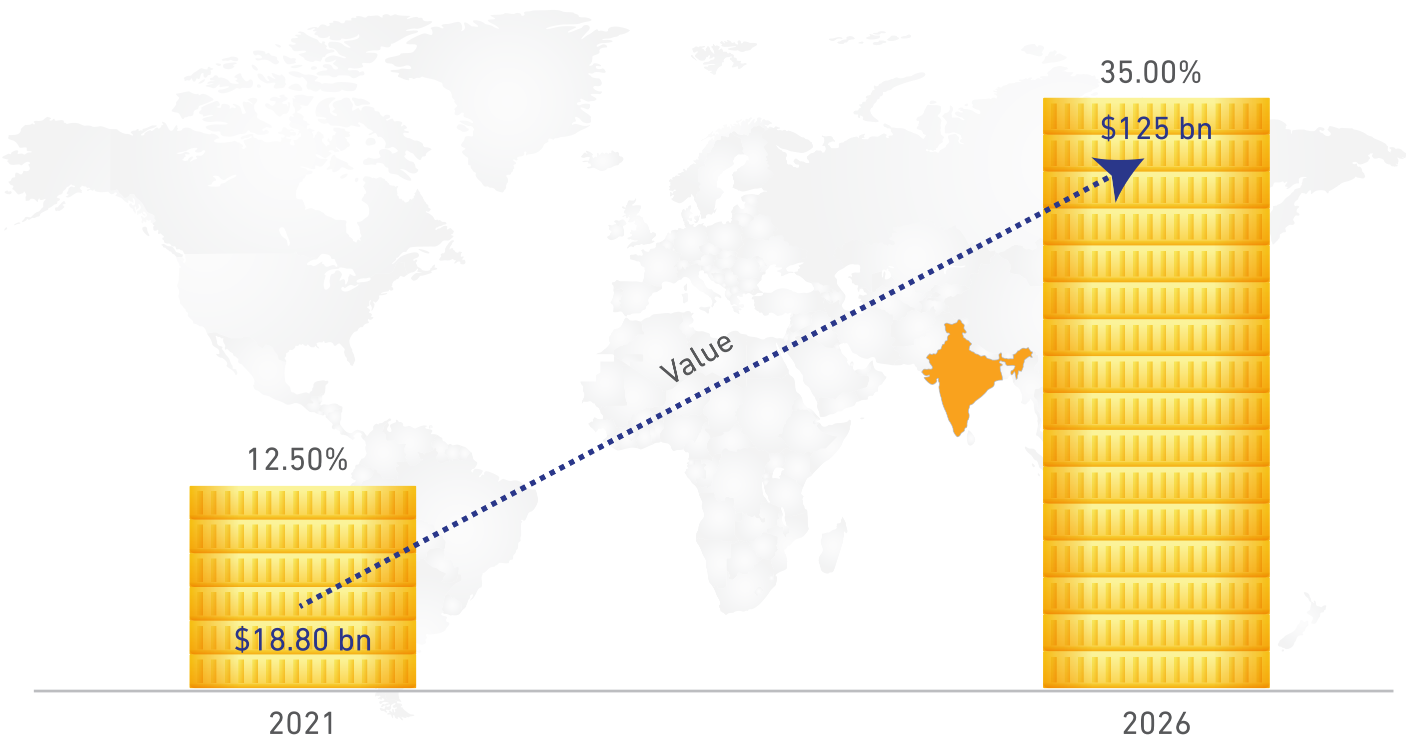
2.1 Key Findings

Fund Allocation Toward Sustainable Investments

- According to our evaluation, sustainable investments account for 10%–15% of the total assets under management (AuM) being managed by PE/VC* firms in India.
- India is in the early stages of its sustainable investments journey and is estimated to reach around 30%–40% of the total AuM by PE/VCs in the next 5 years.
- According to our analyses, the total value of sustainable investments by PE/VC AuM in India in 2021 is estimated to be $18.80 bn and is expected to grow to $125 bn in the next 5 years.

