Climate Investments are not immune to the laws of risk v reward

A week of economic turmoil has highlighted a fundamental disconnect between the enormity of the financing required to decarbonize the global economy and the importance of a strong risk-adjusted return on that capital. There is a perception that ample funding is available for all the climate infrastructure and early stage investment required and that climate investment is somehow immune from the traditional rules of capital allocation. The shockwave moving through the venture capital industry may have been highlighted over the last ten days by the demise of SVB, but the value destruction that is permeated through early-stage investments has its roots in the US Federal Reserve tightening cycle that ended the era of loose money 12 months ago. For all the government support, moral imperative, and economic tailwinds in venture capital, private equity, and infrastructure climate investment, allocations to climate funds will not be shielded from the monetary pressures facing every asset class, from public equities to real estate.

A reckoning is coming to climate investing. It will see the failure of extension rounds, down rounds being commonplace, and the complacency of many climate founders being exposed. It will be a painful 12 months for climate venture investing as valuations become more realistic, and management teams appreciate that the cheap money era of the past decade is behind us. Long term, this is incredibly healthy. Investors can focus on high-quality, scalable solutions to climate challenges requiring companies to be innovative, profitable, and financially stable. This only comes with a prudent assessment of valuations that remained far too high by any metric. The effects of the most aggressive interest rate tightening cycle in four decades will produce this valuation adjustment in the quarters ahead. The result will be that strong companies will survive, firms with dubious models will fail, and high-quality investors will be left supporting those companies that will be truly transformative and scalable.

The rules of investment apply to all firms. VC back climate startups and other climate investments are not insusceptible to the basic laws of risk versus return. Some vitally important sectors will need to dramatically rethink their funding models if the scale they desire is to be achieved. Nature-based solutions need to play an enormous role in reducing carbon output to net zero by 2050. No man-made technology can come close to the scale and efficiency of forests, oceans, and mangroves. Yet the capital required for reforestation, biodiversity protection, and soil enhancement is lacking. The primary reasons for this boil down to a simple investment narrative of the perceived risk of investing in emerging economies. The Global South has remarkable nature-based assets that can be readily enhanced to set us on a ten gigatons carbon extraction pathway by 2050. The problem is capital allocation.

The opportunity in a country like Ghana is enormous, but their recent sovereign default and negotiations with the International Monetary Fund imply that allocating capital for several decades is a nonstarter to any organization using traditional risk metrics. While countries like Brazil, Mexico, and Indonesia are viewed as less risky, they are still defined as emerging markets, and hence the sizable risk premium will be allocated to carbon projects just as they are to equity, debt, and other credit instruments. There are very few investors who will allocate money to the emerging world for decades, and while mission-driven investments such as nature-based solutions should be viewed differently than a traditional financial allocation, emerging market risk parameters will hold back the scale of growth in voluntary carbon markets.

This is but one example of where the vision of a scalable climate solution fails to consider financial reality. Electric vehicles are another segment with enormous economic challenges. For valid decarbonization reasons, governments are asking automakers worldwide to cease producing cars that are major contributors to greenhouse gas emissions. However, they cannot make these vehicles profitably. The debate around price parity is often seen as the defining issue for the broad-based adoption of electric vehicles in Europe and the United States. There are often numbers thrown around that say that at some stage in 2024 -2025, price parity will be met in the United States. The problem is the profit margin. US automakers can produce a combustion engine and generate a mid-teens gross profit margin. Current EV pricing has the likes of Ford and GM losing between 10% and 30% per unit. That is not price parity. That's a ticket to bankruptcy, and hence the notion that government support for consumers and electric vehicle manufacturers will only grow over time.

No one expects a company to be profitable from day one, regardless of its sector. However, there needs to be a pathway where the capital deployed from investors can achieve an appropriate risk-adjusted return. This may well include government subsidies and tax credits, which should be utilized as much as fiscally possible.

The stresses in broad-based venture capital will lead to slower capital allocations for all early-stage funding programs, including climate investment. This will be cyclical, and flows will return when valuation becomes more realistic and confidence returns to mission-driven and rent-seeking investors. This won't be quick. The adjustment and climate valuations have only begun, and one should expect that 2023 will be a year where capital allocation is relatively slow for all the structural positivity around the climate narrative. No mega theme of the past four decades, like China, the Internet, Smartphones, Semiconductors, or the Cloud, has removed cyclicality from the equation. In the quarters ahead, unicorn candidates will go bankrupt, high-profile founders will see their businesses crumble, and the power base will shift from founders with transformative climate solutions to the investors who will choose which to fund. This is organic and constructive, leaving the climate sector in good stead once this flush-out is concluded.