Investing in the green transition through private equity funds

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The challenges of climate change, decarbonising the economy and greening society require huge investments. For the European Union alone, the European Commission estimates the annual investment requirement at €600 billion. Globally, estimates are in the single-digit trillions. The question for investors is how to invest in this environment and still meet their return targets. They want to invest in the markets and companies that will be the winners of the future: gaps in public budgets have never been an incentive for the financial market. So what is the investment case for climate?

For many, investing in sustainability and climate protection has become virtually synonymous with investing in renewable energy, particularly solar PV and wind, and in some cases also in related infrastructure such as battery storage and transmission grids. As important as this is, the ambitious goal of near-total decarbonisation by the middle of this century will not be achieved by expanding renewable generation capacity alone, let alone the many other sustainability goals beyond CO2 emissions, such as resource efficiency.

A closer look shows that the conditions for attractive potential returns also exist outside the renewables sector. Early climate technologies such as solar, wind and energy storage are already cost-competitive with fossil alternatives, which explains their popularity with investors. Over the next five years, we expect further breakthroughs in areas such as food and agriculture technology and the circular economy. This will continue to drive demand for sustainable technologies and, consequently, for sustainable financial products. Investors have recognised that now is the time to invest in climate technologies: in 2023 alone, 27% of European growth capital flowed into the sector.

Green transformation requires green innovation

In addition to energy infrastructure, business models and innovations are needed to develop resource-efficient production methods or increase the energy efficiency of processes and products. Both agile start-ups and large, innovative companies can play a role here. However, they are often supported by established SMEs with strong engineering capabilities.

Investment in green transformation does not necessarily have to be in infrastructure funds but can also be in companies and their business models. However, very few of these companies are listed or have issued green bonds. As a result, investments thus almost inevitably mean private equity. Especially in times of rising borrowing costs and, in some cases, more restrictive lending institutions, it is essential for these companies to have sufficient equity and liquidity to continue financing their own growth. Of course, return expectations also play a role for investors.

Funds of funds provide access to private equity specialists

Private equity funds of funds are suitable structures for investors to invest in a broadly diversified portfolio of assets, i.e. companies with appropriate business models and products, through a number of specialised target funds. Private equity investments require highly specific sector and technology expertise, which is best provided by specialised fund managers. The fund of funds manager can use its market overview to structure a suitable and diversified portfolio allocation and make it available to institutional end investors in a cost-effective manner.

In this way, it is also possible to structure a fund of funds that meets the requirements of the most demanding classification, Article 9 of the EU Disclosure Regulation (SFDR). The individual target funds themselves do not necessarily have to be Article 9 funds - some are not even launched in the EU and are therefore not subject to EU regulations. However, with thorough sustainability due diligence at the fund and portfolio level by the fund of funds manager, it is possible to demonstrate alignment, which is also accepted by the regulator.

Two private equity fund managers with a strong focus on impact investing are Alder in Sweden and Ara Partners in the US.

Alder has a clear focus on environmental and climate technologies

Alder was founded in Stockholm in 2008 by five partners with both private equity experience and environmental science expertise. Long before the term sustainability became commonplace, Alder's vision was to invest in and help breakthrough small and medium-sized industrial companies in Northern Europe with a focus on environmental and climate technologies. With its first two funds, Alder I and Alder II, the current team of 13 have established a successful track record. With the companies it has already sold on, Alder has multiplied his invested capital by a factor of around 3.5.

Last year, Alder III became the third private equity fund in the series. The fund has a volume of SEK 3 billion (approx. € 260 million) and invests in buyouts in the climate technology sector, primarily in the Nordic countries, but also in the DACH region. Target segments include natural resource conservation, building efficiency, smart infrastructure and sustainable industry. Approximately ten investments with controlling positions are planned, each with a volume of SEK 100-300 million. Alder III is itself registered as an Article 9 fund under the SFDR.

Fund name	Alder III
Issue date	2023
Fund volume	SEK 2.94 billion
Planned maturity	10 years
SFDR	Article 9
Portfolio	Approximately 10 investments of SEK 100–300m each
Target markets	Climate technology buyouts in the Nordic and DACH regions

Insort: Sorting systems to reduce food waste

One example of a company that Alder has included in its current fund is Insort, a manufacturer of food sorting systems based in Styria, Austria. Thousands of tonnes of food are wasted every year due to inaccurate sorting. This is a huge economic problem worldwide: according to the World Food Programme, the global cost of food loss and waste is around one trillion US dollars per year. Better sorting technologies offer both environmental and financial benefits.

Insort's innovative technological processes increase accuracy and can help reduce unnecessary waste of potatoes, fruit and vegetables, nuts and pulses, meat and other agricultural products. To do this, the sorting machines rely on real-time, full-spectrum analysis to determine chemical composition, offering a level of accuracy far beyond the human eye. Insort has enjoyed strong and profitable growth in recent years. The Austrian company's products contribute to more efficient food production, which in turn conserves the world's finite resources and has a positive impact on the environment.

Ara Partners aims to decarbonise the industrial sector

Ara Partners was founded in Boston in 2017 by Troy Thacker and Charles Cherington. Both have many years of experience in the private equity and energy sectors and founded Ara with the clear goal of driving the decarbonisation of the industrial sector. Ara invests exclusively in companies that aim to decarbonise the industrial sector through new technologies and better business models. To put this approach into practice, Ara's investment strategy focuses on two types of companies: those involved in process technology capacity expansion and those driving decarbonisation.

To date, Ara Partners has invested more than USD 5 billion in 46 different companies. Since its inception, Ara has achieved impressive returns and significant reductions in carbon emissions.

Ara Fund III is the third and most recent addition to Ara's family of private equity funds. It was launched in 2022 and has USD 2.8 billion of assets under management. The fund will invest in growth and buyout opportunities in the chemicals and materials, energy efficiency and clean fuels, food and agriculture, and manufacturing sectors in North America and Europe. The fund plans to make between 12 and 14 investments, typically majority stakes, ranging in size from USD 50 million to USD 200 million. As one of the few exceptions in the US, Ara Fund III is itself registered as an Article 9 fund under the SFDR. The fund is currently invested in five companies with different business models, ranging from bio-methane plants to sustainable packaging materials free of wood and plastic, to renewable energy price insurance.

Fund name	Ara Fund III
Launch Date	2022
Fund size	USD 2.8 billion
Planned maturity	10 years
SFDR	Article 9
Portfolio	Approximately 12–14 investments of USD 50–200 million each
Target markets	US and Europe

Vacuumschmelze (VAC): a hidden champion in magnets from Hanau, Germany

One of the investments is a German company, Vacuumschmelze (VAC), based in Hanau, near Frankfurt am Main. VAC is a true hidden champion, with a century-old history, and is now one of the leading manufacturers of permanent magnets. These are used, for example, in electric cars and charging infrastructure, as well as in wind and solar power systems. With geopolitical tensions around the world, governments and automakers are scrambling to find alternative supply chains and reduce their dependence on China. As the leading Western manufacturer of permanent magnets, this gives VAC a very favourable market position. The strong order book not only brings financial returns, but also has an environmental impact: with permanent magnets for electromobility alone, VAC has the potential to contribute to the reduction of one gigatonne of CO_2 equivalent over the next five years.

As these examples show, the path to climate-friendly investments does not necessarily go via renewable energy systems. The necessary transformation of the economy is far more complex and multi-faceted, and offers a wide range of investment opportunities, for example through private equity strategies. The complexity and very broad range of opportunities require a great deal of experience, and this is where a fund of funds manager can play a key role for many investors.