Exhibit 1 represents the estimated share of AuMs toward sustainable investments by PEs/VCs out of the total AuM by PEs/VCs in India in 2021 looking forward to 2026.

Exhibit 1: Estimated Share of Sustainable Investment PE/VC AuM out of the Total PE/VC AuM in India



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Sectors Attracting Sustainable Investments

- Renewable power generation, e-mobility, agritech, and waste management are the major sectors attracting most sustainable investments in India.

Key Challenges from an Investor's Perspective

A variety of issues are currently plaguing India's sustainable investments and the hurdles that investors are facing include:

- Lack of quality data and measurement criteria
- Traditional mindsets, a limited record of sustainable funds, and a lack of awareness
- Lack of talent pool with sufficient knowledge and expertise on ESG/sustainability

Major Approaches Toward Sustainable Investments

The two most prominent approaches that came out are ESG integration and exclusion based negative screening. However, a few firms with relatively small fund sizes prefer screening and theme-based investing approaches.

> Firms that don't follow ESG guidelines will find themselves at a disadvantage as their relative cost of capital increases due to lower allocation by both private and public market investors. To follow ESG practices is not expensive, it requires diligence, hard work, and in the long run is very rewarding for the company, employee, and investors.
>
> **Maninder Singh Juneja, True North**

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3. Key Trends

3.1 Trending Themes in Sustainable Investing

Even though India is in its early stages, there is a realistic path for ESG-focused investing to drive growth fueled by regulatory pressure. ESG adoption has progressed from a risk-mitigation tool to a core strategic priority for entrepreneurs.

The Government's environmental policies are expected to largely impact the sustainable investments by PE/VC. Hence, it is imperative for companies to move toward green investments due to India's commitment to control carbon emissions in the recently concluded COP 26 conference. India is on track to deliver its global commitments, such as reducing its carbon emissions by 30% by 2050 and procuring 40% of its energy from non-fossil fuel sources by 2030. These are clear indications of its focus and the requirement to integrate ESG factors into the investment process.

Investors are keen on investing in companies that are solving the climate crisis, leveraging innovative technology, and propelling humankind's progress toward a carbon-free economy, with a particular interest in in green buildings, electric vehicles, improvement of public transport, and renewable energy. It is also noted that there is a transition from investing in ESG-focused funds towards impact investing and sustainable products such as green bonds.

Exhibit 2 depicts the intersection of three factors — Environmental, Social, and Governance — which are key to sustainable investments.[2]

Exhibit 2: Environmental, Social, and Governance factors

Environmental:
- Clean energy technologies
- Climate change
- Environmental pollution
- Water scarcity
- Biodiversity
- Waste management
- Organic products

Social:
- Equality and diversity
- Mental health
- Gender and diversity inclusion
- Community relations
- Supply chain management
- Data protection and privacy

Governance:
- Management structure & compensation accounting and auditing standards
- Board leadership, diversity & independence
- Succession management
- Shareholders rights
- Corruption & bribery

3.2 Role of Institutional Investors in Driving ESG Agenda

Recent trends indicate a rising interest towards sustainable investments led by institutional investors, since they are investing capital from both equity and debt issuances where sustainability is the main consideration. The stakeholders are becoming more cautious of the outcomes of their investments. Currently, they are investing in companies with increased focus on sustainability, with the expectation that this will bring a long-lasting impact on their credibility. The attitude and approach of institutional investors have matured in many important areas including ESG performance estimations, ESG-influenced investment decisions, sustainability-related valuation, and engagement and public reporting.

> Even if sustainability is not their main objective, every firm must conduct business the right way, with the right governance standards, right E&S practices, and being mindful of their impact. Investors have increasingly begun to recognize that just financial metrices are not enough. The focus is shifting towards investing into businesses that provide not only good returns but also sustainable returns.
>
> **Rupali Gupta, Eversource Capital**

Creditors such as banks prefer lending to organizations with a high standard of ethics than to firms with a high gross profit margin. The issuance of green bonds, the most extensively leveraged bond product under ESG, have increased, mostly by power companies and financial institutions.

