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Why anti-ESG sentiment could ultimately prove positive

Mounting ESG scepticism is part of a healthy debate that could help eliminate the scourge of greenwashing once and for all, five industry insiders tell Amy Carroll and Isabel O'Brien

The climate change emergency, coupled with deepening and corrosive social divisions, has placed ESG at the heart of global discourse over the past decade. Meanwhile, private equity firms have come to view getting ESG right as an existential challenge given mounting pressure from limited partners and regulators alike. Indeed, a recent survey conducted by Bain & Company and the Institutional Limited Partners Association found that 93 percent of LPs would walk away from an investment opportunity if it represented an ESG concern.

But in some parts of the world, the idea that incorporating ESG principles into investment policy is unquestionably right – both ethically and financially – is an increasingly polarising point of view, as culture wars in the US intensify and a growing number of states adopt legislation preventing pension funds from factoring environmental, social and governance issues into their investment decision-making.

It is easy to view the strength of antipathy towards ESG that is emanating from some corners as a step backwards for the cause. But Aaron Scott, head of sustainable transformation at PATRIZIA, points out that extremes inform the mean. "The constructive aspect of Red [that is, Republican] states taking a counter position is that hopefully it allows for a balanced conversation. After all, rational debate should strengthen our society."

Nick Grant, partner at Igneo Infrastructure Partners, meanwhile, believes that the ESG and boycotting bills

Nick Grant
Partner, Igneo Infrastructure Partners

Nick Grant is head of asset management for Europe and a member of the investment committees of the firm's European Diversified Infrastructure Funds I, II and III. Grant joined the firm in 2018. He was previously the CEO of Severn Trent Services and also held senior roles at Centrica.

Kaj Bakker
ESG director, Arcus Infrastructure Partners

Kaj Bakker joined Arcus in 2021. He is responsible for managing ESG activities across the investment life cycle. Prior to joining Arcus, Bakker was an international sustainable manager at Cromwell Property Group.

Ross Grier
Chief operating officer, NextEnergy Capital

Ross Grier oversees the listed NextEnergy Solar Fund and NextPower UK ESG, a private fund focused on unsubsidised UK solar and storage. Prior to joining the firm in 2013, Grier worked as an analyst at ExxonMobil.

Kate McKeon
Head of sustainability, InfraRed Capital Partners

Kate McKeon joined InfraRed in 2016. She is responsible for the development and implementation of InfraRed's sustainability strategy. McKeon was previously a member of InfraRed's infrastructure investment team.

Aaron Scott
Head of sustainable transformation, PATRIZIA

Aaron Scott was named head of sustainable transformation at PATRIZIA in 2022, having previously served as head of strategy and ESG. Prior to joining PATRIZIA, Scott was responsible for the firm-wide sustainability programme at UBS.

proliferating in the US are part of a broader anti-ESG sentiment that is emerging around greenwashing. He points, in particular, to BlackRock whistleblower Tariq Fancy, who turned from ESG evangelist to apostate, claiming that ESG products are a guise that allow managers to charge higher fees with "scant or little evidence of real-world impact".

"These kinds of revelations are making investors more sceptical and that is damaging but also helpful to flush out poor practices," he says. "There is still sometimes a real disconnect between what people say and what they do. I believe that this is part of the existential crisis that ESG is facing today, rather than specific legislative actions being taken in the US."

Ross Grier, chief operating officer at NextEnergy Capital, adds that the risk of discrediting ESG lies in the fringes of the framework. "The grey areas are where greenwashing flourishes," he says. "Just look at the BPs of this world, paying multi-million bonuses that are ESG-tagged. That kind of behaviour fundamentally undermines all the work we are doing."

Grant believes that part of the problem is that many investors are still prioritising box ticking, policies and certifications, over continuously improving practices within portfolio companies themselves. "A policy is a piece of paper that no one beyond the person who originally writes it ever reads," he says.

"I always ask investors whether they ever go through the new terms and conditions that iTunes publishes every three months. Of course, they don't. In the same way, an ESG policy is not worth the paper it's written on unless it is implemented, understood and followed by all in the portfolio company. These are valid criticisms that are being levelled against the industry, when it comes to that disconnect between what is said and what is done."

