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TRANSCRIPT

Private Assets Can't Hide from Climate Change

Featuring:

Larry Lawrence, Executive Director, Head of ESG & Climate Products for the Wealth Management and Private Assets Segment, MSCI

Brian Schmid, Managing Director, Global Head of Product Management and Applied Research, Burgiss

Adam Bass (00:03):

This is MSCI perspectives your source for insights for global investors and access to research and expertise from across the investment industry. I'm your host, Adam Bass. And today is September 16th, 2021.

Adam Bass (00:17):

Today we begin our journey down the road to the upcoming climate conference cop 26, by looking at how climate considerations are affecting private assets. Now, before anyone starts thinking, this is going to be yet another discussion about the lack of transparency in private assets. Let's dive head first into that issue with a question I asked of both our guests today, that is when it comes to climate data, how different really are private and public investments? We start with the answer from our first guest...

Brian Schmid (00:53):

Hi, I'm Brian Schmid. I'm responsible for product management and applied research at Burgiss.

Brian Schmid (00:58):

If you ask me that question six months to a year ago, before I started working closely with, with MSCI on climate, I would've told you that it's a night and day in terms of the data availability within the privates, but the more I've learned, I I've learned that there's a significant amount of estimation happening on the public asset side. And listen, there will be in terms of the initial role allows of the private assets, there will be a good amount of estimation happening.

Brian Schmid (01:27):

I do expect that the kind of private assets will continue to lag the public assets, but listen, at the end of the day, these estimates are being used for real purposes and being used effectively in the public markets today to give clients of the, you into their portfolio and to give clients a path to improvements and the paths to net zero, we would expect the same to be happening in the private assets. Potentially a little bit of a lag, but listen, it's certainly not night and day...

Larry Lawrence (01:56):
For our ACWI IMI,

Adam Bass (01:59):
And that would be...

Larry Lawrence (02:00):
So my name is Larry Lawrence. I sit within in the ESG product team at MSCI for our ACWI IMI, all country, world index universe, which has over 9,000 of the large, small, medium emerging markets, small cap companies out there only about 30 to 40% of the companies in that and these are public companies report on their sort of scope one and scope two emissions since 2014, 2013, we've had to adopt and implement an estimation model to cover a large portion of even the public universe and the fixed income universe, because, not a lot of companies have been reporting. Obviously those, the number is increasing, but still our estimation models have been in place and are still huge for a large part of that coverage universe to provide that transparency cover those gaps.

Larry Lawrence (02:55):
So there's still a lot of work to do, but, but we've had to adopt estimation models to fill the gaps. And I think for private companies and private equity, while they're just getting started, I still think there's a lot of work to do on both sides...

Adam Bass (03:10):
Now that we've hopefully ushered that elephant out of the room, let's zero in on private asset investors.

Adam Bass (03:17):
Now we've spoken before with Brian, when he first appeared on the program, as well as with MSCI's president and chief operating officer Bear Petit about the importance of all investors, including those in privates to consider climate, but are they doing so, or rather are more of them focused in this direction than in the past? The answer seems to be a resounding yes. And that goes for investors in Europe, as you might expect. But also in the Americas...

Larry Lawrence (03:49):
We've talked to, I would say most of the largest, not only asset owners, investors, but asset managers in private equity shops. And some of them are at different stages, but, I think this is top of mind for everyone, I think, this is a trend across the board, more and more they're allocating their portfolios to private assets. You will see sustainability and climate be a big part of that. But I wouldn't be surprised, because based on the discussions, we've had many of the firms in the Americas, for example, the U.S. And Canada by the way are certainly

leading the charge. And this is top of mind, and then I think it will certainly not be followers for long...

Adam Bass (04:33):
But why what's driving this focus?

Larry Lawrence (04:37):
What we're seeing in with private asset investors are pretty similar with the trends we've seen in our public universe. To be honest with you, we've seen a tremendous momentum in awareness of climate and ESG issues within the public universe.

Larry Lawrence (04:53):
For example, year over year, more and more companies, corporates within the equity universe are becoming more and more aware of these ESG issues. We're hearing from them more, they're being engaged by their investors and different stakeholders in the subject. And it's very similar to what we're seeing in, in private assets.

