ESG Investing

Operational excellence in real assets – Part 1 Planning and Development

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> This report is part one of a three-part series on the operational challenges of ESG integration in real assets. In it, we focus on the most important steps investors need to take to integrate ESG criteria throughout the lifecycle of a real asset investment. As we will show, integrating ESG-related tasks into the operation of real assets is likely to reduce costs and boost returns for investors.

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Introduction to the series

In this series we will focus on the environmental, social and governance challenges throughout the lifecycle of a real asset. We aim to enable investors and asset managers to achieve a higher level of operational excellence when assessing and managing real assets.

The series will track the typical lifecycle of a real asset investment over three parts:

- Part One: Acquisition
- Part Two: Ownership
- Part Three: Divestment (Realisation)

For each of these three stages, we will outline the most important challenges in the E, S and G dimensions and provide guidance on how best to address them. We will also sprinkle in a few case studies so that readers can gain a better understanding of how other investors have tackled some of these challenges.

Before we address these questions, it is important to emphasise that pension funds, insurance companies and other institutional investors who want to invest in real assets need to have the appropriate internal structures in place before engaging in these investments. A clear commitment from the entire organisation and senior management towards ESG-related policies needs to be in place. Written guidelines, such as investment policy statements or ESG strategy descriptions for the organisation, help to gain a common understanding of how to engage in ESG-related matters.

And of course, proper monitoring and controlling mechanisms must be in place to compare how each investment is tracking against the stated goals of the organisation. In the previous three reports in this series, we have provided guidance on how this can be achieved in each of the major real asset classes.

Part One: Acquisition

In part one in the series, we address the ESG-related challenges that arise during the planning and development stage of a real asset. No matter whether we are talking about property or infrastructure projects, one of the key phases of development is the acquisition of land. It also covers the planning efforts for the project, including the application for regulatory approvals.

Because of its importance to the outcome of the project, because the development stage is often outsourced to dedicated external developers, who then hand over the project at construction or after construction is finished, bad practice in this stage can have a negative impact on all subsequent stages.

Insufficient environmental planning, for example, potentially creates hazards and substantial unforeseen costs during the usage and the recovery stage of the lifecycle.

Land governance

One of the key requirements for any real asset project is to secure the title to an appropriate piece of land that is fit for purpose. In developed countries, this means ensuring that the title of the land is secured and registered at the appropriate authorities and that no disputed ownership issues exist. The land also needs to be designated for the desired use, be it residential or commercial property, roads, farmland, etc. This may seem straightforward at first, but even in highly developed countries like the US, land disputes are common. Faulty registries, unknown ownership and even forged title deeds can create a host of legal problems for a new project before it even begins. Companies should ensure that land acquisitions have been executed properly and recorded in official government registries. When possible, title insurance can sometimes help to reduce the risk of legal costs for land disputes.

The issue of land governance becomes even more important in both developed and emerging markets where land is more at risk from having been expropriated from indigenous people on unjust terms or obtained as a result of deforestation. Greenfield projects are particularly vulnerable to these risks.

With respect to land governance we thus recommend the following steps which investors and their agents should take to mitigate risks:

- Ensure that land is acquired using the official government institutions and at fair market prices. Previous owners may also need to be compensated for lost harvests and other forms of forfeited future income.
- Carry out a full ESG impact assessment that adheres to the FAO Guidelines of Responsible Governance of Tenure that protect basic human rights, such as access to drinking water, food, housing, etc. Part of this ESG impact assessment should be a full consultation with residents and other stakeholders to guarantee the rights of indigenous people and local landowners. Part of the consultation process should also be the establishment of dispute resolution mechanisms that are accepted by all stakeholders.
- Ideally, hire local businesses and local labour to provide additional economic benefits to the communities.

The benefits of these practices are straightforward. They help avoid unwanted surprises at later stages of the lifecycle and at the same time create goodwill with the local community. There is no use in having title to a piece of land if construction is blocked by local indigenous communities who consider the land sacred. Local environmental groups may also have concerns with the development of the land and want to prevent construction. The Keystone XL tar sands pipeline, a pipeline from Alberta, Canada, to Nebraska, is a good example of this scenario. The developers of the Keystone XL pipeline continue to endure ongoing delays and cost increases, due to legal challenges by local indigenous and environmental groups, not to mention the reputational damage to the developers.

Another recent example is where mining company Rio Tinto destroyed two sacred indigenous rock shelters in the Juukan Gorge in the Pilbara region of Western Australia in May 2020. The rock shelters were 46,000-year-old caves. While Rio Tinto had Western Australian Government approval to undertake this blast, the Rio Tinto consultation with the local Puutu Kunti Kurrama and Pinikura people was inadequate. Rio Tinto has conducted an internal review and three senior executives have been dismissed as a result of the incident. This example highlights the importance of consulting and engaging with the indigenous communities to ensure the land is used in a just manner. This incident also highlights the shortcomings in the governance of both Rio Tinto and the Western Australian Government planning and development approval process.

Case study: TIAA-CREF farmland investment[1]

TIAA-CREF is one of the largest providers of retirement and investment funds in the US. The company established a global agricultural company, TIAA-CREF Global Agriculture (TCGA) with $5bn[1] (total FUM for TCGA 1 and TCGA 2) in assets from institutional investors. TCGA looks to invest in farmland, predominantly in Australia, the US and Brazil.

To select appropriate pieces of land, TCGA follows several due diligence procedures prior to acquisition. Projects that do not meet the UNPRI Farmland Principles are rejected outright. The projects that meet these standards have to pass additional due diligence criteria that cover a detailed analysis of previous ownership, the identification of any boundary disputes, the uses and conditions attached to the land and any environmental issues like the presence of rare species or fragile wetlands. TCGA also checks for any issues concerning water rights, patent rights, crop usage, etc.

