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Secure income assets: lifting the lid on ESG integration

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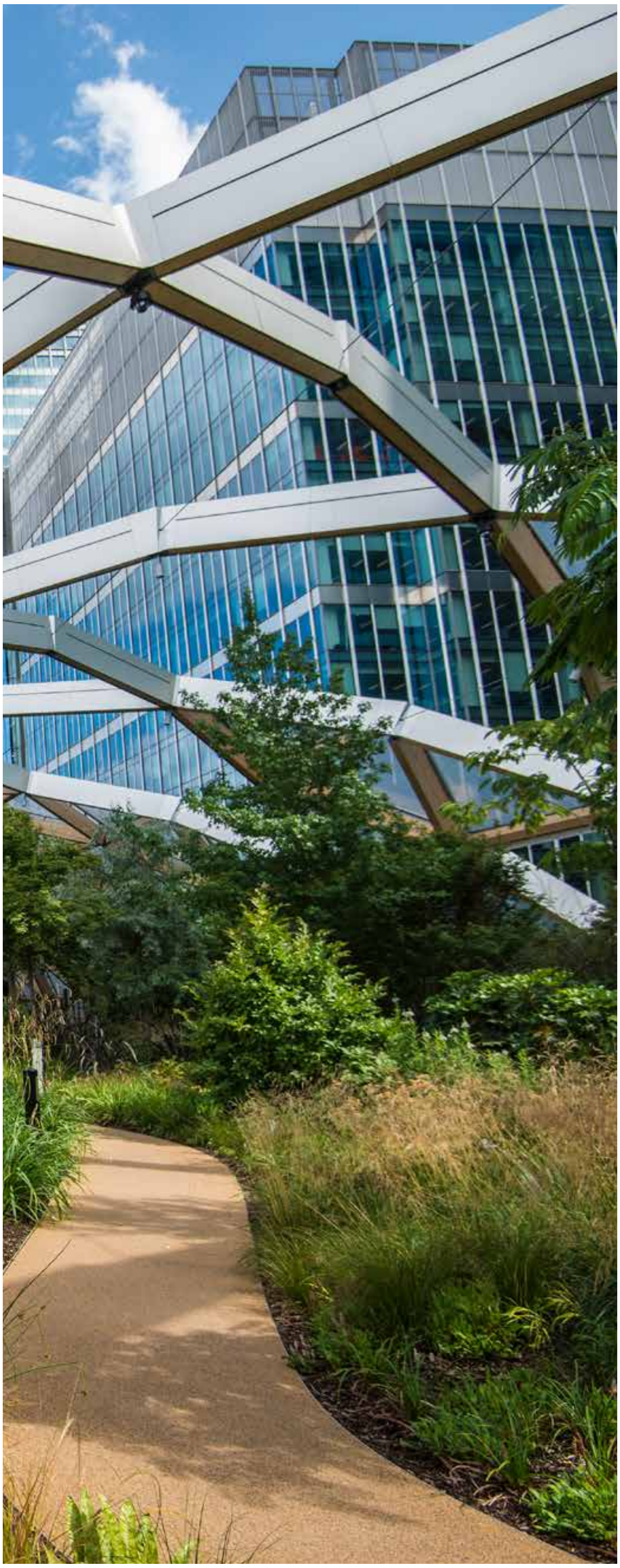
As demand for investments in the private market continues to grow, there is an ever-increasing interest in considering environmental, social and governance (ESG) factors to promote greater transparency, for better risk management and to aim to deliver long-term value.

Integration of the principles of responsible investing in public equity and credit portfolios is increasingly improving – despite the myriad ways of doing so – as ESG data become more standardised and transparent. Private assets, however, could appear by definition to present challenges to responsible investors, due to the different nature of that market.

This question is of growing importance as allocations increase, amid the continued hunt for yield, and in the face of growing regulatory pressure. At the same time, ever greater numbers of asset owners seek to deliver positive change through generating sustainable returns.

