

How do real assets contribute to tomorrow's world?

As part of the UBS-AM inaugural 2021 Alternative Investments conference, a diverse and highly experienced panel from the Real Estate & Private Markets (REPM) business provided a cross-asset view on how ESG is changing the game for real assets investors.

This session was expertly moderated by Joe Azelby, Head of REPM, and featured specialist contributions from Darren Rabenou, Head of Food & Agriculture and Head of ESG Investment Strategies, Declan O'Brien, Head of Infrastructure Research & Strategy, Zachary Gauge, Head of Real Estate Research & Strategy Europe, Bronte Somes, Head of Infrastructure Equity Europe, and Eric Byrne, Head of Multi-Managers.



Key takeaways

- 1 There is clear investor appetite for sustainable real asset funds, but the market is yet to evolve to meet this demand.
- 2 A combination of forces is resulting in a dramatically increasing universe size including investor demand, specific laws and regulations, technological advancements and the increasing social pressures and generational shifts in the prioritization of ESG goals.
- 3 Governments, corporates, research organizations and individual investors are all playing a key role in the growth of ESG in the real assets industry.
- 4 The correlative appetite that investors have for ESG, closes the loophole where more (long-term) value is attributed to real assets.



Joe Azelby, Head of REPM

Institutional investors are increasingly recognizing the potential for ESG factors to affect the valuation and financial performance of their portfolios. The recent boom can be viewed as both an economic and ethical opportunity to draw together expertise across a wide range of real asset investments. Regulation (such as the EU Sustainable Finance Disclosure Regulation – SFDR, 2015 Paris Agreement on Climate change and third party industry benchmarks such as TCFD and GRESB), investors, stakeholders and social pressures are increasingly holding businesses accountable for sustainable practices. The growing relevance of ESG issues is further driven by recent legislative developments which reflect the urgency to mitigate environmental risks related to climate change. In addition, technological advancements that can help to achieve energy efficiency and carbon neutrality, e.g. solar power, are “also” increasing in importance.

Private market investments provide a unique opportunity for investors to express their ESG objectives and control the related positive outcomes. We believe many investors will do so in this format.

Investors getting broad exposure to sustainable strategies



Eric Byrne, Head of Multi-Managers

A good starting point for investors looking to construct a portfolio around impact investing, are the 17 UN SDGs. Today, strategies in private markets are increasingly aligned to certain UN SDGs such as: good health & wellbeing; affordable & clean energy and sustainable cities & communities. The risk and return profile of the investments will also vary. Taking these examples one by one, the health theme can be invested in via private equity funds focusing on supporting the R&D of vaccines and medicines.

Currently in the industry, there is a typical private equity return profile of 15%+ reflecting the venture and growth profile of the investments. It can also be invested in via real estate investments in life sciences, medical housing, and aged care living. The industry shows that this can provide real estate development type returns of low double digits and stabilized returns of 7-8% made up of mostly income. The affordable & clean energy theme can be invested in via strategies focusing on clean energy and water as well as climate action elements. This will provide typical more stable long-term infrastructure returns with a much higher yield according to current industry levels. The final example is sustainable cities & communities, which can be accessed via investments in real estate funds primarily focusing on regeneration and affordable / social housing.

There is a choice here to focus on development and higher capital gains focused returns or stabilized assets with a bigger income focus. Today investors are spoilt for choice, they can either invest in a diversified portfolio of funds hitting 6-8 UN SDG's or have a narrower investment focus and select an impact theme and risk & return profile that suits them.

Attractive ESG opportunities in direct investment



Darren Rabenou, Head of Food & Agriculture and Head of ESG Investment Strategies

There are vast ESG opportunities for UBS across real estate, infrastructure, private equity, private credit and US agriculture. REPM is already playing a leading role as one of the US's leading managers of institutional farmland investment portfolios. Bill Gates's book titled *How to avoid a climate disaster* outlines how the global economy emits 51bn tons of greenhouse emissions across 5 major business sectors; real estate and infrastructure (cement, steel, plastic and other materials) 31%; power (electricity) 27%; agriculture & animal production 19%; all forms of shipping (planes, trucks, cargo ships) 16%; and all forms of heating, cooling and refrigeration 7%.

Gates believes that technology innovation, private businesses and governments need to better align their activities and incentives in order to address climate action. The US food business, specifically cold storage (due to the growing interest globally of people eating more perishable goods), can be a valuable ESG investment opportunity.



Declan O'Brien, Head of Infrastructure Research & Strategy

Transportation and eco-transport are attractive ESG opportunities available in infrastructure. Supporting this, over the past 10 years more than 50% of infrastructure transactions were in energy & eco-transport, however, the sector focus will move from renewables to storage and opportunities around the circular economy. Further to this, there are opportunities in the transportation sector, which has made little to no progress in decarbonization over the last decade when compared to electricity which has reduced carbon footprint by around 50%.

There is currently a keen focus on electric vehicles and charging infrastructure, although there is still significant investment needed in the heavy good vehicles and maritime sector. The maritime sector has less than 2% of vessels which use low carbon fuel. Despite this, the International Maritime Organization is targeting reductions of 70% by 2050. Shipping, is likely to be included in the EU Emissions Trading System and opportunities may arise around fleet and ancillary refuelling infrastructure.

