

Building back better: ESG trends, opportunities and challenges

James Gow, Chief Client Officer at the Aztec Group, moderated a BVCA Alternative Fund Strategies Conference panel discussion on the issues making environmental, social and governance (ESG) such a priority across the infrastructure sector. James was joined by Mary Nicholson from Macquarie Infrastructure and Real Assets, Neil Krawitz of Arcus Infrastructure Partners and Carolyn Pearce of InfraCapital.

Moderator, James Gow (JG): It is expected that this year will mark a real turning point for ESG, but to what extent have you seen ESG considerations being applied to traditional infrastructure investments?

Mary Nicholson (MN): ESG has always been a fundamental consideration within infrastructure investments, which are typically favoured by investors with a longer-term time horizon. When making an investment over 10-20 years, we also consider what can happen to a business that itself might last for 50 or more years, as well as the investment horizon of the party that will be acquiring the business from us in due course. There are always a variety of ESG issues you need to think about. But over the past year, the social aspect - the 'S' in ESG - and health and safety in particular, has really come to the fore for our businesses.

Neil Krawitz (NK): We've seen an exponential increase in demand for good ESG management from investors in the last five or six years. Deutsche Bank statistics recently showed the number of investors citing ESG as a key consideration in investment decision-making increased from 25% in 2015 to around 50% in 2020 which echoes our experience at Arcus. When we closed fundraising for our last European fund in early 2020, investors representing about 65% of the capital raised had a clear and prioritised ESG driver in their allocation decision and manager selection. This was evident from the extensive diligence they undertook,

as well as around their respective ESG reporting requirements.

We are now seeing more investors using ESG ratings provided by independent bodies like Principles for Responsible Investment (PRI) or an infrastructure-specific organisation such as the Global ESG Benchmark for Real Assets (GRESB), to make sure what the manager says is backed data that has been externally assessed by credible bodies. We have also seen investors developing their own bespoke internal due diligence tools, and even approaching us on a reverse inquiry basis, specifically because of ESG considerations. This all gives us a sense of the momentum at present. Investors are demanding more detail, a more sophisticated approach from managers, and are increasingly using ESG as the key criteria in their decision making.

Carolyn Pearce (CP): Our experience on the investor side has been very similar. One of the positives for the industry this year is the greater focus on firms quantifying their ESG impact. I am aware of a number of investors who have been getting impatient with general partners (GPs) who say they have great ESG programmes, but cannot measure basic impacts such as carbon footprint. We have also started to see updated investor questionnaires with a bigger focus on the social aspect. So, I think the events of last year have definitely created a new trajectory for ESG.

JG: How do you define an impact investment and what are you seeing in terms of the differences between impact and traditional investments within infrastructure?

CP: An impact investment in our eyes is something that delivers a material and measurable positive societal or environmental impact, while hopefully also generating competitive returns. Given their essentiality to society, arguably traditional infrastructure can be defined as an impact asset. The more interesting question is to ask what is an impact fund versus a traditional infrastructure fund? Given the growing need for sustainable infrastructure, many funds are delivering material positive impact. An impact fund however takes it one step further with impact intentionality embedded into the strategy.

I think ultimately there will be a greater focus on how you define an impact fund.

It can't just be about greenwashing due to the nature of assets we have always invested in. The core part of its strategy needs to be a commitment to delivering the material positive societal impact, alongside investment returns. For this, there will have to be changes to the behaviours of investment committees and arguably incentive models that ensure fund managers are focusing on investments with that positive impact and are no longer being driven just by financial incentives. That is where I think we can expect an interesting evolution for the industry we know.

MN: There are a lot of players now moving into the impact space, which is obviously great to see. But setting aside that shift from investors towards impact investing for the moment, we're also clearly seeing a greater emphasis from investors across all sorts of traditional products. They want to know the impact of the investments you have made, and want to see it being reported against the UN's Sustainable Development Goals, or tracking carbon footprint information over time.

Investors are all certainly demanding a lot more from GPs on the non-financial performance of the businesses they are invested in, even when through traditional funds. I think that is a really positive development, and makes it even more important that we show our progress and keep communicating what we are doing.

JG: What are your views on upcoming legislation and governance including SFDR (Sustainable Finance Directive) and which areas do you think infrastructure needs to focus on?

CP: The purpose of the legislation is to create a common language across the industry, and to increase everyone's ability to communicate in a transparent and consistent way. It's not just a positive for investors who are better able to allocate in favour of managers who really do care about ESG across their investments. It's also positive for the industry, which can articulate the pivotal role that private funds play in terms of providing essential services to society.

Of course, the devil is in the detail, and you don't want to increase the burden or paperwork to deter people from making stronger commitments with regards to

their ESG activities. But net I see new initiatives as a positive, because it generally reflects more policymaking support for private investment in sustainable investments generally, which creates more investment opportunities for us. New incumbent technologies often require a government subsidy or government support to get off the ground and mitigate some of the risk for investors. So, I think the momentum is a positive one for the sector, as well as for investors.

NK: It's very important to ensure standards exist that people can be compared against, particularly to reduce the risk of 'greenwashing'. From my perspective, what we want to see is standardisation rather than divergent frameworks and differing ways of reporting. We need a critical mass of companies reporting using the same tools and converging around the same ESG frameworks. But the challenge within the infrastructure industry is that we have many different sub-sectors that are quite dissimilar businesses and have different ESG or sustainability elements. This requires a well thought-out and tailored approach to managing each infrastructure sub-sector differently dependent on what is material for that business.

Certainly, the environmental aspect of ESG is being tackled through measures like the Taskforce on Climate Related Disclosures (TCFD) and the European Union's taxonomy for sustainable activities. However in the last year, a light has been shone on the social side of ESG - whether from employees, customers, contractors, or the community generally, harmonisation on the social aspects of ESG looks like the next important step.

MN: It's good to see standardisation and common reporting being introduced, but what is more important is that the information produced by the reporting leads to better investment decision making. It's all very well reporting on a number of metrics, but investors need to understand the context.

Those of us who have been living and breathing the European regulations over the last few months are looking toward to some sort of clarity on what the detail looks like when they come into force in March. Of course, the UK is continuing to undergo a post-Brexit consultation period, and will hopefully implement its own similar versions. I think consistency between jurisdictions is something that those of us on the GP side are going to be looking forward to, and I am certainly hoping very much for.

JG: The topic of our discussion is ‘building back better’, so just how optimistic are you for the opportunity within infrastructure over the next few years and beyond?

CP: In some ways, it’s business as usual for us. There is a great opportunity for political support to encourage further private sector investment in the space. There are lots of very diverse and very interesting opportunities - from fibre infrastructure projects to sustainable transport - for us to build back better. The infrastructure sector has already been looking into these areas, but if we have clearer policy support as well as more of a commitment from private capital, then fantastic.

MN: Governments around the world have put investment in infrastructure at the centre of their economic recovery plans. So, I see this very much as an opportunity for businesses like ours, and I am looking forward to it.

NK: Yes, there are challenges for infrastructure, but as an industry we have a growing allocation, and underlying investors who recognise the sector as the clearest route to delivering sustainable benefits, investing into new types of assets or transitioning existing businesses to fit with to a more sustainable future. The opportunities are fantastic for the infrastructure sector to meaningfully contribute in this evolution, and in building back better.