



# ESG Investing In Private Capital Markets, Real Estate, Infrastructure, Fixed Income and Differentiation From Equity

ESG & Sustainability Transformation

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12/2023

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## ESG Investing In Private Capital Markets, Real Estate, Infrastructure, Fixed Income and Differentiation from Equity

ESG investing in real assets (including land, agricultural land, timber, infrastructure, intellectual property, commodities and private real estate) has certain advantages and challenges compared to investing in equity and corporate fixed-income investments. In many cases, the investor is a majority or full owner of the asset. The fact of majority or full ownership gives investors much greater control to define, apply and report ESG data in parallel with or in addition to existing reporting standards such as GRI or the Global Real Estate Sustainability Standard 2009 (GRESB). The materiality frameworks used may have philosophical similarities – such as in the material ESG factors – but the definition of those factors may differ.

The full GRESB Standard Report provides the following information:

- Aggregate sector information,
- Overall performance of the portfolio's key performance indicators (KPIs),
- Aggregate environmental data on utilization and performance,
- A GRESB score assessing governance, policies and disclosure; risks and opportunities; and the Environmental Monitoring and Management System (EMS),
- Environmental impact reduction targets, and
- Data validation and assurance

This type of reporting is highly dependent on the companies that participate in the GRESB reporting review process.

Historically, commercial and residential real estate have been perceived as less concerned with ESG factors (especially before 2009, before GRESB). Typically, tenants and operators may think differently from owners and builders (sometimes referred to as the "split incentive problem") because tenants are required to pay regular energy bills, while builders are not.

Buildings also have carbon emissions. An ESG integration perspective could consider reducing the carbon footprint of buildings by using more energy efficient standards and materials, thereby reducing the risk of being affected by carbon pricing or reaping the benefits of energy efficiency.

Like the unlisted credit and real asset markets, integrating ESG into private equity faces a number of challenges, primarily a lack of transparency, established reporting standards, regulatory oversight, and market expectations around ESG. Existing initiatives are addressing these challenges, such as the PRI's infrastructure reporting framework.

In addition, smaller private companies are often challenged by ESG reporting requirements in terms of capacity. Private equity investors may have to negotiate asymmetrically with a strong founder or founding team of the company.

However, early stage investors and key shareholders may have a strategic and long-term orientation, creating a strong incentive to establish a strong set of ESG KPIs early in the life



of the company or by establishing important cultural values. Some investors will undertake materiality analysis in the same way that listed equity investors might; a similar SASB framework could be used or developed through private equity industry initiatives, such as the British Venture Capital Association (BVCA) Responsible Investment Framework.

Two notable examples in recent years are the role of governance (G) analysis in the Uber IPO and valuation and the failed WeWork IPO.

These examples show how ESG can add or subtract value.

Asset owners can also evaluate private equity investment managers on ESG criteria, especially if they may be co-investors in an asset. A typical evaluation might include an assessment of policies, people, processes, transparency, and collaboration.

### **Fixed Income ESG Investing and How It Differs from Equity:**

Historically, corporate bond investors have adapted the materiality and sustainability frameworks and ESG techniques used by equity investors to meet their own needs. More recently, they have increasingly used new techniques that focus specifically on bonds because bonds differ in the following ways:

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

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

Fixed income investors in corporate bonds can use the same materiality principles and ESG frameworks as equity investors but adjust them as materiality differs between equity and bonds. Bond investors may find ESG factors that affect balance sheet strength (and therefore default risk) more important than equity investors, who may be more concerned about future growth opportunities.

The opportunity side of ESG may be less relevant for bond investors because what is often of most interest to bond investors in their analysis is the impact of ESG factors on a company's ability to service its debt obligations. For example, an equity investor may view the purchase of green technology more favorably than a bond investor because the equity investor is optimistic about the future value of the technology, while the bond investor may be concerned about the amount of debt required to finance the purchase. ESG scores (whether assessed by a third party or internally at the investment institution) accompany or are incorporated into investment decisions and internal credit analysis.

Sovereign debt investors have begun to analyze ESG, but borrowing the same materiality frameworks as equity or corporate debt investors is not straightforward because some



country-level factors (e.g., peace, corruption, ease of doing business, freedom of expression, education levels, rule of law, and regulation) may not be important to equity or corporate bond investors. Furthermore, a material factor (e.g., climate or carbon policy) will interact differently with analysis and valuation. As a result, translating ESG analysis into meaningful assessments of credit ratings or credit spreads for sovereign debt is difficult. That said, investors often incorporate certain ESG factors (e.g., political risk and governance factors) into sovereign debt, even when not explicitly labeled as ESG.

ESG analysis of municipal debt can also vary across municipalities. Within the municipal space (region, province, state, or city), the issuer's governance and operations should be assessed, as well as:

- Overall transparency,
- Reporting,
- Corruption levels,
- Budget practices,
- Pension liability, and
- Contracts.

Some investors will view a city's financing of inclusive communities as a lower-risk investment because of its social benefits. Alternatively, there may be a parallel benefit, where market returns are expected to coincide with social impact. This is different from social impact, which is not always expected to generate returns at market (risk-adjusted) rates. Environmental factors (e.g., the air quality of the area and health risks associated with its components) and the quality of public infrastructure (e.g., wastewater treatment plants) can both pose risks that affect the issuer's ability to repay the debt.

Overall, while there are philosophical similarities in identifying material ESG factors and then applying them to analysis, the type of factors used can vary across asset classes, as can the type of techniques incorporated into investment analysis.

To learn more about ESG and sustainability-related models, please contact [YTT Consulting](#)!

