

Thinking beyond exclusion:

ESG risk screening and opportunity assessment during the various stages of the investment process

Arcus Infrastructure Partners, a European Mid-Market Infrastructure Manager, asks the right questions about ESG and climate risk from the very beginning.

There has been a substantial increase in the evaluation of ESG factors in infrastructure decision making processes over the last few years, however it often lacks a systematic approach and can regularly overlook any consideration of ESG as a value creation lever. We believe that as an industry, comprehensive ESG integration into the investment selection process needs to move beyond being viewed as just a risk management issue, but rather, should be looked at as an issue which has significant value enhancement potential.

We know from experience that best in class ESG principles and practices can become a source of competitive advantage, reducing disruption, vulnerability to risk and bringing about significant increases in efficiency to create long-term sustainable value. Arguably, the infrastructure sector has some of the greatest exposures to ESG factors such as climate change, cyber-security, workforce health and safety, to name just a few, as it generally exists at the centre of the communities of which it is designed to support. As regulation around the application of ESG factors to industries like infrastructure has also increased, the consequences of failing to meet high levels of ESG standards have become more transparent, with recent reports concluding that financial performance of listed companies with stronger ESG credentials have tended to outperform their peers^{1,2}. For private markets infrastructure investors like Arcus, one of our primary goals is to increase the multiples at which we end up selling our underlying companies and demonstrating strong, “year-on-year” improvements in ESG performance metrics certainly helps influence these exit values in a positive way.

As a “long-term” investor, we take a “long-term” view, typically owning our businesses anywhere from 7-10 years. As a result, we always make long-term assessments of how “future-proof” or “sustainable” the company, and the market in which it is operating in, is when considering an investment. ESG factors can have a profound impact on the “sustainability” or “resilience” of a business’s operating model and ultimately financial performance, and therefore not including a thorough analysis of ESG factors early in the investment process may lead to an incomplete assessment, wasted efforts in diligence or worse, poor investment decisions.

In the intensive and short time periods often encountered as a transaction progresses, it can be challenging to make sure that both ESG risks and opportunities are identified and valued correctly. A recent ERM survey³ of leading private equity managers seems to support this claim with 77% of firms conducting it simply to comply with firm policy, rather than to fundamentally understand and properly incorporate these factors into any future business plan. Although, it is encouraging that such a large number of managers consider ESG in pre-investment decision making, the study’s authors

point out that the survey highlights a focus on risk management and firm policy in the industry, rather than opportunity identification. Arcus has found that with the development of robust internal processes, strong awareness and training across the team, ESG opportunities as well as risks are properly assessed, which we strongly believe adds value to the companies that we acquire over our investment ownership cycle.

Throughout the Arcus origination process, ESG is factored into each review step to ensure that potential ESG related risks and opportunities are considered and presented to the Investment Committee accordingly. Sometimes, a potential acquisition may be discarded, purely based on material ESG risks being present that would be difficult to mitigate.

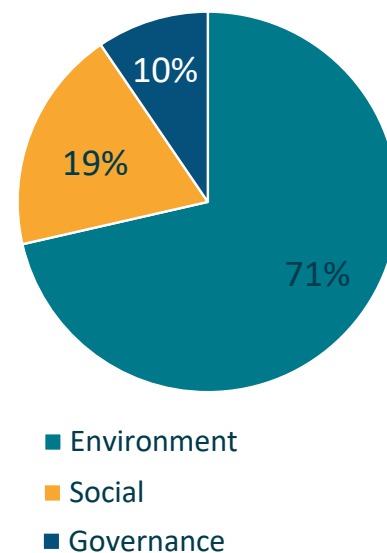
During 2020, Arcus excluded 13% (c.20 potential investments) of all screened investment opportunities, solely on grounds of ESG concerns (see below chart). Some of the more specific examples of the reasons that Arcus excluded these transactions were, in relation to the “E”, due to the presence of hydrocarbons, such as oil & gas storage or assets which posed an immediate environmental risk or would ultimately become “stranded assets” as the world focuses on decarbonisation and moving to net zero. In relation to the “G”, minority shareholding positions without controlling governance rights which posed a lack of control risk or mismatch to the investment thesis or where the profile of the existing shareholders, management teams, customers or country involved created governance concerns which posed a potential reputational risk. Lastly, in terms of the “S”, which is arguably a more subjective test, due to a history of poor safety management either by virtue of sector dynamics or business culture that cannot be reversed, human rights violations or hazards to human health such as tobacco products.

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As Arcus’ current Fund’s strategy is to invest in the “infrastructure of the future”, potential acquisitions, fundamentally, need to have good ESG value creation drivers, as “this is the future”. For example, the transition to a low carbon environment provides a fantastic opportunity not a risk, with energy transition assets and transportation assets, two of the industries that need to transform the most, offering a huge array of potential investment opportunities.

In our current Fund (“AEIF2”), we have recently acquired two energy efficiency businesses, which are fundamental to the energy transition: Smart Meter Assets and Horizon Energy Infrastructure. Similarly, we have acquired a transport ISO tank container storage business, Peacock Containers, which has been supporting the transportation of chemicals used in disinfectants and hand sanitisers (as well

Of the 13% of total transactions discarded for ESG reasons, the categories were as follows:



as other chemicals supporting the healthcare and pharmaceuticals industry), which has been extremely important during the Covid-19 pandemic.

We also have two investments in fibre to the home (“FTTH”) businesses, one in Switzerland (“Swiss4net”) and one in the Netherlands (“E-Fiber”), both working hard to build new fibre networks and provide fast internet access to local communities, again, seen as an increasingly essential utility during, and beyond, the pandemic. As you can see, there is a wealth of “positive” ESG potential in each of these investments that we pre-identified at the start of our acquisition process and continue to develop as we move through the lifecycle of these investments. With fast-evolving legislation around environmental matters, global initiatives encouraging increased consideration of further social and governance matters, an emphasis on good stewardship and events such as the COVID-19 pandemic, Arcus continues to refine and differentiate its due diligence process to ensure that we are encompassing all these relevant matters into our decision making, as we strongly believe that it will lead to better investment performance.

Shirene Madani, Senior Investment Executive and Arcus ESG Committee member. Shirene co-ordinates Arcus ESG due diligence processes.

FOOTNOTES:

- 1 IIF Green Weekly Insight, “ESG Funds Deliver”, June 2020, Q2 2020 data as of June 18, 2020
- 2 George Serafeim, Financial Analysts Journal, “Public Sentiment and the Price of Corporate Sustainability”, March 2020
- 3 ERM “Eyes on the prize: Unlocking the ESG premium in private markets”, October 2020