KEYNOTE INTERVIEW

A strong ESG framework is essential in infrastructure

ESG best practice mitigates risk and enhances returns, says Whitehelm Capital chief executive Graham Matthews. What's more, investors are becoming increasingly sophisticated at spotting the real thing

Q Why is environmental, social and governance best practice so important for infrastructure investors, in particular?

In some asset classes, I can accept the argument that there may be a trade-off between getting ESG right and maximising returns. But that is definitely not the case for infrastructure.

If you think about what it is that we're actually investing in, these are long-term assets that have a real impact on the local environment and on local communities. That means if you don't get ESG right, it is going to hit you in the cashflows. It's not like you are buying a business that is all about brand or short-term dynamics. These are long-lived assets and that means ESG is critical.

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We made our first investment in infrastructure with the Eastern Distributor toll road in Sydney in 1998. Even then we were looking at these long-term factors. We weren't calling it ESG, because ESG hadn't been invented yet. But we were focused on factors that affect the long-term sustainability of the asset. We are far more sophisticated in terms of how we approach these issues now, but it is something that has been important to us right from the very start.

180

ESG factors in Whitehelm Capital's proprietary implementation framework

Q What are the risks associated with not getting ESG right?

At the most basic level, if you don't take ESG factors into account, you might end up investing in something that can no longer be used. When the world changes and that business model is no longer viable, there is a real risk of ending up with stranded assets. A good example would be an oil pipeline. In other energy sectors, the energy transition can forge pathways for fossil fuel-based assets to be converted into low-carbon assets over time. But an oil pipeline is always going to be an oil pipeline. It can't be anything else and so it has a finite life. When oil stops being used at some point in the future, that asset's worth is going to be zero.

There are other risks as well. There are regulatory risks, of course. All the assets we invest in operate within some sort of regulatory environment. It doesn't necessarily have to be an asset that's subject to direct economic regulation, but every asset is affected by regulation to a greater or lesser extent. Those regulations naturally encompass ESG factors; so if you are not taking those into account, you risk falling foul of regulatory changes.

Then there's financial risk. There's risk around the availability of debt and the availability of insurance. And there is risk around operating and capital costs. A good example of taking that risk into account would be what we did with Kvitebjørn Varme, a district heating waste-to-energy asset in Tromsø, the largest Norwegian city inside the Arctic circle. It's obviously a very cold place, which is a good fundamental for district heating. But we also know that the world is warming. As temperatures increase, we can expect demand for heat energy to fall. Therefore, we engaged an environmental expert to provide us with advice on future heating requirements and their impact on operational and capital costs, and factored that into our analysis of the investment.

There is also a fundamental risk around the social licence to operate. If you are not in tune with ESG factors, and if you don't take them into account on a day-to-day basis as part of your asset management, ultimately you risk losing that licence to operate, with all the associated financial implications.

Box ticking: no longer enough as an ESG assessment approach

Q How do you expect infrastructure's ESG journey to evolve?
I think it definitely will continue to evolve. I don't think we have reached the peak. This is not just the flavour of the month. ESG will increasingly be seen by both GPs and LPs as an integral part of the investment toolkit and an essential requirement for anyone positioning themselves as a successful manager.

I also certainly think that ESG assessment will continue to move away from a tick-the-box compliance approach, to an approach that is focused on outcomes. We call that 'moving beyond the bullshit'. You have to be able to demonstrate how ESG affects your investment decisions, how it is taken into account in your asset management and, importantly, how you measure results.

I think we'll see a greater use of benchmarking and scoring systems. I also think we'll see increased calls for transparency, with investors and with the broader world as well. Finally, I think investors will become increasingly sophisticated in their own articulation of what they want from managers, with more stringent requirements built into limited partnership agreements.

Q To what extent has ESG risen up the priority list for investors in infrastructure funds?
Some investors, particularly those from the Nordics and Australia, have been at the forefront of ESG considerations for many years. But it's been interesting to see how quickly other regions are catching up. The US, in particular, where a lot of investors outside the public funds space were not as concerned about ESG until a few years ago, has seen a real transformation.