"Being challenged on these issues is not necessarily a bad thing," adds Scott. "It is a reflective exercise and to be welcomed by those of us that are genuinely doing our best to deliver and who are growing frustrated watching others who are all talk and no action."

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KAJ BAKKER
Arcus Infrastructure Partners

Regulation: help or hindrance?

Despite ongoing concerns around the scourge of greenwashing, European regulation has certainly done a great deal to promote transparency around ESG claims. The EU's Sustainable Finance Disclosure Regulation and its Taxonomy clearly represent a major compliance burden for managers, however, and Scott also questions whether the approach is entirely right.

"I understand that we are going through a massive change, reorientating entire economies as green and inclusive," says Scott. "But the onslaught of regulation we have been subjected to and the bureaucracy that comes with having to digest it and translate it into operating models has certainly been tough. I also question the normative versus empirical bias. There is this sense that if you comply with this checklist of requirements then all is right with the world. The focus must be on whether firms are delivering genuine ESG improvements rather than simply marketing spiel."

There is certainly no desire to see alternative frameworks jostling to supersede current EU regulation, however.

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> **Igneo Infrastructure Partners**

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> **ROSS GRIER**
> **NextEnergy Capital**

"SFDR is demanding but helpful. I certainly wouldn't want to suggest further frameworks are required," says Grant. "There have been plenty of attempts to establish the de facto standard. Several scoring frameworks have also been discredited, for example, giving five-star ratings to companies which then found themselves issued with multi-million-pound fines in the UK for malpractice."

Grant also points to the backlash that occurred when the S&P ESG 500 index took Tesla out but kept Exxon in. "It is a classic example of hitting the mark but missing the point. More frameworks aren't the answer."

Market participants are also keen that any regulatory framework takes into account that ESG is a journey. "You are not perfect in your current form and you won't be perfect tomorrow. But you are mission-focused and know what you are trying to achieve, and you are making tangible gains against certain ESG metrics that are auditable and transparent," says Grier, who adds that it is also important that investors are able to focus on what is material in a given sector or business, rather than having blanket requirements to address every possible aspect of ESG.

Kate McKeon, head of sustainability at InfraRed Capital Partners, agrees that prioritisation is critical. "Clearly net zero is a key issue. That in itself will take years to work through, in terms of understanding how assets can be decarbonised and updating processes accordingly," she says. "But net zero is just one of the pressing topics we need to be actively considering. You also have everything from biodiversity to human rights. I believe that tackling the material issues, being transparent about what you are doing, and clearly demonstrating the positive actions you are taking, is understood and recognised by most investors."

"I would agree that there is an extraordinary amount of sophistication in the LP space around ESG. But aligning expectations relative to that journey needs more work," says Grier. "Everyone is talking about Scope 1, 2 and 3 emissions, including full clarity in your overall supply chain. But realistically, for most portfolio companies, that represents a monumental challenge that will take a long time to resolve. The fact that we can't tick every single box today should not be a reason to undermine the great stuff that we are doing and the value that ESG investing can bring where focus and mission are clear."

Scott, meanwhile, is hopeful that regulators are increasingly realistic about the scale of the challenge and the timeframes involved. "I hope the powers that be share our conviction that this is a journey," he says. "The EU Commission came out with a Q&A recently that softened some of the definitions around what constitutes a sustainable investment, perhaps an

acknowledgement of the implementation challenges that investors are facing."

Kaj Bakker, ESG director at Arcus Infrastructure Partners, says that regulation is inevitably evolving as real-life lessons emerge. "We are in a transition from voluntary reporting standards that have been around for a decade, to regulated reporting. The first material step in that transition is SFDR, which has only really been through one full reporting cycle," he says. "I think we will see more consultation papers and more changes coming from regulators. The voluntary standards took a decade to develop, and given the regulated standards are brand new, they will also need time to evolve."

