



Sustainability and investment decision making

A Q&A with Natalie Sinha, sustainability analyst infrastructure at UBS Asset Management, on what infra decision makers need to know about sustainability

What sustainability topics are investors most interested in today?

Investors want to explore how they can combine a financial return with sustainability objectives and outcomes, and demonstrate real-world impact. Comprehensive sustainability reporting at the fund level is a minimum expectation, and there is a seismic shift happening toward providing quantitative data to demonstrate performance. Net zero remains a hot topic. We are also receiving increasingly sophisticated information requests from investors on climate reporting. Having basic carbon footprint and greenhouse gas emissions (GHG) data is the bare minimum, and over time scope 3 will become an expectation. We've started receiving requests from investors about implied temperature rise and whether we have targets under the Science-Based Targets initiative (SBTi), and whether we can report on Climate Value at Risk (VaR). We've also started having conversations around fossil fuels and our views on divestment versus engagement and stranding risk. Regular and structured engagement is also increasingly expected, with the expectation that firms have fund-level stewardship priorities in place and specific engagement objectives, along with a clear direction on what they want to achieve and how they are measuring and tracking progress.

For fund managers, how are sustainability considerations influencing investment decisions?

There are two key ways: either sustainability is an important and fundamental overlay onto a strategy, e.g., with specific, measurable sustainability objectives, targets and commitments in place, or sustainability could restrict the investment universe and determine the entire strategy – or both at the same time. For example, one of our recent strategies invests solely into specific themes: digital and energy transition only. That means sustainability is built into the lifeblood of the investment strategy, as we are investing into sectors that positively contribute to a sustainable future. The strategy also has specific targets in place for a proportion of “sustainable investments” under the E.U. Taxonomy, and it aims to outperform the GRESB fund and asset benchmark annually. As a result, we have investments into sustainable sectors, plus the overlay of targets that mean you need to meet specific criteria defined by the European Union, and also an externally recognized industry benchmark.

What we are aiming to achieve is the implementation of sustainability criteria throughout the entire investment lifecycle: the sustainability due diligence feeds directly into the development of a tailored roadmap, which gets monitored on a regular basis to ensure key milestones and objectives are being reached. Investment team buy-in and ownership is key, plus board buy-in at the portfolio companies.

There are also more niche-specific strategies developing – for example, focusing on the decarbonization of a specific sector, such as transport, and looking at electrification opportunities beyond the traditional passenger vehicle, as well as decarbonizing other elements of the transport system across a variety of sectors, including ports and airports.

What best-practice guidance exists for net zero and decarbonization for infrastructure investments?

It's the topic front and center of everyone's mind. There is a lot of guidance out there already, including the Institutional Investors Group on Climate Change's (IIGCC) Net Zero Investment for Infrastructure, which serves as a useful starting point and proposes some clear components of net zero for infrastructure. There are also a variety of other guidance:

- The Science-Based Targets initiative (SBTi) Net Zero Standard for finance and other sectors related to infrastructure
- Transition Pathway Initiative's (TPI) Management Quality and Carbon Performance Methodology
- Net Zero Asset Owners Alliance's (NZAOA) Target-Setting Protocol

Market intelligence suggests infrastructure investors are coalescing around the IIGCC Net Zero Investment Framework (NZIF). This means fund managers need to have 50 percent (or higher) of assets aligned to net-zero targets by 2030, plus other specific criteria for greenfield and operational assets, covering items such as portfolio-coverage target (asset alignment), portfolio reference targets and engagement threshold. All targets should be reviewed and updated at least every five years, in line with the existing NZIF guidance and net-zero commitments (NZAM and Paris Aligned Asset Owners). We're awaiting supplementary guidance on what the IIGCC NZIF looks like in practice, which is expected from the IIGCC at some point in 2023 or early next year.

Given that net-zero guidance is still in the early stages, how are you approaching net zero and decarbonization?

We're not standing still because standing still will leave you behind the pack. For our newer infrastructure strategies, our asset management objectives include goals around identifying economically viable carbon-reduction opportunities and looking at net zero. This is a multi-step process, and it depends on good carbon-footprint data availability as a starting point, including direct emissions (scope 1), indirect emissions (scope 2) and, importantly, having a view of supply-chain emissions (scope 3).

