



Investment Insights

# Sustainability in private markets

In recent years, Environmental, Social and Governance (ESG) factors have moved from a tick box exercise to the forefront in the minds of investors, corporations, and financial markets. Sustainable investing is one tool investors can use to mitigate investment risks and access opportunities. Within each asset class, investors can take a myriad of approaches to invest sustainably – private markets can offer certain qualities that warrant further focus.



In this note, we consider the extent that those investors wishing to invest sustainably can do so via the private markets. We consider whether the differing nature of private markets, compared to public, make the application of a sustainable investment approach more or less achievable.

## What is sustainable investing?

Before we start to consider the investment rationale, we need to define what we mean by sustainability.



**Sustainable investing** is intentionally investing in ways that minimise harm on society and/or the environment or contribute towards the long-term sustainability of the global economy and financial markets. In our view, sustainable investing is driven by financial motivations, such as limiting financial risk and/or accessing opportunities for higher returns. Sustainable investing is not limited to climate risk and includes broader ESG considerations.



**Impact investing** is intentionally investing to achieve measurable social and environmental benefits as well as financial returns. Distinct from ethical investing, which disinvests from assets that are inconsistent with the values of the investors, it instead invests in assets that provide both a positive societal benefit and positive financial returns. Distinct from sustainable investing, impact investing will have a positive non-financial objective as well as a financial one.

Sustainable investing and impact investing are two sides of the same coin and the line between the two can sometimes become blurred. Regardless of the underlying motivation, the profit or return on the investment remains a key objective in either approach. For the purpose of the remainder of this note we focus on sustainable investing.

## Why is sustainability important?

World leaders recently gathered in Glasgow for the COP26 conference. 'Mobilising finance' was one of the four key pillars of COP26's agenda, stating that the private sector has a significant role to play in accelerating the transition to a low emission, net zero economy. The opportunity to investors is increasingly clear. The International Energy Agency (IEA) predicts that annual investment into clean energy needs to rise to \$4 trillion by 2030 to achieve net zero emissions by 2050 and limit global warming to 1.5C. This figure compares to \$1.9 trillion that the IEA estimate is the current level of entire investment in the global energy sector.

- The breadth of investment required for the transition to a green economy is huge, covering decarbonising energy generation, electrification of energy usage, energy storage, and improvements in efficiency of consumption. This is an important point that we revisit later in the note.

Changes in government policies and public perception, along with technological advances, are already affecting investors and businesses, resulting in both risks and opportunities. We expect this to continue and, given the scale of climate risk, it is highly likely that governments around the world will be forced into more action. Managing a portfolio's exposure to this risk will be essential to achieving good investment outcomes.