Arcus, for example, started collecting data on PAIs – Principal Adverse Sustainability Impacts – over 18 months ago. "An important element of the disclosure is reporting on actual KPIs that matter in the ESG space," Bakker explains. "Collecting actual data sources has been a big piece of work for us and our portfolio companies, but it's important that we are able to show that information to our investors. And next year, of course, we will be able to present consecutive years' worth of data, so you start to see a quantitative illustration of progress."

In addition to the 14 PAIs that are mandatory under SFDR, Arcus has decided to report on another 16 voluntary PAIs "that we consider to be material to infrastructure sectors we invest in", Bakker says. "We use the standardised PAI reporting template that has been released by the EU and this is something we will publish on an annual basis."

Aside from standardised reporting, there is also tailored reporting that investors are still requesting, according to Bakker. "We need to be mindful that various voluntary reporting

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standards or other reporting formats don't dilute the standardisation and reporting efficiency that SFDR brings." he says. "And that's no different to the approach taken for many years when it comes to the equivalent fund financial information reporting, where there is only one set of reporting. We value this kind of standardisation and accept the costs that come with it, but bespoke approaches impact the usability of such standardised reporting and add to the time and cost involved."

Should LPs then share that cost burden?

"The fact we are providing clear, auditable results that investors can integrate with their own processes should be valued, certainly," Grier says. "But unless there is additional customisation required, as a mission-driven business, it is something we should be doing as part of our core operations."

Speaking of burdens, McKeon agrees that while regulation is putting a significant burden on asset managers, the results will ultimately be worth it. "It can be challenging to pull together all the quantitative metrics required for SFDR, but there is real benefit in formally tracking ESG data and being open about performance," she says. "Ultimately, this is positive for our industry and will lead to overall improvements."

Grant, meanwhile, says that if you look at what SFDR set out to achieve, it has largely been successful in its aims. "It tried to do three things. First, to provide a common framework, which it has done. Second, to tackle greenwashing by focusing more on the outcome than the sharing of documentation; and third, to divert capital towards green investment," he says. "In all three areas, I would say that it has largely achieved its purpose. If you take a long-term view, my prediction is that once SFDR is embedded, the number of customised data requests from investors will fall. In the long-term, the industry conversation will move away from reporting to focus on what really matters, which is improving underlying ESG performance." ■

Green-botching

A whole new language is evolving for initiatives that don't go to plan

Greenwashing is, by this point, a well-known phenomenon. Nonetheless, new derogatory language is already emerging including so-called green-botching – in other words well-meaning green initiatives that otherwise backfire.

Electric vehicle charging is the oft-cited example of so-called green botching. Governments have spent years nurturing a nascent EV industry and EV deployment has soared by more than 100 times. The problem, however, or so critics say, is that EV charging infrastructure has failed to keep pace.

Kate McKeon of InfraRed Capital Partners believes the criticism is unwarranted. "It is quite clear we need to fundamentally change the way we do things, including the way we transport people and goods, in order to reduce emissions."

InfraRed has recently completed its debut EV charging deal. "Our house view is that EVs are here to stay," says McKeon. "The electrification of transportation is essential and there will be massive take-up over the next five to 10 years, so we continue to look for further opportunities. In that sense, we are putting our support around the EV transition, so that consumers can continue to make the move from combustion engines."

"If this was easy, we would already have done it. But it isn't," says Kaj Bakker of Arcus Infrastructure Partners. "It is a transition and that inevitably takes time. Some markets are already well advanced when it comes to EV charging infrastructure, including the Netherlands and Norway. There are solid business models in those countries. But different markets will accelerate at different rates. We have seen that with other industries as well. I am confident, nonetheless, that we are moving in the right direction."

"ESG is above all a transition," agrees Ross Grier of NextEnergy Capital. "It is about getting rid of the concept of growth at all costs and replacing it with building a sustainable future. Not everyone is on board with that journey because it conflicts with the way they are currently living their lives. EV charging is just one example of that. An industry that is challenging the status quo has become an easy target for critics.

"The electrification of transport is the right thing to do. Of course, there are challenges. We all understand the limitations that the grid puts on our ability to deploy sufficient chargers. There will be fits and starts in supply of charging infrastructure vs vehicles on road as the business case cannot support one without the other, but the direction of travel is right."