In this paper, the latest in a series on responsible investing, we look at how long-term investors can incorporate ESG analysis to optimise portfolio risk within secure income assets – infrastructure debt, private corporate debt and real estate debt. We also offer real-world examples and consider future developments in this exciting and under-explored area.



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INVESTMENT MANAGEMENT

Private credit and equity versus public markets: key differences

Through their voting rights, equity investors can influence company policy, operations and decisions. As owners, they have a degree of influence over the day-to-day management of their assets.

Indeed, in our Real Assets business, our UK real estate equity portfolio has become a market leader by placing sustainability and ESG as a core part of our asset and investment management process. We have achieved this through setting ambitious environmental, climate and social targets to improve the operational efficiency of our assets and promoting the social value of the communities where our assets are based.

But for secure income assets, also known as private credit, investors' influence is limited by virtue of being a creditor (lender) rather than a shareholder (or owner). These debt investments tend to have a long time horizon – often of ten years or more – while their more illiquid nature means that exiting them before the intended time horizon can be difficult.

As a result, we believe it is just as crucial for secure income investors to assess a company or project's ESG credentials as part of their investment process to ensure that they are comfortable with such long-term exposures.

ESG integration in practice

Long-term investors, in our view, have a responsibility to protect client capital through integrating ESG considerations into investment processes. We believe this leads to better risk management and will drive the long-term value over the next several decades.

For example, investors can minimise long-term risks by avoiding borrowers who do not maintain their social licence to operate, or avoiding energy assets which may become obsolete in a decarbonising world.

Within LGIM Real Assets, we seek to ensure the E, S and G are fully considered as part of the wider decision-making process with regard to all investments in private credit. We do this by taking both a top-down and bottom-up approach to assessing ESG risks, which enables us to mitigate downside risks on financial performance.

We conduct research to analyse long-term ESG trends and their implications for the markets in which we operate; the findings inform our views on sector allocation and asset selection. Meanwhile, we also conduct ESG assessments of individual assets, analysing performance against key metrics to flag and address potential risks – and highlight opportunities - by identifying the issues that are, in our view, the most material to our assets across the investment lifecycle.

This approach is reflected in five key steps:

1 Origination and pre-assessment:

Conduct an initial screening process to ensure we do not do business with borrowers on our exclusion lists

2 Due diligence and scoring:

Identify sector-specific risks and material ESG factors in detail

3 Structuring and engagement:

Highlight potential inclusion of ESG-related covenants and monitoring criteria in the Investment Memorandum

4 Investment committee:

Review the mandatory ESG assessment and input from the ESG Team

5 Asset management:

Monitor, conduct reviews and report on ESG factors

The value of an investment and any income taken from it is not guaranteed and can go down as well as up; you may not get back the amount you originally invested.

Two case studies

Accepted: a private placement in a sustainability-linked loan for a renewable energy operator

The borrower is a state-owned company and one of the largest electricity generators in Iceland. The company has committed to becoming carbon neutral by 2025 and is targeting becoming carbon negative by 2030. We provided a loan earlier this year where the coupon is linked to meeting certain CO2 sequestration targets. The borrower achieves carbon sequestration targets to offset its carbon emissions by afforestation (planting trees), re-vegetation and wetland restoration.

Declined: airline financing

This transaction, which we declined on ESG grounds in the first half of this year, was based on the financing of mid-life aircraft (with an average age of 12.3 years) which are less fuel efficient than newer models. The use of proceeds from the transaction was intended to allow the company to buy out aircraft, thereby reducing financing costs and moving away from a business model whereby it primarily leased to an ownership fleet. However, there was no intention to improve and modernise the airline's fleet. In our view, the airline's market positioning as a mid-life carrier reflected a lack of ESG integration within the company's strategy.

Looking ahead, we believe there are plenty of reasons to be excited about opportunities for investments with strong ESG profiles in private credit and to have real world impact.