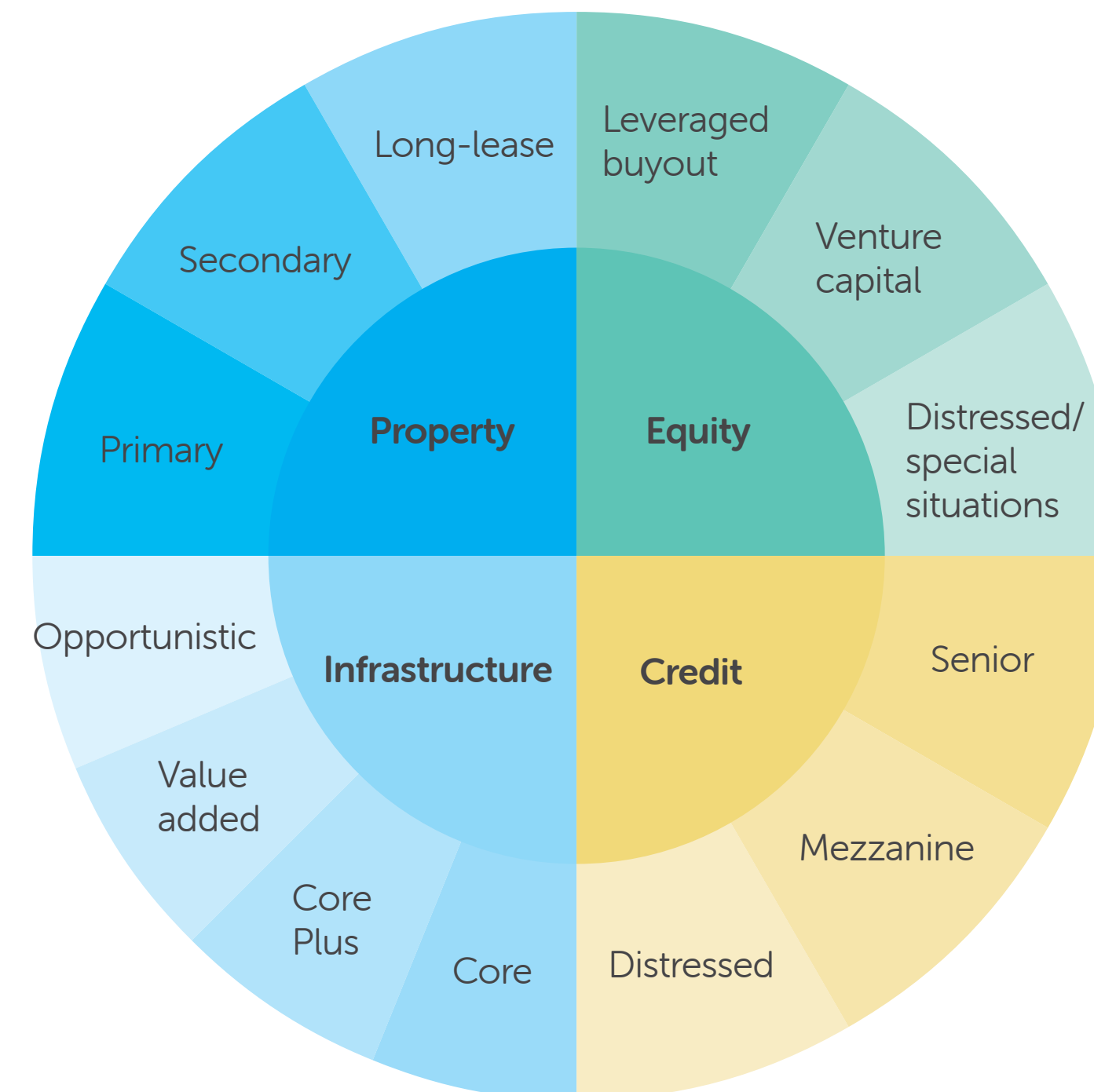
However, sustainability is not just about climate risk. Most investors now agree that it is important to consider ESG factors to both access opportunities for higher returns and manage investment risk. From a risk management perspective, the emissions scandal at Volkswagen and data privacy issues at Cambridge Analytica are well-known examples of how not taking into account ESG factors could negatively impact your portfolio.

While the headlines have been dominated by climate related developments, the Department for Work and Pensions' recent call for evidence on social risks and opportunities for occupational pension schemes and efforts by the Taskforce for Nature-related Financial Disclosures highlights the direction of travel for sustainable investing more broadly.

This is likely to result in further inflows for sustainable funds. In Europe alone the expected assets under management within ESG private market funds is expected to increase from around \$250bn in 2020 to upwards of \$800bn by the year 2025<sup>1</sup>. While the US is arguably behind Europe, it will no doubt catch up fast and the extra demand will help to support valuations for sustainable assets.

## Why private markets?

Before we combine sustainability and private markets it's useful to consider the wide range of assets available in private markets. We tend to think of four headline asset classes – private equity, private credit, infrastructure, and property.

