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ESG: What's in your infrastructure wallet?

BY JOEL KRANC

Environmental, social and governance (ESG) investing is a relatively new term, and idea, among institutional investment managers. In 2004, then U.N. Secretary General Kofi Annan asked 50 CEOs of major financial institutions to participate in an initiative of the U.N. Global Compact, the Swiss Government and the International Finance Corp. The point of the exercise was to incorporate ESG issues into capital markets.

This action eventually led to the creation of the Principles for Responsible Investing (PRI) in 2006 and the creation of the Sustainable Stock Exchange Initiative in 2007. As of March 2020, there were 3,038 U.N. PRI signatories with more than $103 trillion of assets under management. Saying the idea has taken off would be an understatement. But how and why does the incorporation of ESG play into the thinking of institutional investors seeking out large infrastructure projects?

As institutional investors seek out infrastructure investments for their long-term horizons and mostly stable cash-flow arrangements, they are having to face the effects of climate change on their investments. For example, once-in-a-generation storms that occur more frequently, extreme weather, pollution, etc., can all lessen the life of an investment and increase risk.

According to a report from the OECD, *OECD Business and Finance Outlook 2020: Sustainable and Resilient Finance,* "… the long-lived nature of infrastructure assets exposes them to risks of disruption over time, often arising from ESG factors. If not managed and mitigated, these risks may ultimately impact the performance of an asset and the rate of return for investors." The report goes on to say that, "… pension funds and insurance companies are increasingly choosing to integrate ESG factors in their investment decisions but that major

challenges remain. Major barriers to ESG integration are also obstacles to the elaboration of better risk management strategies for investors and the allocation of finance to infrastructure investments."

And yet, whereas ESG was at one time more of a novelty and curiosity for investors, it has now become an everyday part of investment decisions. "What's changed over the past 10 years, even though our investing style has not changed, is that ESG underwriting and upfront risk mitigation was formerly an ancillary benefit to our process. Now it's more required," notes Adam Bernstein, a managing director at North Sky Capital. "It's more of a prerequisite to generate investor interest to deploy upfront ESG screens. This prerequisite has been influenced not just from the investor side of the equation but also from the market side."

In order to get local support for projects now, adds Bernstein, the incorporation of ESG and adherence to social metrics into the process is more relevant than it had been 10 or more years ago. "Ten years ago, it would be a nice-to-have and, now, it is more of an upfront requirement."

How to measure

The good news, for investors interested in both infrastructure and injecting their philosophies of ESG into the process, is that new indices and metrics are beginning to come online. In fact, the Global Listed Infrastructure Organization (GLIO), along with the Global Real Estate Sustainability Benchmark (GRESB) and Global Property Research (GPR), earlier this year launched the GLIO/GRESB ESG Index.

"The idea is twofold," notes Fraser Hughes CEO with GLIO. "The first is to get a financial benchmark out into the market that uses public disclosure … and it also gives investors a tangible touch point with the companies, which is their ESG score."

Essentially GRESB goes through the GLIO list of companies and gives each one a rating or score that addresses all elements of the "E," "S" and "G." A good score weights the company up in the index and, alternatively, a low score weights them down in the index.

"We would expect that going forward, investors would have conversations with the companies, and as part of that conversation they will say – 'Did you know you were part of the GLIO/GRESB Index, and you have a low score that weights you down?'" The idea is that those investors can talk to or persuade the companies to consider their ESG and look at more transparency to increase their score.

"Hopefully," adds Hughes, "it builds momentum for companies to disclose [their ESG] better, going forward."

Of course, strategies and metrics used by investors change over time. Rick Walters, chief of standards and innovation with GRESB, says his organization assessed the investment strategies used by fund managers. "Interestingly, we are seeing multiple strategies become the common approach. It's almost rare now to use one strategy when making decisions for your fund."

Of those strategies, notes Walters, ESG integration is at the top of the list for managers, as well as things such as corporate engagement. Other screening tools, such as positive/best-in-class screening and negative exclusion, remain popular strategies and, according to Walters, impact investing has been used less and less as a strategy.

But is using more than one strategy necessarily better than just one? Notes Walters, "They are being asked by their clients because some investors have particular needs but beyond that, particularly in private infrastructure, the ESG integration and active ownership engagement work really well hand-in-hand. So, I think [managers] are seeing these strategies as quite complementary."

But there are challenges with these strategies. Walters adds that getting good data is still problematic for managers, although standardization is helping with that. Another challenge, he notes, is how best to use the data when making investment decisions. Leading investors take the underlying data and are able to build it into asset pricing models. "As the data becomes more reliable [managers] will trust the data and bring it into their models quite quickly," he says.

Moving forward

Investors, for the most part, have had to separate what their aspirational goals are versus what they are able to achieve through ESG investing. But things are changing.

"The gap between what's achievable and aspirational has narrowed a lot," says Bernstein. "If you were to have said in 2010 that more than 100 gigawatts of wind and solar would be deployed in the following decade, most people would have put that in the aspirational bucket versus achievable. But it got achieved."

For the industry, as a whole, if you say the goal is to be 100 percent energy sustainable by 2050 or, for certain states, to be 70 percent sustainable by 2030, those could be aspirational, according to Bernstein. "But achievement is nonlinear. All it takes is a tipping point, not even a new technology, but things like improvements in existing technologies, like solar or storage efficiency. The gap between aspirational and achievable can close suddenly and not gradually when what appears to be just an incremental process improvement catalyzes an exponential commercial shift."

There are differences between how managers view ESG, depending on their size and needs, says Andrew Harris, principal at North Sky Capital. "We are seeing a good and healthy dialogue between institutional investors, investment managers and industry over what is material, what should be measured and what should be factored as risks. That dialogue will take time to play out with different people at each of those three levels of the equation."

It is that dialogue that will shed light on different concerns and goals and how best to deploy capital. Measuring that capital to meet those needs will be an important step at satisfying all parties at various stages of their ESG evolutions.

Building commonality for investors is also a first step, according to Hughes. It is important for managers to have indices
they can point to as a common resource, which allows dialogue and goals to be addressed from the same vantage points, even if those benchmarks are being looked at by different managers.

The good news is that dialogues are occurring at all levels – governmental,
as well as fund and institutional managers and investors. ESG, which was, in the not so distant past, a small consideration, has become part of the model by which many infrastructure investments are made. As manager thinking on the issue evolves, so too will the strategies leading to sustainable investments well into the future.

Joel Kranc is head of Kranc Communications in Toronto.

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