Larry Lawrence (05:13):
You know, as an example, we've seen significant increase in regulations, targeting corporates. If you were to compare 2018 to 2019, as an example, there was a 136% rise in the number of regulations related to ESG and climate targeting companies, corporates. The other things are climate risks are influence in market dynamics. Climate is and will continue to influence valuations, rates, liquidity access to capital. It's a basically, it's something that can no longer be ignored. If you are a participant in the capital markets and need to grow, borrow money, issue that equity, you need to be aware of climate considerations because they're playing a big role into how companies have valued their ability to borrow money. And then everything else around that.

Brian Schmid (06:05):
One of the forces is pretty straightforward, right? It's, it's the, the goal of maximizing risk adjusted long term returns, just considering one additional factor and that's climate. So the idea is just maximizing upside return and minimizing and mitigating downside risk over this long term. So the second factor, or the second force here is really doing their part, right? So at the end of the day, our clients, the sovereign wealth funds, the endowance foundations, family offices, they have constituents, right? And they answer to those constituents and those constituents, want them to do their part to encourage a sustainable future. So, the third force is, is regulation. Regulation and, and, or reporting recommendations. So acronyms such as TCFD SFDR SDG are all part of, kind of the everyday discussions with our clients, including the fund to funds and the GPS themselves...

Adam Bass (06:58):

TCFD, the task force on climate related financial disclosures and SFDR the sustainable finance disclosure regulation. These are ESG and climate reporting regulations in Europe, SDGs, those are the UN 17 sustainable development goals.

Adam Bass (07:19):

I asked Larry to elaborate on this point and are those regulations that you mentioned the what was it 136% rise, incredible, in regulations? Do you see those helping? Are they trying to make this more systematic, more consistent across companies and what they report?

Larry Lawrence (07:41):

Yeah, certainly some are just some want to just ensure that companies are paying attention to these real risks. These, these climate risks are ensuring that they had look at some type of scenario analysis looking forward and they're at least of how their firm could be impacted onto multiple scenarios. Some are just asking for basic reporting, just make your investors and your stakeholders aware of your profile as a firm. So I certainly think there, it's helping. I think it will encourage a lot of people and participants in the market to begin to pay attention to this. If you look at some of the things happening with the EU with the a number of the regulatory requirements, especially with TCFE I mean, a big part of that is climate. And I don't think, as I mentioned earlier, you it is just something you can't escape at at this point.

Brian Schmid (08:36):

Listen, regulation certainly is helping. But, I think it's the, a drive of the asset owners, the asset owners we serve, and frankly, them serving their constituents, which is the largest driver in the industry.

Adam Bass (08:48):

These asset owners and asset managers, the limited and general partners, LPs and GPs respectively. When you're talking about private assets, these are MSCI and Burgiss's clients. So what are they looking for? What kinds of questions are they asking?

Brian Schmid (09:07):

Burgiss focuses on data and analytics solutions for private assets. Our clients include institutional investors or LPs, fund to funds, and the general partners themselves. Now general partners are looking through the lens of climate by selecting the portfolio companies and monitoring the progress of the portfolio companies, as it relates to climate now, fund to funds, they're selecting managers and creating portfolios on behalf of their investors. And finally institutional investors, they're constructing portfolios based on the liabilities goals and preferences of their constituents. Our institutional investor clients include sovereign wealth funds, public and private pensions, family offices, and endowments and foundations.

Larry Lawrence (09:54):

Recently, we held a consultation with about 25 of our clients around the world, just hoping to, well aiming to understand what are the key questions they're trying to answer? What are some of their concerns and essentially, what are they trying to solve for? And I think it boiled down to a few things. The first is with the focus on climate and net zero, and not only communicate in how you can, how you're contributing to the solution, but also making sure you make your stakeholders aware and comfortable with the fact that you are aware of some of these risks, from making sure, climate risk management is embedded in your processes, making sure that you report to your stakeholders around your climate risks and different things that you're doing and sort of your carbon footprint as an example.