Institutional investors are incorporating ESG elements because they believe it will help them "cultivate better investment practices" and "promote a long-term investment mindset."

4. Fund Allocation Towards Sustainable Investments

The share of VC funding in India accounted for more than 50% of the overall PE and VC investments in the country in 2021. Since they have a significant contribution to total investments, VC is particularly ideal for sustainable investment given its characteristics as compared to other forms of financing. VC is uniquely positioned with the needs of sustainable projects as they have a long lock-in period which aligns well with the needs of sustainable start-ups to secure investment for an extended formation period. VC funds are also able to add value to sustainable start-ups by providing technical knowledge, industry relationships, or management skills, thereby bringing additional benefits.[4]

Based on our analysis of the industry and survey responses, we understand that the fund allocation towards sustainability in India is less than 20%. Most of the survey respondents confirmed that the estimated fund allocation toward sustainable investments is between 11%–20%. Having discussed in-depth with a few firms that are majorly focusing on sustainable investments, we observed that these firms invest almost 50% of their allocated funds toward sustainable investments. However, the number of such firms is low.

With many recent announcements to launch sustainable and responsible investing (SRI) focused funds and asset management businesses signing up for the UN-supported Principles for Responsible Investment (PRI) for better risk management, the asset management industry in India is seeing a significant amount of activity.

In comparison to the global average, the share of sustainable investments in total investments in India is currently low. Sustainable investment accounts for around 33%[5] of the total of the US' AuMs and approximately 36%[6] of the global AuMs. Currently, the estimated share of sustainable investment PE/VC AuM out of total PE/VC AuM in the US is between 30%–40%. According to an estimate, sustainable investment accounts for around 10%–15% of the total AuMs managed by PE/VC firms in India, which is estimated to grow significantly to reach around 30%–40% in the next five years.

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5. Sectors Attracting Sustainable Investments

5.1 Major Sectors Attracting Sustainable Investments in India

Currently, investors in India are focused on cleantech and emerging green sectors for sustainable investing, including renewable power generation, agritech, e-mobility, waste management, and waste recycling.

However, companies across all sectors are now moving toward strengthening their sustainability parameters, backed by investor support.

Solar power generation is a rapidly growing industry and investing in a solar power project is both sustainable and financially beneficial. Currently, private companies account for most of the installed renewable capacity, while the Central and state government units account for few. Therefore, we expect more investments in renewable energy projects and capacity in India by PE/VCs.

E-mobility is attracting investor attention and is gaining both financial and strategic importance in the Indian ecosystem by PEs and VCs. In fact, investments have doubled between 2019 and 2021 as compared to the previous three years. The Indian EV industry is picking up pace as well as consumers are showing interest in shifting toward less energy-intensive options. It is estimated that the EV market will attract investments worth INR 94,000 crores in the next 5 years.[7]

Healthcare funding also leverages different technologies, since there is substantial opportunity in the market for investments post-pandemic, that is expected to lead to the growth of health in coming years.

Green finance is one of the fastest-growing sectors in finance with growing investors support. As the need for responsible investing has grown, several PE firms are targeting real estate developments in India that are environmentally, socially, and economically compatible.

As **technological innovations** are fostered, it is a motivation for entrepreneurs to shift toward technology-based investments such as fintech, agritech, edutech, and healthtech. It is estimated that currently more than 4,500 start-ups are operating in the Edutech space in India and the sector is projected to grow to $30 bn in the next 10 years from the current market size of around $800 mn.[8]

Waste management seems to be a critical issue in India due to a lack of clarity and awareness among stakeholders. The current systems in India cannot cope with the volumes of waste generated by an increasingly urban population, and this affects both the environment and public health. Therefore, we also expect investor's interest in waste management projects to pick up pace in the coming years.

5.2 Future-focus Sectors Toward Sustainable Investments

With the rapid rise in urbanization and industrialization, a sustained increase in sustainable commitments by Indian investors can be expected, given the demand has surged energy, sustainable transport, water supply, and waste management sectors in recent years.