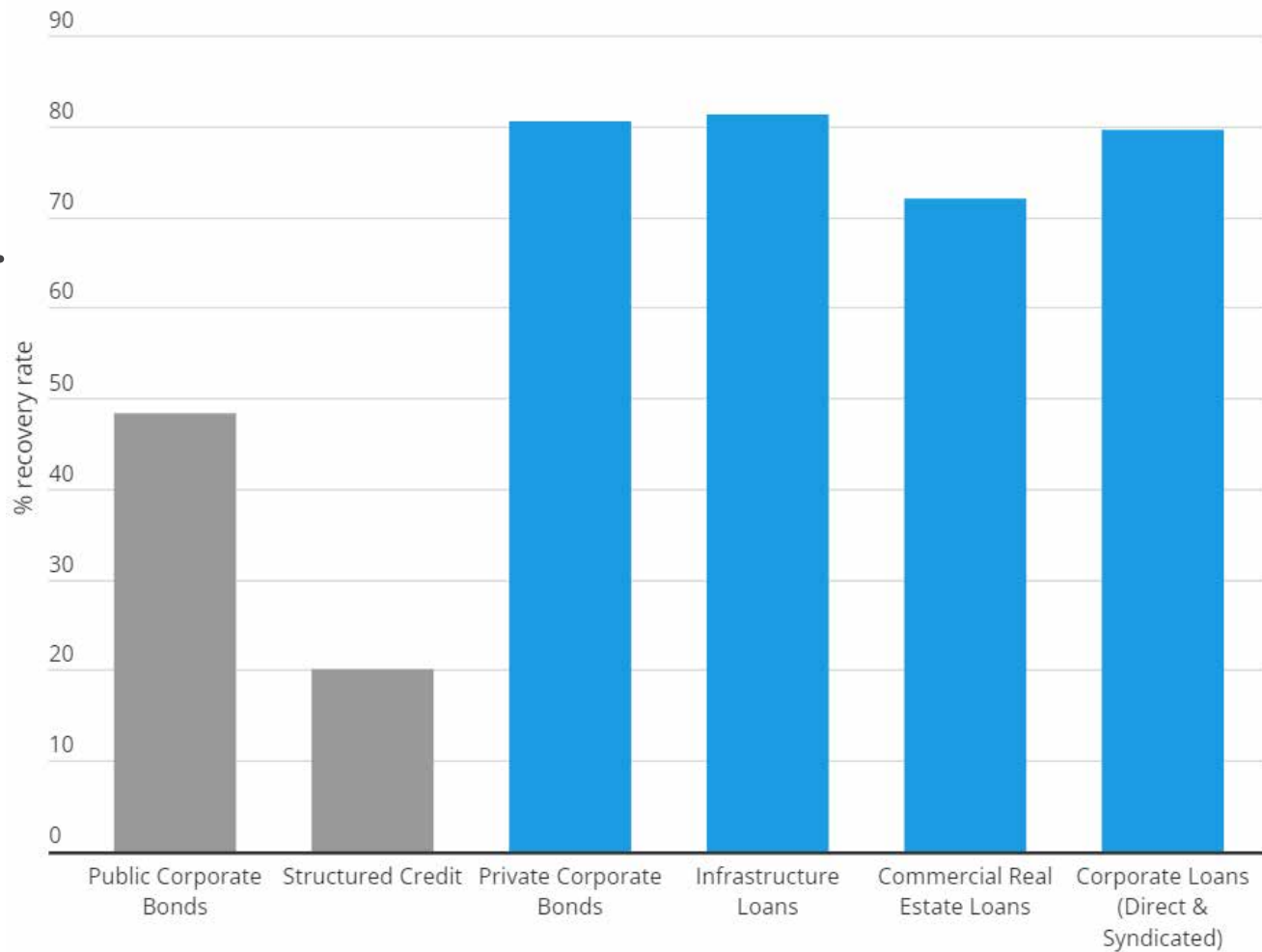


While it can be dangerous to generalise, there are a number of longer-term trends that are affecting the supply and demand of capital to private markets. It is useful to consider and factor these in to any analysis of the role of sustainability within these asset classes. These key trends include:

- **Low default rates and high recovery levels** – default rates have remained low in private credit markets and public markets, but recovery rates in direct lending are higher relative to high yield corporate bonds available in public markets. Recovery rates refer to the amount of capital an investor can get back when a company defaults. The yields earned in direct lending are generally higher relative to high yield corporate bonds as they benefit from an illiquidity premium.