Larry Lawrence (10:41):

So we're getting questions from them across the board. And two things stand out; The first is from these investors, they want a consistent view of how to measure their total portfolio across all of these different asset classes that I just mentioned, equity, fixed income, and, now sort of private asset of private equity and debt funds. The other thing is reporting, how do we then convey to stakeholders, investors, owners, and the like that we're either not carbon intensive or we're taken the right steps to help contribute to the solution.

Adam Bass (11:15):

So despite our best efforts here, we are talking about reporting and data. So before we commit to going down that path completely, I do want to stick with this idea of the private asset investor and what they're after in terms of climate, what, what sets them apart?

Adam Bass (11:33):

One key factor is time horizons, which tend to be longer on the private side of the ledger. And this is a very important feature, particularly when we're talking about climate...

Brian Schmid (11:45):

Yeah, so private asset investors, you know, they're investing in buyout funds or investing in venture capital funds, they're investing private debt funds or private real asset funds, including real estate, depending on the asset class. Those, the life of those funds could be anywhere from, let's say seven to 15 years. So almost by definition, private asset investors are, are committed for the long term and listen, the investment horizons of those clients that we have, those sovereign wealth funds, pensions, endowments, foundations, family offices, they are long termed investors, right? They're willing to accept the illquidity of private assets for the illiquidity premium that they receive by investing in those private assets. So these institutions that I mentioned earlier, they have to have these long horizons, often multi-generational horizons, investment horizons. So when they're making investment decisions to deciding in context of 10-20, and sometimes 50 plus year investment horizons.

Brian Schmid (12:47):

And so over these long term horizons, risk and opportunities such as climate pretty much can't be ignored. And, when you look at longer horizons, 10, 25 years, 50 years issues such as climates are big factors over the 50 year horizon, right? So, I think the, the answer here is that the benefits of focusing on climate for these institutional investors, private assets, are that the risks are real, right? The, the risks are real in terms of climate changes over those time periods. And these are the time periods they're thinking of when they're making investment decision and frankly, ultimately, satisfying their constituents in terms of the return profile, in terms of risk management over those horizons.

Larry Lawrence (13:34):

In some of the discussions, we've had one of the interesting dynamics and many of our clients have told us to us, there's a ton of value and opportunity here, both in the pre-investment stage, when you do due diligence to evaluate targets, climate is playing a role in helping you assess those potential targets for acquisition, and then post investment where, you can as an asset manager or general partner work with your portfolio companies to close the gaps where they exist in terms of their climate profile, their risk management, and also on the opportunities that exist there as well. You know, in Europe, there are a number of examples where we have a number of private equity shops who go in with the methodology to help create value in companies they acquire and sustainability and climate is leading that charge.

Larry Lawrence (14:29):

Consumers want to purchase and work with companies, who have a great profile when it comes to the environment and when it comes to climate change. So there's a ton of opportunity there in and of itself to, reposition a company, to make them look from an environmental perspective as a contributor and as a solution provider, versus as someone who is either dismissing this issue and not adding value from, from that perspective. So there's a ton of opportunity there and think of it as, think of the cost savings itself. And you think about sustainability and make operations more efficient, less intensive from a carbon or climate perspective. I think there's a ton of opportunity there as well.

Adam Bass (15:15):

Whether it's accounting for risk looking for potential opportunity, or trying to get your own portfolio to net zero, it does come down to data. And honestly, I'm not sure why I thought we could avoid that discussion. As we heard early private and public investors, they're not terribly far apart when it comes to availability of data. And while neither have come terribly far, either the news is better than you might imagine in terms of what's available and how investors can put it to use.

Brian Schmid (15:48):

So I guess first, I just, I want to kind of, of remind folks, or just continuing to make the point that there's a lot available today. I would just start with recommending to asset owners to know what they own today, and Burgiss isn't alone, but Burgiss is a provider of a solution to provide look through to the underlying portfolio and companies and properties within your fund investments. So based on the industry geography and the client's ownership in each portfolio company, that asset owner can get a bottoms up view of their private asset portfolios, industry, and geography exposure. That by itself tells an asset in a lot about the climate, their climate risk exposure. But second, listen, a few more details of each of those underlying portfolio companies, data points such as revenue, total enterprise value, or these underlying portfolio companies allows companies like MSCI to estimate the carbon footprint of each of these underlying portfolio companies.

