KEYNOTE INTERVIEW

How ESG creates value

Private markets managers now recognize that ESG integration is a vital ingredient for remaining relevant in the market, says MUFG's product development director for funds, ESG and digital assets, Jack Lee

Q What changes have you seen in how private markets engage with ESG?

ESG investment has been a must-have in traditional asset classes for some time. A similar move is now underway in private markets. Put simply, any manager not offering ESG investment is going to really struggle to remain relevant going forward.

Indeed, private markets have made great strides when it comes to ESG and sustainability integration over the past couple of years. This is largely due to a recognition that ESG can actually generate performance. It isn't just a feel-good factor – real value sits behind it.

It was interesting to see that 76 percent of respondents to the *Private Funds Leaders Survey 2022* bought into the idea that a stronger ESG vision and culture can create value within a business. Yes, greater adoption of ESG principles is being driven by pressure from investors and regulatory requirements. But I think the understanding that ESG can be used as a proactive tool to create value is just as important.

Q How is wider stakeholder pressure being felt?

There are a wide range of stakeholders with a role to play. There are investors that want to see their money deployed in sustainable investments. There are employees who want to work for organizations that are, at least in some small way, making a positive difference to society and to the planet. There are regulators ensuring greater transparency around ESG and there are standard setters producing mandatory and voluntary reporting ESG frameworks. All these stakeholders are working coherently to help reorientate capital to sustainability themes.

Q Which asset classes are leading the way?

I would say that infrastructure has been the frontrunner to date. Obviously, big energy and transport projects with heavy government involvement are required to have a strong sustainability focus. But private equity has also become increasingly sophisticated in its approach to ESG.

New acquisitions in the private equity market now consider ESG due diligence part of the pre-investment process. Real estate assets, especially newer ones, have a focus on being sustainable, so there is a huge focus on how real estate assets can report on their sustainability impact.

Q In light of the pandemic, and the Black Lives Matter and #MeToo movements, has focus shifted to a more social dimension?

The environment has been the dominant focus over the past couple of years, not least because of the regular UN Conferences of Parties on climate change, focused on reducing global temperature rises to less than 2C as part of the targets set in the Paris Agreement. From a European perspective, we have the EU Action Plan and the EU Green Deal, which are concentrated mainly on environmental objectives. Having said that, absolutely, we are also seeing greater attention being paid to social issues as well.

In particular, we have seen a marked increase in the number of private markets firms setting up impact funds, many of which have social ambitions. At the same time, the EU is developing a social taxonomy that will require reporters to report on the adverse impact companies may have on society.

There are other voluntary frameworks that focus on social matters, such as the UN Global Compact principles, and many of the UN SDGs are focused on reducing inequality and other social goals. All of this means that asset managers are waking up to the importance of the S in ESG.

Q Have you seen changes in how private markets firms are resourcing ESG?

One of the most striking challenges when it comes to greater ESG adoption is a shortage of individuals with an appropriate level of ESG expertise. There are only so many people that have a degree in sustainability or have trained as a sustainability engineer, and you need that expertise in order to really understand the sustainability impact of your investments.

From an asset management perspective, that has manifested itself in a push toward upskilling and there has been a huge push from industry bodies to support in the upskilling of ESG expertise. Firms are working hard to gain the knowledge they need to analyse their investments through an ESG lens. That sometimes means outsourcing data collection and analysis to third party vendors.

Q What metrics are most commonly tracked?

The environmental metrics are the most widely tracked metrics because they tend to have quantitative information around them. It is relatively easy for portfolio companies to collect data on greenhouse gases, carbon intensity, energy consumption and waste management, for example, and then report those figures up to the asset manager. The same is true of diversity, and board and management team composition.

It is more complicated, however, when it comes to some of the other metrics that are becoming increasingly popular, such as biodiversity, renewable energy or violations against social principles such as those contained within the UN Global Compact principles or the OECD's multinational guidelines.

Another area coming under growing scrutiny is the gender pay gap. Not a lot of organisations are currently reporting those statistics but in Ireland, for example, a bill has been published that requires companies to release this information. A lot more guidance is starting to emerge within individual jurisdictions around these non-environmental issues. In addition, mandatory sustainability reporting requirements such as the Corporate Sustainability Reporting Directive in Europe and the SEC guidelines on climate and sustainability disclosure in the US will enhance the disclosure of other metrics going forward.

Q Is it possible to show a correlation between ESG and performance?

I think it depends on where you are in the world. It is probably easier to demonstrate a positive correlation between ESG and performance in Europe, simply because the demand for ESG products is so great. That has naturally led to a greater amount of reporting and tracking of metrics.

At the same time, a lot of asset managers are now using ESG metrics to perform financial scenario analysis; for example, to understand the impact of extreme weather events for assets that are particularly exposed to climate change risk. In some models, clients are also effectively pricing in a carbon tax. Coming off the back of the UN's COP26, a lot of jurisdictions have committed to reducing their carbon footprint, and in all likelihood that will involve some form of taxation on emissions.

If you are operating in a carbon-intensive industry, that is clearly going to impact profitability. For assets not as impacted by climate risk and that have sustainable practices, these assets will increase in value and there will be more capital flows orientated towards these assets, which will ultimately create value.

Q How challenging is ESG data collection?

While data standards in public markets have improved drastically, private markets' ESG data varies widely and is often unavailable. Asset owners and managers alike agree that this lack of ESG data standards makes it difficult to compare potential investments and to assess their sustainability credentials.

For private markets, ESG data is not public or available for some of the assets early in the life cycle and therefore these may not have mature ESG reporting frameworks in place. Some asset managers with a majority stake in a company may be able to engage directly with management to access ESG data and drive sustainability but data gathering is still very manual in most cases. ■