**Figure 1: Recovery levels for public debt (grey bars) versus private debt (blue bars)**

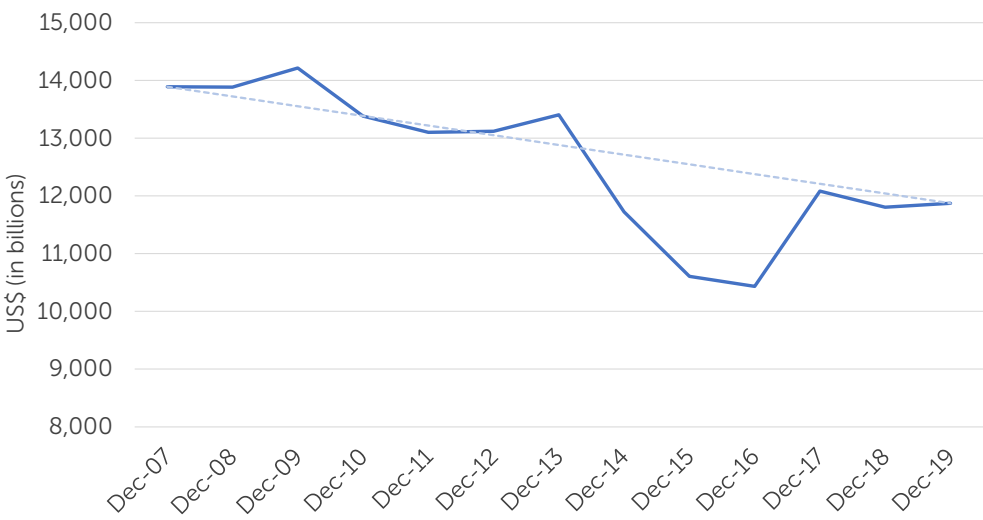
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- **Increasing number of private companies coming to market** – notably there are more private companies coming to market than public companies.
- **Companies staying private for longer** – typically there is more value to be gained in the private stages of a company. With companies staying private for longer, public investors could be missing out on more value.
- **Banks are pulling out of lending** – private debt began when banks got out of lending after the financial crash and ever since they continue to pull back creating an opportunity set for private lending.

**Figure 2: Withdrawal of domestic bank financing from Europe's non-financial sector**

Source: Bank for International Settlements (Euro Area - Credit to Private Non-Financial Sector from Banks in US\$bn)



- **Ageing infrastructure** – even before we consider sustainability angles, there was a huge need for private capital to support infrastructure needs in both the developed and developing world. In the US, 9% of bridges are in need to be repaired or replaced<sup>2</sup>.



# The case for sustainability in private markets

We are generally supportive of the investment case for private markets given these longer-term trends, but what about the role of sustainability within private markets?

## Long-term outlook

Concerns that decision making in public markets is driven by short-term considerations have been prevalent for decades. Indeed, those concerns motivated the Law Commission's review into the fiduciary duties of investment intermediaries in 2014, which culminated in the requirement for pension scheme trustees to include a policy on financially material considerations (including ESG) in their Statement of Investment Principles.

Sustainability is a long-term issue. Private markets can allow investors to focus on the longer term since it is more difficult to trade assets regularly than in public markets. How this works in practice will depend on the asset class and the fund manager.

Taking private equity as an example, the goal is typically to add value and sell up in three to five years. As a result, private equity managers are often accused of being short-term in nature, despite the fact that this timeframe is beyond that of many a public company.

Given the focus on sustainability is increasing at pace, it is evident that over these time periods investors will demand more sustainable companies.

This view is shared by fund managers. A 2021 survey conducted by PWC revealed that private equity managers are increasingly acknowledging ESG as a driver of value creation, demonstrating that sustainability is one of the key components of a value creation toolkit that fund managers can use to increase the attractiveness of investments on exit. There is therefore the potential, at least, for private equity managers to use that additional timeframe to implement changes at a company to put it on a more sustainable, long-term, footing. As noted earlier, this is driven by producing superior investment returns.



## Influence

The investment manager will generally have a bigger ownership stake in a private company compared to an equivalent publicly listed entity. As a result, they can influence how the underlying businesses or assets are run, including for sustainability issues.

- ⋮ In private equity, managers have typically either selected the management
- ⋮ board or have seats on the board putting them in a position of influence.

In private debt, fund managers are increasingly incorporating so-called 'ESG ratchets' into the terms and conditions for loans where they are acting as sole, or lead, lender to a company. This involves linking the amount paid in coupons to the issuer's sustainability performance. This can encourage companies to address sustainability concerns to reduce the debt interest cost. While this reduces the return to the lender, it also reduces their risk. If, however, the company does not make sufficient progress on sustainability targets, investors will be compensated by way of higher coupons. In contrast, in public markets, while companies are issuing 'sustainability bonds' in ever-growing numbers, the ability of the lender to influence those terms is significantly reduced.

The ability to influence is even more tangible in property and infrastructure as fund managers may be responsible for managing the underlying holdings. This can include redevelopment to, say, improve energy efficiency and drive up value (more on this below).

## New money

In public markets, a decision to invest often means buying a share or bond from another investor. In other words, investors in public markets are often moving money around, buying and selling holdings among themselves, rather than providing new capital. Investors in private markets typically invest directly with the underlying businesses rather than exchanging holdings with other investors.

This is significant from a sustainability perspective. In many circumstances, improving sustainability requires companies to change, whether adapting existing processes or investing in new ones. This needs new funding.