Brian Schmid (16:47):

This is the way I would maybe start is; first, just you know, creating a strategy and creating the goal and stating that is certainly a starting place. Today, they can, they can start to measure and take a baseline kind of however, low fidelity that that baseline might be, they can take a baseline based on the information that's available to them today and remeasure periodically on that progress relative to that, to that baseline. They certainly document the assumptions that they make and revisit those and kind of recalculate over time. Again, to the extent it's very low fidelity, it might be just an industry and geography breakdown of their allocations, but there's a lot that can be said with that. So if you're an asset owner, create the strategy, but at the end of the day, your job is to kind of allocate your capital and select your managers and funds according to that strategy.

Brian Schmid (17:38):

And so you should be having those discussions with those managers that you're allocating to and what your expectations are of those managers. So, let your allocations speak if you will, if you're a general partner, if you're the asset manager yourself or the general partner, you have a similar job, right? So you select the portfolio companies that you want to have in your portfolio, and you kind of manage and operate those portfolio companies. You should be doing so in a way that achieves the strategies that you've set forward for your firm or you've set forward for your LPs in those funds.

Larry Lawrence (18:15):

So one of the things we've observed in, in speaking to not only the investors, but also the asset managers, the general partners, is that many times these asset owners and investors come to them asking of varying degrees of different pieces of information. So it's quite fragmented. You may have one investor asking you for questions, one to five and another investor is asking you a completely different set of questions. So a lot of times what they're looking to us for is there a framework or a consistent set of metrics that we can be begin to ask, or even begin to provide investors with that would help solve for that to sort of address some of the fragmentation issues that we're seeing, because it is very difficult to manage when you have if you've got, let's just say as an example, a hundred investors across all of your different portfolios and they are each asking a different set of questions that just makes it very difficult.

Brian Schmid (19:09):

You know, role that Burgiss plays in the process is to facilitate that data collection from the underlying GPs, to make it easier for those GPs to report that information, to allow their LPs to get this, this carbon footprint estimation of, of their portfolio. And certainly the role that MSCI plays in this, in this is to make the best possible estimate available based on the best data available. And so with that combination in the very near future, clients will be able to see a carbon footprint of their private capital portfolio or a large percentage of their private capital portfolio.

Adam Bass (19:43):

When we're talking about getting those baseline measurements, improving transparency, consistency, where do we go from here?

Adam Bass (19:53):

How do we move away from estimates, whether it's on private or the public side, how, how are we going to get there as a, let's say an investment ecosystem?

Larry Lawrence (20:04):

I think just the awareness of participants in the ecosystem and the fact that they recognize that, climate is playing a much bigger role and influence in every aspect of capital markets and the ecosystem in general, that I think this will just become naturally and organically you'll just see more and more information being asked for and more and more information being reported. Regulation will certainly drive a lot of that. Interest from stakeholders and investors will drive a lot of that beyond regulation.

Larry Lawrence (20:39):

You know, in one example I've seen, and I believe this was in Australia, we had a large provider of capital, an asset owner, who committed to strip capital from companies failing to act on climate change risks, for example. So you know, that in and of itself, I think will encourage more reporting and more disclosure. And then we have a role to play as a service provider and in the solution provider where we can make it a lot more easy for not only public but private companies. And I think that's key make it very easy for private companies to have a sort of framework for reporting and disclosing this information, but then give them a platform where they can do this much more easily, but, and even beyond that, give them a place, could benchmark how they're doing relative to their peers as well.

Adam Bass (21:32):

That's all for this week. Our thanks to Larry and Brian and to all of you for listening next up on Perspectives, believe it or not, we are nearing the end of the third quarter of 2021 and that means it's time for friend of the pod Hittenra Vani to join us for a look at the markets along with some special guests to help us get the complete picture, until then I'm your host, Adam Bass, and this is MSCI Perspectives. Stay safe, everyone.

TRANSCRIPT

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