EXPERT COMMENTARY

Arcus' head of ESG and asset management, Neil Krawitz, discusses the importance of making all infrastructure investments sustainable, not just the usual suspects

Going beyond impact and renewables

Sustainable investing is here to stay. By no means a new phenomenon, investors have focused on environmental, social and governance factors in some way for decades. However, in the last 24 months, we have observed a marked shift in the infrastructure market and investor attitudes from an ESG perspective.

At a macro level, ESG has moved from being considered a hygiene factor to a key differentiator in attracting capital and defining investment strategy – and this is not just impact or renewables, it is across all infrastructure spaces. For many of our investors the focus on ESG factors is no longer perceived as a cost drag in their investment selection, they view it as a value generator and an important driver of returns.

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During 2019 and 2020, more and more insightful ESG questions, from the impact of climate change, to covid-19 resilience, to equal opportunities and diversity have been raised by the public, regulators, politicians, investors and employees who all want to know if, through infrastructure investment actions, we can drive and support a sustainable future. Infrastructure plays an important role as a critical asset class, serving communities, cities and countries, in delivering Europe's future economic growth, environmental protection, societal development and ultimate reduction of inequalities.

We are also at the forefront of challenges regarding the 'social licence' that is inherent for many infrastructure operations. Today, all owners and potential acquirers of assets must think about their commitment to sustainability and consider all stakeholder impacts and interests, rather than just those that relate to the shareholder.

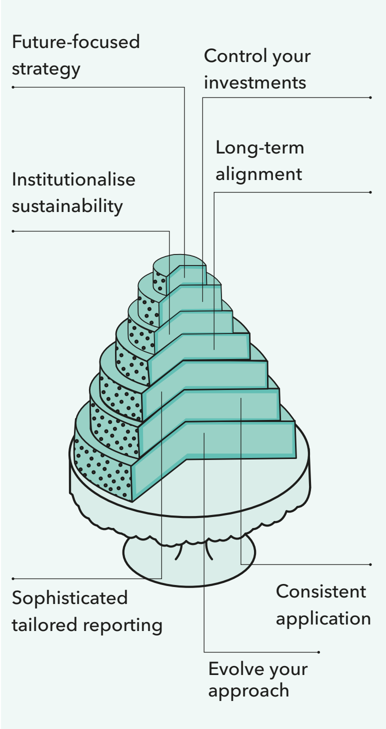
Since our inception in 2009, Arcus has believed that doing the 'right thing' as a responsible shareholder will help to ensure that we and our investee companies remain environmentally sound, safe places to work, positively contribute to the fabric of our local communities and are well-respected organisations. We believe that in the long term, this will also deliver more sustainable returns to investors.

We have spoken before at length about how events in 2020 have taught us to not rely on the status quo when investing. As my colleague Simon Gray previously told *Infrastructure Investor*: "All of us involved in this business should rightly question how best to undertake this in the present rapidly changing world."

And it is clearly not just the infrastructure universe that is concerned. A Vice Media Group article in June 2020 – 'Our infrastructure is being built for a climate that's already gone' – examined how past models of historical information can no longer accurately predict what infrastructure we will need in the future. It is clearer now more than ever that an investment strategy needs to be focused on owning, building and managing the infrastructure of the future, not the past.

Our investment strategy incorporates a deep understanding of the European infrastructure landscape and our assessment of the broader thematic trends affecting key infrastructure sectors in the forthcoming years. Our strategic approach is driven by a thorough analysis of the long-term trends affecting our core European markets to focus our efforts on the infrastructure of the future:

- Decarbonisation driving change in transportation and energy generation, storage and flexible management;
- changing demographics impacting production, consumption, logistics and transportation;
- data explosion with the desire for ubiquitous connectivity driving disruption, efficiency and disintermediation.



"An ESG policy built on exclusions is a thing of the past"

So, what does this all mean for asset allocation and how does a capital allocator build a portfolio of investments that are sustainable and future proof?

