Talking Points

ESG in infrastructure – October 2021

In the following interview, Bronte Somes, Head of Infrastructure Equity Europe, and Declan O'Brien, Head of Infrastructure Research & Strategy, at UBS Asset Management, Real Estate & Private Markets, discuss ESG's impact on infrastructure investing.

ESG-driven investment strategies

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1 How can institutional infrastructure investors gain exposure to ESG?

Declan O'Brien: The options for institutional investors to gain exposure to ESG have never been greater. The public markets, for example, have seen net new money into sustainable investment funds increase from USD 17.5 billion in the first quarter of 2018 to almost USD 140 billion by the fourth quarter of 2020[1]. That is more than the total capital raised from all real asset funds. Real assets are also experiencing an increase in sustainable offerings, though that sector is at an early stage of maturity so a bit harder to track.

We can easily see that real estate is leading the way, due to more efficient buildings, and the increase in both subsidized housing and measurement of the social impact of assets. However, infrastructure is beginning to catch up and, potentially, offers more interesting opportunities in the future to take advantage of the more secular trends in the economy, such as decarbonization, digitalization, the need to support aging demographics, as well as healthcare and housing.

The ability to directly invest in and control these assets to target sustainable outcomes is an advantage of this sector. When you invest directly in infrastructure, you aren't just investing in a company with favorable ESG ratings, you are investing in assets in the real economy that can have a positive environmental and social impact.

2 Which infrastructure sectors are most effective in delivering an ESG outcome?

O'Brien: As you know, the infrastructure sector is really a collection of very diverse subsectors with very different ESG profiles. When it comes to supporting ESG goals, infrastructure is particularly well situated to support the environmental component. The biggest change over the past decade has been in the decarbonization of the energy space and electricity sector, which requires new and more efficient infrastructure assets.

The next frontier likely is going to be in the transportation space. If you look at the UK and most European economies, the electricity sector has almost halved emissions over the past decade, whereas the transportation space has basically stayed the same. So, we see a big opportunity in clean transport. But ESG is more than trying to mitigate environmental impact, and we often need to balance the different components.

3 Can you give me an example of the need to balance?

O'Brien: Some transportation assets, such as airports, tend to have a high carbon footprint, but clearly provide important social and economic benefits to a region. It is important when you look at these less environmentally friendly assets to look at ways of improving the ESG profile over time. We also look for subsectors that provide social benefits without a large carbon footprint, such as healthcare assets and fiber networks in rural areas, which help to close the urban/rural divide.

4 How is UBS incorporating the "G" component in its strategy?

O'Brien: In terms of governance, we tend to look for small- to medium-sized companies where we can get a majority position. It is very important to have control when setting the strategy, as well as having access to data that is required to make informed ESG decisions and satisfy regulatory requirements. If we didn't have the majority position, I think we would struggle to get the data needed to meet those requirements.

Bronte Somes: Our latest strategy, which at the moment comprises two renewables, a fiber asset and a data center, is a prime example of how the decarbonization and digitalization trends can become investor opportunities

5 Have ESG considerations become a must-have rather than a nice-to-have?

Somes: ESG has definitely moved from being a nice-to-have, to being an integral part of a transaction and is actually used to drive action and outcomes. In the past, ESG was a little bit of a check-the-box exercise. Now, our due diligence process includes ESG aspects. We have an ESG template that we need to complete and present to our investment committee as part of the pre-acquisition due diligence. Then, in the first hundred days after purchase, we work with an ESG specialist to assess the asset and areas for improvement. We formulate KPIs, which are used to measure ESG performance, and will report on those key metrics to our limited partners (LPs).

O'Brien: We need to track these KPIs properly and ideally try to find ways of linking improvement to remuneration. This all requires investments in additional resources, people and better data reporting systems.

6 How is your business adapting to the evolving ESG landscape?

O'Brien: Integrating ESG aspects in our due diligence has allowed us to focus not only on the opportunities of ESG, but the risks as well. The Task Force on Climate-Related Financial Disclosures (TCFD) provides a practical framework to assess the asset both in terms of the risks and opportunities from transitioning to a low-carbon economy, and we are working with management teams to integrate best practices into business plans going forward.

Somes: We are already building ESG into our business plans. We have refined our investment strategy as we have become more focused on decarbonization and digitalization, and that is reflected in our recently acquired and soon-to-be acquired assets. In fact, we have targeted a portion of our portfolio to be sustainable investments and to achieve a minimum level of the GRESB benchmark. In addition, we have a list of excluded investments, specifically oil, coal and nuclear. This all looks slightly different in the US versus Europe because the US is a little bit behind Europe as it relates to the "E" part of ESG. But, arguably, the US is ahead in the social aspects of ESG. Eventually, the two will align. Europe will pick up more of the "S" and the US will pick up more of the "E" out of necessity, as well as managers and LPs wanting to head in that direction.

O'Brien: This focus on ESG is flowing into the new strategies side of the business, as well. There is support from the organization to look at inventive ways of creating scalable, sustainable strategies. There is a real effort to stay ahead of the trends and come up with innovative solutions that give investors the types of strategies they are demanding.

7 What are LPs demanding in ESG-driven infrastructure investments?

Somes: LPs are expecting managers to thoroughly consider the ESG aspects of an asset during acquisition, to remedy any issues post acquisition of these assets, or to pass on an asset where an ESG issue can't be addressed. LPs are also expecting their managers to report on ESG metrics and to satisfy the ESG reporting frameworks, hence the increase in human capital resources and other tools that managers need to fulfill these requirements for LPs.

O'Brien: The level of data requested from LPs and consultants has increased exponentially, and that is something we are taking into consideration when designing what metrics we are starting to track. Doing this on a bespoke basis is extremely inefficient, so we have invested in people and a data system that allow us to track these key metrics across every asset from due diligence through to exit, which we think is going to be extremely beneficial in the long-term.

8 How are the different regions emphasizing ESG differently?

O'Brien: As Bronte noted earlier, Europe is a bit ahead on the environmental side, while the US has focused more on the social and governance issues. In Europe, the risk of owning less-environmentally friendly assets is rapidly growing. For example, the price of carbon has almost doubled in Europe in the past 12 months, so owning assets with a large carbon footprint will become increasingly expensive. You are also seeing rapid energy transition, with more and more governments signing up to net-zero targets. On top of that, you have regulation, such as the EU Sustainable Finance Disclosure Regulation (SFDR). While it remains unclear whether enforcement is going to be a carrot or a stick, it is clear that the European Commission didn't go to the trouble to design all of this regulation to then have it ignored. There are also societal elements, where Europeans are more anti-hydrocarbon than Americans. With all of that working together in Europe, it leaves the US quite a long way behind.

But things are moving in the right direction. If you look at carbon pricing, for example, certain US States do have a carbon-pricing market. These prices are still probably too low to make a meaningful difference, but they have been increasing, and even the National Institute of Petroleum says they would potentially support carbon pricing. However, given how cheap gas is at the moment, it is very difficult politically to sign up for anything like the same sort of commitments that Europe is able to make. I think Europe has got a lot to learn from the US in terms of some of the social metrics, but clearly in terms of the environmental side of things, Europe is quite far ahead. And if they manage to implement a carbon border, the EU will only provide further impetus to the ambitious decarbonization plans.

[1] Source: Preqin; UBS ISS Market Intelligence (SI); May 2021
* Real assets capital raised based on Real Estate, Infrastructure and Private Debt

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