Sectors the business views as viable opportunities



Bronte Somes, Head of Infrastructure Equity Europe

Infrastructure is gaining momentum as a natural sub-sector for sustainable investment strategies (e.g. energy, transport, industrial) as managers, society and policy steer focus towards ESG. Echoing Eric's earlier points on the UN SDGs, namely affordable & clean energy, there is a material amount of capital flowing into renewable energy – mostly in the form of wind and solar. Historically, assets were subsidized in whole or part. And as cost of generation has come down, there has been a shift towards unsubsidized models which require a refined approach to due diligence and management of assets. Supporting this view is REPM's move from 100% offtakes to material merchant exposure.

In addition, there is a growth of renewables only funds or platforms within diversified portfolios in recent years. There are more energy transition funds that are investing in earlier stage technologies and also in assets that are transitioning from fossil fuels to renewables, gas or battery storage, or a mix. Further, green hydrogen is currently a buzz sector and is considered a potential major player in decarbonizing steel and transport. And although infrastructure funds have been slow to deploy in scale, revenue flows in the form of offtakes and/or government support is not yet readily available.



Zachary Gauge, Head of Real Estate Research & Strategy Europe

Awareness is growing that real estate can have a significant social impact either through the form of social measurement work, strategies for multitenant shared spaces or life sciences (where REPM is currently active in and hits the sweet spot between delivering a strong sustainable investment return but also supporting breakthroughs in health research). The Social side of ESG is the hardest to measure, but is by no means any less important than the Environmental and Governance aspect. As a result we hear a lot of greenwashing around the topic and it will be important for investors to cut through the marketing to extract the positive difference that a scheme genuinely does (or doesn't) deliver.

ESG, aside from fostering environmentally-friendly buildings, also allows space to include considerations about the impact of properties on the community. The real estate industry must respond to this challenge by creating opportunities through social impact investing, like multitenant shared spaces or the transformation of underutilized buildings into enthusiastic venues. In practice, the major obstacle is that investors will need to reinvent their traditional investment models to match the needs of the local community. Real impact policies rather than buzz words carry far more weight. One example would be owners of commercial buildings ensuring all staff employed on site are paid at least the living wage for that area.

Q&A

- 1 How do you see ESG regulation evolving? And are any key differences between Europe and the US?

Declan O'Brien: Whilst ESG has been around for some time, mainstream ESG investing is still in its relative infancy, which complicates the task of making well-reasoned plausible future scenarios. This is due to lack of historical data on how ESG compliant investments perform, how certain types of risk affect their performance, and how their levels of return may differ from conventional portfolios. As time progresses, taxes & environmental capex and increased investment regulation will see further integration of ESG practices for business and portfolios.

Europe is leading the way through the EU Emissions Trading System which is hitting the pockets of owners of carbon intensive assets and through the EU SFDR which will impact where end investors allocate their capital. And while there are currently large divergences between Europe and the US, we see this closing over time. If you want to sell your product or service to end users in Europe, you will need to abide by EU standards. A change in administration may also put climate change higher on agenda.

Darren Rabenou: US investors can be viewed as being behind Europe as it relates to addressing the Environmental aspect of ESG. Europe has so far led on investing that impacts the environment, especially with their objectives regarding Article 9 regulations. However, the US may be ahead in addressing the Social aspect in ESG. US investors are very keen on incorporating Social screens in investing. An example of this would be the interest in funding affordable housing and Opportunity Zone investing by real estate investors. In the long-run, both the US and Europe are expected to converge, paying equal attention to the environment and social impact (and government).

- 2 Real estate and infrastructure have seen good progress over recent years in ESG – what about private equity? Are return hurdles too big of a challenge for private equity?

Eric Byrne: In the past, private equity funds typically addressed ESG through exclusion policies. Today, the shift to sustainable portfolios and impact investing reflects growing public concern about global challenges such as climate change, social inequality etc. By investing at the early and growth stage, private equity funds can facilitate positive environmental and social impact in the areas of healthcare, energy transition, education, food & agriculture. Currently, the industry shows private equity funds returns are typically not compromised with this approach and can still offer competitive advantages, with target returns usually in the 20%+ range.

Darren Rabenou: While pressure is growing on fund managers to pay greater attention to ESG issues, many also realize that ESG and impact investing can generate strong financial returns. For years, investors assumed a commitment to ESG performance would automatically lower profits, with many investors still believing that. ESG now makes sense for the risk and return-focused investor.

3 With COVID-19 giving the opportunity to further the sustainability / decarbonization agenda, do you also see a push towards allocations to social infrastructure / real estate? e.g. education, health, housing, recreational facilities etc.

Bronte Somes: Infrastructure and ESG are two sides of the same coin. The push towards social infrastructure had already started pre-COVID-19. Historically, managers invested in PPP type social infrastructure where there was a concession with the government. Today, managers are investing in care homes, childcare facilities and diagnostics or healthcare assets. If managers can point to high barriers to entry or a look through to government funding, they are investing in it as infrastructure.

Zachary Gauge: Yes we do. However, with so much capital moving towards a relatively small part of the market it's important to clearly define your investment objectives. Is it capital allocated specifically for social impact potentially to the detriment of returns, or is it still a returns driven strategy that wants to be exposed to more social assets? If it's the latter, then the same underwriting principles need to apply as a traditional investment and the anticipated return needs to be reasonably apportioned to the level of risk. This is one of the key attractions of the life science sector – it has excellent fundamentals on the traditional supply-demand and growth measures, but also delivers a real estate product which potentially benefits wider society.

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