Investors' focus continues to expand on carbon offsetting and compensating for greenhouse gas emissions as the earth's temperature has increased by 1° Celsius, an alarming situation globally. They are shifting toward advanced solutions such as carbon capture and energy storage technology as a long-term solution to reduce carbon emissions.

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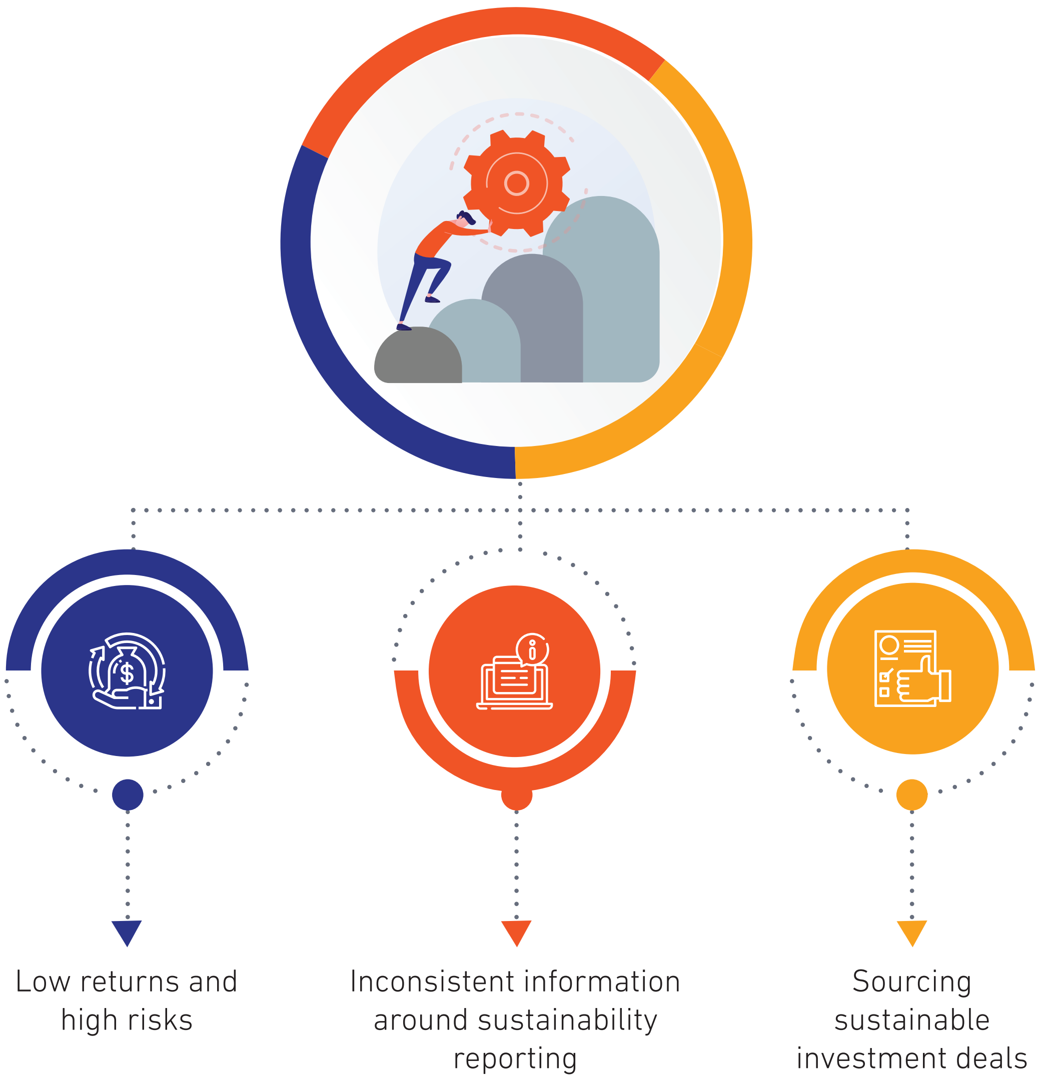
6. Key Challenges

6.1 Key Challenges from Investors' Perspective

Investors aim to create a sustainable portfolio to stabilize profitability in the 21st century, although it is not easy to create and manage a portfolio with such strong sustainable factors. A variety of issues are currently threatening India's sustainable investments—lack of quality data, measurement criteria, traditional mindsets, a limited record of sustainable funds, and a general lack of awareness on the subject.

