

Finding Green in SRI: Understanding EU-led Impact Investing

By Tenke Zoltáni, December 2011

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The 2008 financial crisis led to a fundamental shift across the investment space, with the emergent generation of investment strategies increasingly taking into account the sustainability of financial decision making. Nowhere is this more relevant than in the energy markets, where the rising demand for energy to meet basic social and economic developmental needs globally carries with it the spectre of Industrialisation's hazards. Partly an answer to claims that sustainability criteria—such as environmental, social, and corporate governance (ESG)—are too important to be ignored, partly a means to combat reputational risk, and certainly a conduit to accessing emerging markets more successfully, sustainably responsible investing (SRI) has become a mainstream investment trend in Europe and North America.

Within this realm of SRI, 'impact investing' (or placing capital into a project or business with the intent of earning a profit financially and socially through the implied benefits accrued by stakeholders of the targeted investment) is the latest and most prescient strategy seen in the market. This article explores the opportunities seen in impact investing, a subset of SRI, and argues that investing directly in greenhouse gas mitigating strategies is the only impact investment with unquestionable green credentials and direct exposure to the impact at source. The article details recent advances in the SRI space and identifies this as a leading trend in both European and North American investing.

Policy-driven energy trends

According to the International Institute for Environment and Development, the 'new normal' investment environment following the financial crisis is one of low return expectations and high uncertainty. Uncertainty around energy policy in developed and developing markets echoes this norm and reflects the need to examine risk factors beyond those of traditional investing—the health of equity markets, credit spreads, interest rates and inflation expectations (IIED, 2011). A very salient example is found in Europe's power sector. According to the credit rating agency Standard & Poor's, the most heavily-greenhouse gas emitting utilities can face potential credit downgrades and thus find it harder to borrow money after 2013 as the cost for either internally offsetting their emissions or buying carbon credits to meet EU requirements will rise significantly. *"(This) will in our view likely raise liabilities for all utility companies, and we incorporate this into our corporate credit assessment,"* said Michael Wilkins, head of global carbon markets at Standard & Poor's Ratings Services" (Garside, 2011).

The renewable energy industry understands low returns and high uncertainty as it is still a policy-driven and policy-dependent market often at the throes of fickle politicians. The demise of nuclear power in countries like Germany, Switzerland and Japan has created increased demand for wind power. Both sources are however laden with their own ESG criteria, and subject to sudden flip-flops should nuclear's image suddenly take a turn for the positive. The story of PV (photovoltaics, or solar power), initially popular in Germany as in Spain and Italy has been riddled with difficulties not least of which are the cost to tax payers of feed-in tariffs.

It is not just the renewables sector facing ESG public relations crises driven by policymakers but whole countries as well. For example, thanks to its vast coal reserves, Australia's per capita greenhouse gas emissions are among the world's highest. Realising this is unpalatable in the shift to a low-carbon economy the current Gillard administration has struggled time and time again with implementing a seemingly untenable cap-and-trade system, then a carbon tax. The implications of high-emitting 'dirty' coal are too hard to ignore and have been labelled unsustainable.

Notably, the same is true in Europe looking to adapt to an age of less coal, greater independence from gas-driven regimes like Russia, and with less money to spend post-2008 the greatest emphasis is on spending it sustainably through responsible energy policy. These combined factors hearken a new age of cleaner energy, and investments with 'cleaner' profiles. Recent analysis of the sector in the Financial Times points out, *"When some of Europe's largest utilities started selling off stakes in their renewable energy units in 2008, it was seen as a sign that the industry was beginning to come of ageThe financial crisis and a lack of liquidity, combined with large cuts in capital expenditure and lower power prices in the US, have led to a disappointing evolution of the renewable energy sector over the past few years"* (Scott, 2011).

Climate change as an SRI driver

The flight into more sustainable assets from those leading to the unravelling of the financial infrastructure of the last thirty years guided capital at first into the perceived safety of low-yielding government bonds. Risk appetite has somewhat returned to capital markets and savvy investors are chasing growth assets. It comes as no surprise that some of these growth assets are embedded in the energy policies of emerging markets, providing clear new opportunities for investment, underpinned by one of the key drivers of SRI strategy that this article focuses on: addressing climate change. Emerging markets such as India, China and Africa have the most to lose from vulnerability to major climatic events and migration shifts from long-term changes in climate affecting their food, water and natural resource supplies. Hence many attractive investable assets with both impact and profit are located here. How to meet both the demands of a booming population short of energy services and a world fearing eventual

asphyxiation through anthropogenic climate change has led to the exploration of several investment trends.

