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Strategy and Sustainability

Discussion On ESG Investing In Private Markets, Real Estate, Infrastructure, Fixed-Income and Differences to Equity

ESG & Sustainability Transformation

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12/2023

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Real assets (including vacant land, farmland, timber, infrastructure, intellectual property, commodities, and private real estate) carry certain advantages and challenges compared to the equities and corporate fixed-income investment universe. In many cases, investors are majority owners or own the asset outright. Majority or full ownership stakes offer investors much greater control over the definition, application, and reporting of ESG data alongside or outside of existing reporting standards like those of the GRI or like the 2009 Global Real Estate Sustainability Benchmark (GRESB). The materiality frameworks used might have philosophical similarities - as in material ESG factors - but the identification of those factors can differ.

GRESB's full benchmark report provides the following:

- A composite of peer group information,
- Overall portfolio key performance indicator (KPI) performance,
- Aggregate environmental data in terms of usage and efficiency gains,
- A GRESB score that weights management, policy, and disclosure; risks and Opportunities; and monitoring and Environmental Management Systems (EMS),
- Environmental impact reduction targets, and
- Data validation and assurance

This type of report depends heavily on companies participating in the GRESB reporting assessment process.

Looking at commercial and residential real estate historically, the sectors arguably had little regard for ESG factors (especially pre-2009, before GRESB). Often the tenants and operators might think differently from the owners and constructors (sometimes called a "split incentive problem") because tenants must pay ongoing energy bills, whereas constructors do not.

Buildings also have a carbon footprint. An integrated ESG view might look at reducing a building's carbon footprint by using more efficient materials and standards and thereby lowering the risk of impact from carbon prices or deriving gains from energy efficiencies.

Like unlisted credit and real asset private markets, ESG integration in private equity faces a number of challenges, foremost being the lack of public transparency, established reporting standards, regulatory oversight, and public market expectations around ESG. Current initiatives aim to address these challenges, such as the PRI's reporting framework for infrastructure.

In addition, smaller, private companies are often capacity-challenged by ESG reporting requirements. Private equity investors might have to negotiate with a strong founder or founder team.

However early investors and significant shareholders can be strategic and long-term oriented, creating a powerful incentive to establish a strong set of ESG KPIs early in the company's life cycle or by setting important cultural values. Some investors will perform a

materiality analysis much like public equity investors might do; the same SASB framework might be used or developed via the private equity industry, e.g. the British Venture Capital Association (BVCA) Responsible Investment Framework.

Two case study examples from recent years show the role governance analysis played in the IPO and valuation of Uber and the failed IPO of WeWork.

These examples show how ESG can add or detract value.

Asset owners might also assess private equity managers on ESG criteria, especially when they might be co-investors on an asset. A typical assessment might include policy, people, process, transparency, and collaboration assessments.

Discussion of ESG in Fixed Income and Differences to Equity:

Historically, corporate bond practitioners adapted the materiality and sustainability frameworks, as well as the ESG techniques equity investors use, to meet their needs. More recently, newer techniques focused specifically on bonds have been used because bonds differ in the following ways:

- Credit quality
- Duration
- Payment schedules
- Embedded options
- Seniority
- Currencies
- Collateral
- Time horizon

Equity securities tend to not have these qualities, so different integration techniques are needed.

Fixed-income investors in corporate bonds might use principles in materiality and ESG frameworks that are similar to those used by equity investors but adapt them to where materiality is different between equity and bonds. Bond investors might find ESG factors that affect balance sheet strength (and therefore, the risks of debt defaults) more material than equity investors, who might be more concerned about future growth opportunities.

The opportunity side of ESG might be less relevant for bond investors because what is typically foremost in a bond investor's analysis is the impact of ESG factors on a company's ability to pay its debt obligations. For instance, an equity investor might view a green technology acquisition more favourably than a bond investor would because the equity investor is positive about future value from the technology, whereas the bond investor might be worried about the amount of debt required to fund the acquisition. ESG scores (whether third-party or internal) go alongside or are integrated into internal credit analysis and investment decisions.

Sovereign debt investors have started to analyze ESG, but borrowing the same materiality frameworks as equity or corporate debt investors has not been easy because some country-level factors (e.g., peace, corruption, ease of doing business, freedom of expression, education levels, and regulatory and legal robustness) might not be material to equity or corporate bond investors. Furthermore, a material factor (e.g., climate or carbon policy) will interact with analysis and valuations differently. Turning ESG analysis into meaningful judgments on the credit ratings or spreads for sovereign nations is therefore difficult. That

said, investors have typically integrated certain ESG factors (e.g., political risk and governance factors) into sovereign debt, even if not explicitly labelled ESG.

Municipal credit ESG analysis can differ as well. In the municipal space (region, state, or city) the issuer's governance and management practices can both be assessed, as well as their:

- Overall transparency,
- Reporting,
- Corruption levels,
- Budgetary practices,
- Pension liabilities, and
- Contracts.

Some investors will view municipals investing for inclusive communities as lower-risk investment because of the social benefits. Alternatively, co-primary outcomes are possible, where market rate returns are expected alongside social impact. This differs from social impact, which is not always expected to make market rate (risk-adjusted) returns. Environmental factors (e.g., a region's air quality and the associated health risks for its constituents) and the quality of public infrastructure (e.g., wastewater treatment plants) can all pose risks that could affect an issuer's ability to repay its debt.

Overall, while there are philosophical similarities in identifying material ESG factors and then applying those to the analysis, the type of factors used can differ across asset classes, as can the type of integration techniques.

To learn more about ESG and sustainability-related models, don't hesitate to contact **YTT Consulting**!