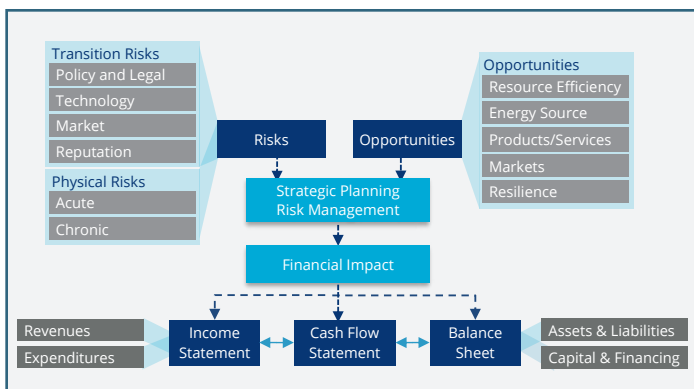
This year, for assets we'll hold for a long period and have controlling stakes, we are focusing asset by asset to consider what initiatives or levers can be pulled to reduce carbon footprints across the portfolio and whether those initiatives are realistic. Some of the key questions to address are: What's the budget? How do we go about implementing? How long will the investment last? What will the pay-back period be? Our focus now is really getting into the detail. We also have mapped the carbon intensity of most of our portfolio, and we're looking at potential sector decarbonization pathways toward a net-zero world.

How are you approaching climate risk at the asset level?

Climate risk is a clear emerging priority; it is arguably the biggest and most relevant for infrastructure sustainability strategies because it has a genuine bottom-line impact in the short-to-medium term on some of our assets. Where we're trying to

get in the medium-to-long term is climate-competent boards at our portfolio companies, as well as an investment team that understands climate risk and can adequately factor that into acquisitions, valuations and as part of the business plans for the companies in the portfolio. A strong understanding of climate risk is critical to encourage our portfolio companies to consider how they might allocate appropriate capital to address climate-related risks and opportunities.

We are aiming for our climate governance and financial planning to be clearly linked together. Climate-change mitigation and climate-change adaptation are included as standard elements in the sustainability due-diligence process. We utilize an external climate-risk software provider to flag any major physical climate-related risks and ensure these are adequately mitigated. We seek to draw guidance from the Taskforce on Climate-related Financial Disclosures (TCFD) in the post-acquisition phase to align to best practice. TCFD is a useful tool to better understand the risks related to climate change, but it isn't prescriptive in telling our portfolio companies what they should be doing or what decisions they should be making.



Source: Recommendations of the TCFD, published June 2017

What does climate risk integration look like in practice?

After acquisition and during the holding period, our infrastructure equity strategies at UBS Asset Management use a tailored online sustainability reporting platform, which has a detailed section on climate considerations. For example, we have a range of questions that are mapped to the TCFD's "maturity map," which helps map against how fully companies meet the TCFD requirements under categories of limited, moderate and full disclosure.

In our online reporting platform, we include questions covering climate governance, strategy, risk management, and metrics and targets. We can track how the responses of our portfolio companies change over time using a baseline year. The intention is that our companies' approach to climate risk develops and improves over time when we directly engage with them on the topic. So, you might expect to see a movement quite quickly from a "limited" to "moderate" disclosure. We are targeting a "moderate disclosure" for TCFD to be available at our portfolio companies within the next few years. For a moderate disclosure, scopes 1, 2 and 3 GHG emissions disclosure is a requirement. Companies also need quantified targets to reduce GHG emissions in relative or absolute terms (scopes 1, 2 and/or 3) and to be able to show performance against these. From a climate-governance standpoint, this means there needs to be clear consideration of physical, transition and liability risks, as well as a named individual or committee responsible for

climate change at the board level and board education on climate.

On the strategy side, our companies will need to have processes in place for identifying climate-related risks and opportunities over the short, medium and long term, and demonstrate they are managing these risks. They also need to have consideration of the impact of climate-related risks and opportunities on the organization's businesses, strategy and financial planning, which takes it a step further and really looks to how companies operationalize climate risk and the genuine financial risk at stake if climate risk is not adequately considered.

What recommendations do you have for investors looking to build out their sustainability capabilities in their investment teams?

Ultimately, sustainability does have to be balanced against other competing demands. Developing robust sustainability investment procedures, bringing the investment team with you, and training and building competencies in key areas over time helps a lot. In the long term, proving real-world impact and outcomes ultimately helps others to see the value sustainability can bring. At the portfolio company level, we try to carefully balance the qualitative aspects of sustainability progress, such as gaining board buy-in and defining sustainability roles and responsibilities, coaching employees, and bringing them along on the journey, alongside reporting on quantitative sustainability metrics.

Having a good overall sustainability strategy on the qualitative side and demonstrable quantitative data are equally important, and arguably having only quantitative data without appropriate coaching, training and buy-in does not add value; it can become reporting for reporting's sake. The hard part is the initial inertia and resistance, and keeping sustainability front and center of everyone's minds against competing demands and a tough macroeconomic backdrop. Once you start gaining traction and making progress on some of the key components of sustainability reporting, the focus shifts to demonstrating performance against your targets and commitments and proving positive environmental and social outcomes in the real world. That is what sustainability is all about.



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UBS ASSET MANAGEMENT

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