Within these lies a pool of non-traditional or alternative investing: project finance for energy conservation and efficiency, fossil fuel switching, renewable energy, nuclear and carbon capture and storage. Renewable energies, accounting for about 13% of primary energy supply in 2008 have been the most touted, but as seen above, marred by uncertainty. As assessed by the Intergovernmental Panel on Climate Change, oscillating government policies in favour of renewables, the declining cost of new technologies, booms in the prices of fossil fuels, coupled by increasing energy demand, and as this article argues, the shift to SRI, led to a rapid rise in deployment, but remain burdened by serious need of subsidies (IPCC, 2011). So where do investors turn?

Investment opportunities in SRI

Looking at the investment horizon, the basket of sustainable opportunities in energy are limited especially when looking for social and developmental impacts. Certainly renewable energy can help to decouple the correlation between increasing energy use and growth in emissions and has been proven to accelerate access to energy for the 1.4 billion people without access to electricity (IPCC, 2011). But, policies are needed to enable these investments and overcome barriers including regulatory hurdles, non-internalised environmental and health costs, lack of general information and access to data relevant to technology deployment, and a lack of technical and knowledge capacity (IPCC 2011). And interest in sustainable investing is soaring. UKSIF, the UK's Sustainable Investment and Finance Association now hold as much as £900bn (\$1442bn) under management in UK SRI-focused funds. *"What used to be about putting your money where your principles were has become a mainstream investment philosophy,"* says the Chairman of UKSIF (Kelleher, 2011).

On an EU level, the results are as impressive. According to EuroSif, the European Sustainable Investment and Finance Association, Europe has become the largest source of SRI managed funds, with 53% in 2008 versus 39% in the US. In Asia the trend is taking off more slowly but seeing rapid growth, from zero SRI funds in 2002 to 8% of the total SRI market in 2008 with more than \$500bn assets under management.

Globally, according to EuroSif: *"In 2002 the SRI sector had assets valued at more than US\$2.5 trillion globally, although this represented only 7% of total global assets under management. By 2008, the value of global SRI funds had risen to around US\$7.5 trillion, equivalent to around 12% of total global assets under management"* (IIED, 2011). Looking ahead, by 2015 up to a third of all global investment assets will be managed according to SRI principles, cites the IIED.

If the opportunities are limited then where do these investments go? An evolving yet small subset of the SRI sector, microfinance has emerged as a trend quickly

absorbed by the investor community. According to Sustainable Finance Geneva, a not-for-profit thinktank established to provide thought leadership on SRI themes, in the past four years foreign investment in microfinance, including both debt and equity, has quadrupled to reach US\$13 billion. But microfinance is arguably oversubscribed without enough small businesses to absorb the capital, causing lenders to lend to unqualified borrowers, and a new SRI theme is sought.

Addressing the shortcomings of microfinance and applicable on a larger scale by less sophisticated investors is the opportunity for spending on sustainable business identified by SRI thought leader Verdantix, including:

- Energy and carbon efficiency: one of the biggest source of spending in the market today for businesses, including decreasing the carbon footprint of and energy usage of buildings, IT and data centres, and telecommunications
- Innovation and cleantech: this includes research, development and deployment of new technologies with lower emissions and energy usage as well as the development of new products beyond conventionally thought of wind power and hydro plants (i.e. efficient network linked IT systems and software as well as smart grids and smart metering for building/company wide savings)

Verdantix assessed the demand and supply of sustainable businesses. They found that in 2012 the combined spend on sustainable business in Australia, Canada, the UK and the US will be US\$52bn, which covers spending of 2,592 firms and implying a compounded annual growth rate of 13-24% (Verdantix, 2010). The biggest proportion of this spending is energy efficiency, and demand for this service should continue to see significant growth. In a seminal report by McKinsey several years ago, the consulting company pointed to the area of energy efficiency as the low-hanging fruit—cheap to implement with palpable returns over a short horizon.

In addition to new energy service companies, financial institutions have identified a market for this theme. Private Equity, Venture Capital, hedge funds and asset managers have all diversified to provide growth capital into the SRI sector and to access trading opportunities. It is no surprise that the FTSE tailored its own series of indices with the help of companies like environmental fund manager Impax. Thus indices like the FTSE Environmental Opportunities (EO) indices were born, specifically for investments in energy efficiency, renewables & alternatives, waste & pollution, and water technologies. The FTSE EO Energy Efficiency Index rose by over 70% from January 2010 to April 2011.

Looking beyond listed equities in SRI

Unfortunately to date, despite investments directly in energy efficiency making good business sense beyond just being 'green', the major players in the sustainability space have been reticent to provide capital for these types of direct investments beyond

taking a themed listed equity approach. The most visible investment trend in Europe for green finance and sustainability is the strategy of creating themed SRI funds (i.e. water, energy, land) with positive screening criteria. For example, see the marketing materials of banks Sarasin, Pictet, ABN AMRO, ING among others.

