Learning from Experience

Making Better Use of ESG Data in Private Markets

Many investors are making significant strides in integrating ESG factors into their public markets portfolios. However, despite a rapid rise in allocations to private markets over recent years, alternative assets remain a more challenging domain for responsible investors. QIC's Kate Bromley and State Street's Rick Lacaille share some suggestions on how to improve the use of data.

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Institutional investors are increasingly focused on environmental, social and governance (ESG) criteria when managing their portfolios.

Finding and applying accurate and relevant data is difficult enough in public securities markets, but it is even more of a challenge in private markets, which have become a fast-growing part of many investors' portfolios — a trend that is set to continue according to a recent State Street survey.[1]

On one hand, private market investors want to commit to companies that make a positive contribution to the environment and society. On the other, they want to manage the risks of investing in companies that are still transitioning away from unsustainable practices or maybe not invest in them at all. In every case, ESG data is central to effective decision-making.

It is a difficult landscape to navigate, but as a specialist alternative investment manager with a responsible investment mindset, QIC has a keen focus on improving its sourcing and application of ESG data on assets such as real estate, infrastructure and private equity over recent years.

The Private Markets Challenge

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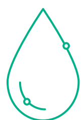
The Private Markets Challenge

In public markets, companies release large amounts of information about themselves, including ESG data, to meet the demands of regulators, investors and other stakeholders. In private markets, which are differently regulated and can be more opaque, companies have the option to reveal less about themselves.

Therefore, a key challenge is to obtain more information on the environmental and social factors that are material to the risk and return profile of private market investments. Another challenge across any market is in identifying ESG metrics that can be standardised across an asset class to allow for comparability. This is particularly the case in asset classes such as infrastructure and private equity, where investments may be more diverse.



QIC's tailored approach

Irrespective of the asset class, the basis of QIC's philosophy is that 'E', 'S' and 'G' factors have a material impact on investment outcomes. These impacts need to be identified and quantified as far as possible and built into investment processes.

However, not all ESG factors are equally material across asset classes and each asset class may require different approaches to ESG integration. As an investor in diverse asset classes including real estate, infrastructure and private equity – with widely varying ESG characteristics – QIC underscores the importance of tailoring the ESG approach to risk assessment and investment portfolio management.

There are several important elements to enable this tailored approach: conducting material risk assessments at an asset class and sub-industry level; selecting appropriate ESG frameworks, which can help to focus risk analysis and help with data standardisation; and engaging directly with investee companies to plug gaps in ESG information.

Putting frameworks to best use

A variety of ESG frameworks and standards are available to support responsible investors today, from the United Nation's Sustainable Development Goals (UN SDGs), the Sustainability Accounting Standards Board's (SASB) standards, to the World Economic Forum's Stakeholder Capitalism Metrics.

As part of their ESG approach, QIC uses a combination of broadly applicable frameworks, such as the UN SDGs and SASB, and asset-class specific benchmarks, such as Global Real Estate Sustainability Benchmark (GRESB), for its private markets portfolio.

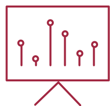
The SASB standards are wide in scope but drill down to industry level and support investors to identify the ESG issues most relevant to financial performance in each industry.

[1] "State Street Survey Finds Private Markets to Experience Significant Momentum in the Next Three to Five Years", December 2021

[2] Responsible investment, Our approach, QIC.

Since QIC incorporated the standards into its materiality analysis process, they have helped to focus ESG risk analysis on the right issues and to ask better questions when engaging company boards, which has led to better insights.However, it is important to note that this remains an evolving space – finding frameworks which provide a detailed, comparable view across all investment classes is an ongoing challenge and QIC recognises that ESG data is in a state of ongoing evolution and maturation.

There is significant effort within the industry to consolidate and standardise sustainability reporting, with the aim of defining comparable sustainability metrics. In time, this will enable investors to enhance their depth of understanding and increase the ability to extract valuable, standardised insights using these and other frameworks.



Finding quality data

The third step is to find the right data, which must be reliable and up-to-date. As QIC acknowledges in its Sustainability Report 2020, a key goal is to do more work to map its portfolio to the UN SDGs, with "the availability of data to measure both positive and negative impact" being a key challenge.

In fact, QIC, like other investors, is seeking more and varied types of data to continue to build sustainability insights into investment processes. For example, QIC uses data obtained from third parties: ESG data vendors such as MSCI's Climate Value-at-Risk tool, and government departments and agencies like the Commonwealth Scientific and Industrial Research Organisation (CSIRO).

It also collects its own data by engaging directly and regularly with investee companies. This tactic captures quantitative and qualitative information on issues such as climate change, modern slavery and social movements, and their views on strategic plans to address material risks and opportunities.

Analysis conducted from the various data sources allows QIC to build baseline carbon emission assessments (carbon footprints) at portfolio and individual asset level; sector, industry and sub-industry analysis to understand carbon intensity profiles and exposure to both transition risks and physical risks.

[3] QIC Sustainability Report 2020.

Seeking better insights into stranded asset risk

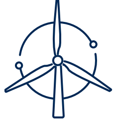
Stranded assets are those that before the end of their economic life are no longer able to earn an economic return because of changes associated with the transition to a low-carbon economy.

This is a major concern for investors in real estate and infrastructure. In some cases, physical climate risks such as rising sea levels and increased frequency of severe floods will see physical assets lose much of their value. More typically, a combination of transition risks – that make running carbon-heavy assets much less profitable – and physical risks, will require a lot of management attention to ensure an effective business and financial transition.

Therefore, investors must build a detailed view of the cost to transition an asset to operating more sustainably over time, for example, whether it is converting an oil-fired plant to electricity or converting a gas pipeline to distribute hydrogen. This is key to understanding the potential impact on returns—and whether it is feasible to transition an asset at all.

Scenario analysis is an important tool to guide an investor's understanding. It may explore a range of variables, such as the impact of carbon pricing, expectations for future cash flows and lost revenues, changes to CapEx and OpEx caused by extreme weather events, and rising costs of insurance cover.

It is important to note that climate transition is a rapidly evolving area and not a set-and-forget concept. As the relevant variables continue to develop and become clearer overtime, it will be important to ensure modelling is regularly updated to enable a higher degree of confidence in understanding the financial risk of climate change.



Achieving portfolio-level visibility

Improving data collection and the application of various benchmarks and frameworks has helped QIC to achieve a more accurate asset-level view of ESG risks and performance across private market assets. The next challenge is in reaching consensus on the best way to measure carbon emissions across asset classes and extracting the full value and insights from asset-level data being collected, to create a consolidated picture at the portfolio level.

However, this is far from straightforward. Answering even basic questions like "What is the carbon footprint of the entire portfolio?" can be unexpectedly complex due to the number of variables between investment classes. Data frameworks help, but within each asset class there is a degree of incompatibility between the frameworks. Somehow they have to be aligned to create standardised and comparable results.

There are three steps that investors can think about to help them move towards this goal

Set clear ambitions for what you want to achieve at the total portfolio level, which may differ from what is most important at the individual asset class level.

Use ESG investing frameworks and standards that have applicability across all relevant asset classes to help you select the right portfolio-level metrics and ensure greater consistency in ESG analysis.

Collect more data. The ESG information publicly provided by investee companies or bought from third-party data suppliers, is unlikely to be enough. In that case, seeking out directors and senior management to fill some of the gaps is fundamental in moving the dial. Obtaining more data not only improves the baseline understanding of the risks facing individual assets, but extrapolations can be made and applied to the entire portfolio. The data is often out there and it is becoming more important than ever to look.

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