And it's not just the number of investors thinking about ESG which is having an impact; it is their increased sophistication. It is no longer just a box-ticking exercise. There is rigorous analysis taking place and investors are really focused on assessing ESG outcomes and measuring improvement over time.

Q What does that look like in terms of the due diligence process and how are benchmarking tools supporting investors in their decision making?
Some investors are now using third-party experts to review a GP's ESG approach. We are also seeing investors develop significant internal capabilities. Some have developed their own methodologies and questionnaires. Others are using external ratings agencies such as GRESB. One of

our fund-of-funds investors has a particularly rigorous approach to ESG, even giving an annual ESG award.

Q Do investors buy that good ESG doesn't come at the expense of returns?

I think investors increasingly accept that this is the case. Up until a few years ago, you would still come across some investors, particularly in the US, that would ask about the cost of ESG in terms of returns. But that is changing. Of course, we need to be hard-nosed investors. As a GP, our responsibility to our investors is absolutely to deliver the best investment returns that we can. But with infrastructure, I feel we have moved beyond the idea of a trade-off.

That said, you do need to be careful about how you implement your ESG strategy. You have to approach it with skill and care, and make sure you are focused on outcomes and that you are tailoring your approach to a specific asset. If you do that, I think you can be absolutely confident that getting ESG right is accretive to returns.

Q How do you, as a GP, incorporate ESG principles into your investment and asset management decision-making?

We have an aspirational ESG policy that applies, at a corporate level, to everything that we do. It articulates what it is that we are trying to achieve as a business, both for ourselves and for our investors. We then have a specific code for implementation of that policy across each business segment. For example, in infrastructure that code specifies various things that we must and must not do. It sets out a blacklist of countries and sectors that we won't invest in and a 'white list' of sectors that we have a preference for investing in. It sets out requirements for us at every step of the process from initial discussions with a potential vendor, through analysis, ownership and then eventually disposal.

We then have a proprietary implementation framework involving 180 different ESG factors. It's like a credit rating. We strive to achieve AAA-rated assets but recognise that not every asset can start off that way. The framework is also a measurement tool, therefore, as we look to improve the asset over time. We reassess assets every year and those assessments are communicated through our annual sustainability report.

"At the most basic level, if you don't take ESG factors into account, you might end up investing in something that can no longer be used"

Q As an industry, is the focus still primarily on environmental concerns, or are ESG parameters widening?

When people talk about ESG, the mind naturally goes to the E. The need to focus on carbon emissions and the resilience of assets in the face of climate change is obvious. It is a clear area of endeavour. That said, in our experience, the S and the G are where we spend most of our time. That is not to play down the importance of environmental factors at all, but we find the S and G to be the most challenging components.

To illustrate that, of the 180 factors that we look at across ESG, only 30 are, in fact, environmentally focused. There also tends to be more room for improvement with the S and the G.

The interplay between all three is also very interesting. For example, we turned down a potential investment into an export terminal development in Australia. The proposal was to expand an existing facility, but as part of that expansion, to dredge material from the seabed and dump it in the ocean, adjacent to the Great Barrier Reef.

From an environmental perspective, that wasn't something we were prepared to be involved in, but it was actually from a governance perspective that we turned down the opportunity. The company had achieved all the necessary environmental approvals, but our concern was that if the board was prepared to take, what seemed to us, like quite an obvious risk, then what other risks was it taking? The environmental concerns were the symptom, but the real problem was an underlying governance issue.

Q How is ESG best resourced within a manager?

It depends on the size of the organisation. We have around 70 in our team, split between London and Australia. For us, what works best is to have ESG as a responsibility for everyone but then also have someone as a dedicated lead.

One of our senior investment directors is our head of asset management and our head of ESG, so we have a very senior person tasked with the responsibility of ensuring everyone in the team is factoring ESG into everything we do. It isn't his job to do it all himself. Other firms may choose to have a couple of people in charge of everything ESG-related, but we prefer a more integrated approach. ■