## Opportunities

Public companies tend to be bigger and involved in a huge range of business activities. It could be the case that you want a renewable investment but have to invest in large companies which take part in a wide range of business activities, like an oil & gas company. You would get some exposure to renewables, but would also get exposed to fossil fuels and risk losing out in the event of litigation or carbon taxes.

Private markets can offer 'pure play' opportunities as investors can invest in smaller companies that specialise in sustainable lines of business. Funds also tend to be more concentrated allowing investors to really narrow down where their money is going.

### CONCLUSION

Overall, there are a number of ways in which we feel that private markets have an advantage to public markets in terms of incorporating sustainability within their approach. The longer-time horizon and influence being the two key potential advantages.



## If you wish to go sustainable within private markets, are renewables funds the only option?

Renewable funds represent only a fraction of the opportunities for sustainable investing in private markets. We've identified a few alternative opportunities that investors could consider to help the transition to a green economy as well as other areas of sustainability such as social housing or healthcare.

### Broader infrastructure fund

Climate change mitigation goes further than generating electricity. There is also a need for infrastructure that supports the electrification of energy usage and energy storage. Examples include charging infrastructure for electric vehicles and batteries. We are increasingly seeing funds that provide exposure to this broader remit alongside renewables.

We are also aware that globalisation left many companies vulnerable to supply chain problems during the pandemic. Many companies may look to shorten their supply chains to reduce risks and, along with more of an emphasis on sustainability, this dynamic could continue to support a trend of decentralised and corporate-hosted infrastructure.

For example, we could see micro-grids for reliable power, localised energy storage, on-site water recycling, and on-site chemical production.

⋮ As the demand for data and connectivity is increasing, it has  
⋮ created an opportunity to invest in digital infrastructure.

To support today's digital world we require efficient processing and distribution of data. Infrastructure assets such as fibre cable connection and cell towers need to keep up and support the fast growing digital needs. This sector will play a role in the shift of how we work and can reduce carbon footprints.

## Property

In general, here we see more of a risk, than an opportunity. Existing property will need retrofitting to improve energy efficiency. We are hearing more and more about discounts on prices for properties with poor energy efficiency and these may well act as a drag on the returns from this asset class over the medium term.

It extends to sustainability more generally too. On the social side, it is estimated that £12.8bn will be required every year, for 10 years, to combat the lack of social and affordable housing<sup>3</sup>. These are buildings designed for those with support needs or those who cannot afford to rent or buy in the market. The private sector has a part to play in tackling the undersupply by allocating funds towards developing affordable housing that otherwise wouldn't exist.

## Farmland and timberland

The preservation of natural resources is essential to address climate change. An investment into agriculture could be useful to act as a hedge against carbon intensive portfolios and offset carbon emissions. Inevitably, companies are going to be facing further regulations in the future regarding ESG, including hitting certain ESG criteria. We could see greater inflow into this asset class in the coming years.

## Healthcare

Healthcare is a sector that we view favourably from a returns perspective. We see an opportunity in this sector given the ageing populations across the developed world and in an increasing number of developing countries. Investing in healthcare naturally ticks the social investing box and can be a useful way to diversify returns.



## Challenges

Let's be clear, private market investing is not without its challenges. Be that transparency, complexity, or costs, these should be factored into your decision making.

One area of particular relevance to sustainability is data. Transparency is crucial but getting hold of reliable data from private companies can be challenging because they don't, at present, have to meet the standards set by stock exchanges in public markets. There is an expectation that reporting will improve as investors demand more.

There is a common misconception that sustainable assets are overpriced, but the scale of the risks and opportunities highlighted by the IEA and others, plus continued pressure from regulation forms the basis of our view that investors should think about this now.

## Conclusion

Beyond diversification and return benefits, private markets are well suited to sustainability. Managers have greater control and can adopt a longer term outlook to work with companies on sustainability.

Investing in private assets typically involves providing new capital to companies rather than simply exchanging assets between investors. Finally, private markets offer a broader opportunity set, allowing investors to focus on specific areas in comparison to investing in large established public companies that have exposure to a wide range of business activities.

For those investors that do look to make an allocation to private markets we think it is important to look beyond renewable energy, with the green transition requiring investment across multiple sectors and broader opportunities being found in areas such as healthcare and social housing.



Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch with Matt Tickle, Partner, via the following:

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