A talent pool with knowledge and expertise in the areas of ESG/sustainability is also limited, and is not growing at the same rate as the demand for long-term investment. Even if investment firms seek guidance from consultants, the right personnel and talent is missing.

When asked about major challenges the firms are facing toward sustainable investments, majority of investors in our survey mentioned (a) low returns and high risks, (b) inconsistent information around sustainability reporting, and (c) sourcing sustainable investment deals.



The reliability of accessible data continues to be a barrier to ESG growth in India as ESG data is frequently obtained through third parties, sustainability reports, and media releases. As a result, the authenticity of data is not always verified.

It has become an organizational imperative to comply with sustainability standards and all teams and functions within organizations need to be aligned on this purpose, that may be speeded up with increased awareness on the subject and threats we all face collectively.

6.2 Factors Affecting ESG Ratings Data

ESG ratings are useful tools that can be used to summarize sustainability. ESG reporting is still in a nascent stage in India, while the investors are considering ESG ratings to make their investment decisions. The process of calculating a company's ESG scores is highly subjective. Differences in ESG scores can occur for several reasons such as different frameworks, measures, key indicators and metrics, data use, qualitative judgment, weightage of subcategories, and reweighting of scores to ensure best-in-class in industries.

While the variety of methodologies, judgment, and data offer investors a choice of approaches and outcomes, large differences in ESG ratings across providers may also reduce the meaning of ESG portfolios that weigh better-rated firms more highly. Moreover, mining such data has an additional cost. As a result, to appropriately appraise a company in terms of ESG characteristics, the company must provide substantial, credible data.

7. Approaches to Sustainable Investments

In recent years, SRI has emerged as a key investment trend. Globally, the most common SRI strategy is ESG integration, followed by negative screening, corporate engagement and shareholder action, norms-based screening, and sustainability-themed investment.

To operationalize ESG policies, devising a strategy and following the appropriate approach is necessary. Based on survey responses, we understand that the two most followed approaches toward sustainable investments by investors are ESG integration and exclusion based negative screening.

> Most investors employ a multi-pronged strategy, beginning with sector-specific due diligence to ensure that they are investing in sustainable industries, and then screening according to their firm's ESG categorization and business standards and criteria.

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8. Conclusion

The sustainable investment size by PEs is estimated to grow at a significant rate in the next few years as compared to other traditional forms of investments, as investors are more aware and consider sustainability factors in their portfolio selection. The investing momentum by Indian VCs is expected to grow rapidly as the share of VC deals has remarkably increased in 2021 in India as compared to global VC investments.

The main area of focus for investors should be to combat climate change by using scientific techniques, technology, and financial means. Due to various factors such as fragmented urbanization and environmental degradation, core sectors, e.g., transportation and e- mobility, fintech, agritech, and healthtech should expand substantially in the coming years.

Growing sustainable demands can only be mitigated by universal acceptance. Slowly but steadily, the investor community will realize that by harnessing sustainable opportunities their firms will get long-term value and endurance. They must imbibe sustainable investments as a culture by considering both short- and long-term financial impact on their business, with increasing expectations from the investor community.

Here are some measures that need to be prioritized actively by stakeholders in the future:

- Firms should adopt a robust sustainability framework and standardized format for reporting to maintain efficient growth toward sustainability.
- To strengthen ESG practices and reduce the reluctance toward sustainable investing there should be significant regulatory push and guidance asking for timely disclosures.
- Quality and quantity of financial reporting towards sustainable investments should increase, which will improve data availability and analysis.
- Companies should periodically monitor measures taken towards sustainability to optimize their opportunities.

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