Renewable energy

As renewable energy becomes a greater proportion of our energy mix, it continues to attract support from the government and from private investors. With increasingly ambitious climate change targets, the number and scale of projects has been increasing.

We have lent to three of the world's largest offshore wind farms that together produce enough energy to power more than two million UK households, and we have funded a collection of solar projects.[1] We expect wind and solar projects to remain an important part of our pipeline. Looking further ahead, as our energy system continues to decarbonise, we expect more opportunities to invest in next-generation clean infrastructure such as hydrogen networks and heat pumps.

Social – affordable housing

The UK continues to suffer from a shortage of affordable housing, with 1.3 million households on local authority waiting lists. Private capital will be a key role in ensuring this gap is closed. For example, we recently made a £100m long-term loan to Bromford Housing Group, the largest provider of affordable homes across Central and South West England.

As a strategic partner of Homes England, Bromford has a key part to play in providing social and affordable housing; this partnership should be able to deliver 12,000 new affordable homes by 2028. These homes will serve the communities in which Bromford operates, as well as delivering both real economic growth and social value for the UK.

Smart/low-carbon grids

In addition to more visible clean-energy projects, such as wind turbines and solar panels, we are also looking for opportunities in interconnectors and Offshore Transmission Owners (OFTOs). These are key parts of the system for transmitting the energy back to homes and businesses, and to different countries. Renewable energy output is less predictable than fossil fuels, and interconnectors enable countries to import power to maintain a constant supply and create the greenest, most cost-efficient energy mix possible.

We see this area as a potential opportunity, as these projects tend to be large in scale and international in reach, requiring financing from a broad base of banks and institutional investors. What's more, the assets are a crucial element in bringing low-carbon energy to life; the technology is already established, the need to integrate new energy projects is growing and the infrastructure will be in place for many years to come.

1. Source: LGIM Real Assets, 2020. Please note, these assets are examples of investments that our real assets teams made, and may not be held by LGIM in the future.

What does the future hold in store?

The quantity and quality of ESG data available to investors in public markets has multiplied over recent years. In the private credit space, that journey is just beginning. Due to the diverse nature of the asset class, there is currently no market standard for ESG management and disclosure.

We are championing several initiatives, working with industry bodies and borrowers to improve the comparability of datasets and consistency of reporting. For example, in the UK, 1.6 million households, accounting for 3.8 million people, are in need of social housing, which is 500,000 more than recorded on official waiting lists, according to the National Housing Federation. To promote greater disclosure and more transparent ESG standards in the UK social housing sector, we have been involved in the development of an industry-wide framework. This new Sustainability Reporting Standard for the social housing sector was launched at the beginning of November 2020. The standard covers 12 ESG themes and 48 quantitative and qualitative metrics, including affordability and security, building safety, climate change and governance. We believe this voluntary standard will help to unlock more sustainable investor capital to deliver more affordable and sustainable homes for our communities.

We are also committed to a number of recognised reporting frameworks and guidelines, including the UN Principles for Responsible Investment, the Task Force on Climate Related Financial Disclosure, the Paris Agreement on Climate Change and the Social Value Portal.

In addition, we anticipate greater focus across the industry on the economic and societal implications of climate change. At LGIM Real Assets, we have set an ambitious commitment to achieve a net-zero carbon target in our real estate equity portfolio by 2050.

Sustainable outcomes

By supporting transparency, data availability and disclosures, we aim to improve ESG standards across the private credit market. This should facilitate further qualitative and quantitative ESG analysis of the asset class, leading to better and more sustainable outcomes for investors, in our view.

More broadly, as the world faces multiple crises – from the pandemic to climate change – we believe that now more than ever before is the time for responsible investing, regardless of asset class.

Still, we have shown that rather than being an obstacle, the private nature of secure income assets in fact means that many are naturally aligned with ESG objectives by virtue of their purpose and function, from clean energy to social housing.

Contact us

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Key risks

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