In early 2011, Legal & General Investments launched a Global Environmental Enterprises Fund, a passively managed fund aimed at profiting from the shift to a lower carbon economy through investments in companies that are addressing energy scarcity, pressures on natural resources and reducing greenhouse gases. This includes a portfolio of (listed) companies in energy efficiency and energy management, low carbon energy production, water, waste and pollution control.

High impact, low correlations: the emissions market

Looking at the limited options available, the investment profile offered by a few limited funds such as the Impact Finance Fund strikes nearest to a clear investment in the SRI space. But, beyond a selection of a few new funds cropping up to address the overlap of 'impact' and 'finance', accessing SRI through the carbon markets is the only verifiable impact investment with unquestionable green credentials and direct exposure to the space.

The carbon market is fragmented with different trading regimes all over the world linked broadly by the Kyoto Protocol, but accessing opportunities in the sector can be thought of in three simple baskets based on liquidity, geography, and risk. Investors who want to put capital into the industries and technologies needed for the shift to a low carbon economy need easily identified and understood opportunities matched to their risk appetite.

First, for the most liquid, transparent, 'commoditised' opportunity accessible through financial instruments in Europe, carbon trading is an ideal approach. Two underlying commodities provide the basis of the biggest traded carbon market in the world by volume and value: the EU Emissions Trading Scheme (EU ETS). These are:

- European Union Allowances (EUAs) or 'permits' allocated to 11,000+ polluting installations in the EU; and
- Certified Emissions Reductions (CERs) or 'offsets' generated by reducing emissions through projects in developing countries without commitments to reduce emissions under the Kyoto Protocol

Sophisticated instruments beyond the underlying certificates in the form of futures, options and swaps exist for the more sophisticated investor. These exchange-traded contracts are offered to investors through hedge funds such as the Bunge Emissions Fund, or can be accessed by registered investors through the ICE European Climate Exchange. Alternately, there are smaller, less liquid and emerging markets for

carbon credits with varying criteria in New Zealand, Australia, Japan, China, parts of the US, Latin America, India and Kenya.

Within this strategy the number of technologies and geographies are incredibly broad, and can be tailored to the interest of the investor. The current focus is on growth in carbon projects in Africa. Having generated less than 2% of all CERs in the market, African projects are receiving a boost as new restrictions for acceptable projects into the EU ETS means that after 2012 only credits from new projects in the least developed countries will be accepted. 33 of the 48 countries classified as the 'least developed' are in Africa.

Finally, in contrast to the listed equity approach adopted by large players, reaching out to capitalise micro-cap non-listed companies exclusively providing energy services in the sectors of energy efficiency, carbon footprinting, monitoring and verification, low-carbon IT and software management solutions will provide the most direct exposure with least noise of uncorrelated areas. This type of investment carries a low-volatility, mid-risk and mid-liquidity profile, returns are expected in 2-3 years time, and the supply of high quality cash flow positive companies is prevalent.

Conclusions

The investment trends seen today in Europe emerged from the attempts to right the errors leading to the financial crisis and a panic-fraught effort by corporations to clean up their acts through 'greenwashing'—often deceptive use of PR to promote a company's policies or products as environmentally friendly. Once these misleading claims were discovered, an even greater attempt to achieve truly sustainable practices through SRI and impact driven investments emerged over the past two years. New studies promoting the benefits of SRI-balanced portfolios and ESG-focused strategic asset allocation, in addition to the success of indices like the FTSE EO Energy Efficiency Index, has increased SRI's popularity. In a study by Allianz Global Investors, it was found that not only can incorporating ESG criteria improve expected portfolio performance, but it can reduce tail risk and increase expected return potential, concluding that ESG risks should be assessed when compiling a portfolio (Allianz, 2011).

But getting past the marketing and the noise is difficult. Large cap equities often listed in SRI themed funds can be in many ways uncorrelated to the effects that SRI investors may be most interested in—lowering greenhouse gas emissions and positively benefiting local communities. This is especially true for investors that are seeking the highest social impacts and are willing to give up some of their returns to maximise the investment's on-the-ground effects.

The modern investor is thus driven to carbon market related investments, where the green credentials can be unquestionable and independently verified by a UN body. The emissions markets are however niche and often difficult to access initially for those

unfamiliar with its intricacies. These barriers to entry yield rewards for those that do invest. Opportunities also abound in equity, trading, and project finance with the potential for attractive returns and true-impact bearing results in a market seeing significant growth year-on-year.

With major players like the private banks, insurers and pension funds interested in diversifying through green themes, SRI as an investment trend is expected to continue its boom.

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