We would argue that 'impact investments' or specialised renewable energy funds are no longer enough to meet an ESG quota and that an ESG policy built on exclusions is a thing of the past. Instead, the real value comes from ensuring that each investment fulfils these sustainability criteria and, through thematic investing, it is possible to deliver the assets of the future.

A new focus

It is clear that we aren't alone in the view that ESG tokenism is no longer enough. During 2019 and early 2020, Arcus undertook its final closings of its latest European Fund, AEIF2. Investors representing around 65 percent of capital raised for AEIF2 have clear and prioritised ESG drivers in their allocation decision and manager selection. This was evident from extensive ESG due diligence undertaken, formal ESG obligations within LP side letters and increased ESG reporting requirements.

This investor focus has not been an issue for us due to our long-standing focus on, and performance in, ESG management throughout the investment lifecycle of our portfolio companies. However, our assessment following this process is that allocation of capital has changed, with ESG now being an important decision factor for many investors.

Today, investors are allocating capital with the same target return threshold requirements that we see more generally in the infrastructure market, but at the same time they are specifically looking for managers to have advanced ESG focus and an investment strategy and track record which matches their vision of a sustainable future. So, it is no longer just specialised pools of capital that are seeking 'impact investing' with acceptance of sub-benchmark return thresholds or asset classes that are easily categorised as sustainable, such as renewable energy funds. Rather, it is a recognition that mainstream global allocators are seeking high-performing ESG managers who can deliver a sustainable approach while also achieving benchmark return expectations.

For the first time, as part of raising AEIF2, we were sought out, on a reverse enquiry basis, by several investors seeking managers who have a strong approach, performance and good track record in ESG management. These were sourced through word of mouth reputation and through ESG ratings provided by independent bodies like UNPRI and GRESB.

So, what is the recipe for how you make all your infrastructure investments sustainable?

We think that the key ingredients for making all investments sustainable are:

- **Investment strategy that focuses on enabling societal infrastructure requirements of the future** – build the future, don't try defending the past
- **Controlling ownership of the investment: if you want change, you have to be able to direct management team activity** – 10 percent, 20 percent, 30 percent ownership interests don't give you the mandate to put sustainability at the top of the agenda
- **Institutionalise sustainability factors across your team (both origination and asset management)** – all team members must talk the talk and walk the walk; this is strategy, not compliance
- **Align investment decisions with responsibility for delivering long term sustainable objectives** – the investment team in origination completes ESG deep diligence and clear sustainability asset management strategy pre-deal, not as an afterthought, and will be held accountable for and be incentivised to deliver those objectives, just like they are for financial targets
- **Consistent and structured institutional approach, tools and forums** – best practice sharing, collaboration, pan-portfolio auditing of specific issues, repeated frequently will generate value in a repeatable manner
- **Using consistent and detailed ESG reporting which caters for the issues material to the variety of infrastructure sub-sectors** – we favour GRESB, it's standardised to ensure consistency but applies materiality to sub-sectors to ensure relevance, which allows setting targets and monitoring material issues but more importantly, it is a tool for engaging with investee company management teams and investors
- **Be part, and at the forefront, of the evolution and look to the future and change** – yesterday's or today's issues aren't good enough, you must be constantly improving. For example, implementing Task Force on Climate-related Financial Disclosures ahead of the curve, developing meaningful Sustainable Development Goal reporting.

"Mainstream global allocators are seeking high-performing ESG managers who can deliver a sustainable approach"

We have seen sustainability focused investors not only being attracted to our 'best in class' ESG asset management but also by our investment strategy focus on long term sustainable macro themes and trends driving the European infrastructure of the future. Such investors see us as a manager willing to invest to build infrastructure and to facilitate the investment needed to transition from carbon intensive to a low carbon or no carbon infrastructure world.

Investors see us as a manager willing to consider smart city projects that assist communities in managing ageing populations, and also a manager willing to build the data infrastructure for the future. Our clear focus on building and managing infrastructure of the future, rather than investing in the assets of the past, is a theme that continues to resonate with our investors.

We look forward to continuing our ESG journey. ■