Once an investment is made, TCGA applies the TIAA-CREF corporate governance standards to address issues like voting rights, anti-corruption measures and compliance with local law. To ensure that their farmland investment does not lead to deforestation, the company focuses on improving the productivity of existing farmland and each investment has to undergo regular environmental assessments that are made by TCGA representatives on site.

TCGA's cooperation with the farmland operators depends on the type of crops cultivated on the land. For annual crops, the farmer leases the land from TCGA and pays rent. The farmer is responsible for growing, harvesting and selling the crops, providing an incentive to create the best possible harvest. For permanent crops (e.g. nuts or timberland) the farmer is employed by the investment entity, providing an income in the years when the trees and vines are not fruit-bearing. The farmer has a crop management contract with TCGA to ensure the farm is managed according to the standards desired by the investor, but the trees and vines belong to the investor as they form a substantial part of the value of the farm.

[1] As at 2015.
Adapted from Kaminker, C. et al. (2013). "Institutional Investors and Green Infrastructure Investments: Selected Case Studies." OECD Working Paper on Finance, Insurance and Private Pensions, No. 35.

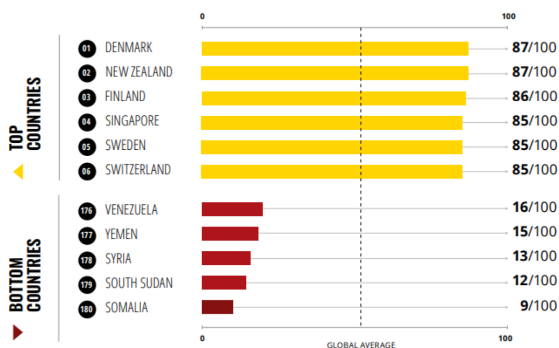
Corruption

Corruption can thrive in countries and regions where there is a lack of governmental oversight or where the rule of law is not properly enforced. Particularly in emerging markets, corruption can be widespread or even an integral part of "doing business". The damage to an investor's reputation, let alone the potential financial damage for engaging in corrupt business practices, can be massive. In the US, the Securities and Exchange Commission (SEC) can fine any company that has issued stocks in the US for corrupt business practices anywhere in the world under the Foreign Corrupt Practices Act (US) (FCPA). The list of offenders reaches far beyond the well-publicized record fines of $3.2bn for Brazilian company J&F in 2017. Here is a short list of examples from recent real asset related fines:

- ENI S.p.A. an Italian multinational oil and gas company agreed to settle charges that it violated the books and records and internal accounting controls for the FCPA in connection with business activities in Algeria. They agreed to pay $24.5 million to the SEC.
- SEC charged a former Director of a US based financial services company with orchestrating a bribery scheme to help a client win a government contract to build a power plant in Ghana.
- Petrobras had to pay $1.78bn in a resolution arising from massive bribery and bid-rigging for energy projects.
- United Technologies was ordered to pay $14m to settle charges that it had made illicit payments to facilitate sales of elevators.
- Kinross Gold agreed to pay $950,000 for violations of accounting controls in Africa.
- Israeli company Elbit Imaging paid $500,000 for illegal payments to consultants in a property deal.

Corruption costs are particularly high in public infrastructure projects where Transparency International estimates that losses due to corruption can range between 10% and 30% of the overall contract value.

The global cost of corruption is estimated to be around 5% of global GDP and loss of tax revenue of US$1 trillion, as estimated by the IMF.



Source: Transparency International Corruption Perceptions Index 2019 Perceived levels of public sector corruption ranking, top and bottom countries.

Avoiding corrupt activities provides clear financial benefits but it also reduces reputational risks and encourages innovation, since companies that do not engage in corrupt business practices have to compete on other dimensions.

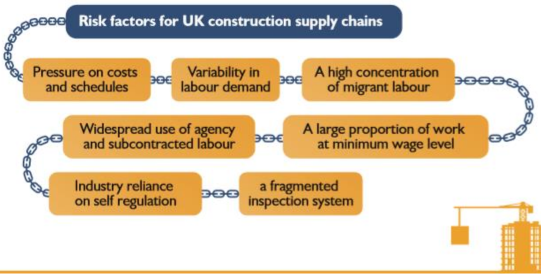
To foster a more transparent business environment and reduce corruption, investors and their agents should:

- Put in place control and oversight mechanisms that prevent people from engaging in corrupt business activities. This includes different measures from training employees on corruption issues and introducing whistle-blower policies, to adopting anonymous bidding procedures in the form of sealed bids and other mechanisms.
- Introduce local ethics committees that assess all reported and known ethics issues on a case by case basis and report these issues, together with the actions taken, to the investors.
- Publicly report progress and achievements on transparency and anti-corruption measures, as well as promote transparency measures with other business partners.

Labour rights

Because developers and constructors often use sub-contractors, ensuring that labour rights are followed through the entire supply chain of a project can be difficult. Labour rights abuses can range from the suppression of labour unions, to slave and child labour in the most extreme cases. Even in developed markets there is a significant risk of labour rights abuses and this should always be considered in the acquisition process.

Because of the immediate impact on local communities, violations of labour laws are amongst the most likely ESG risks to materialise in practice.



Source: Chartered Institute of Building Construction and the Modern Slavery Act, Tackling Exploitation in the UK.

It is a regulatory requirement for all investment managers in the UK and Australia, and many other jurisdictions, to assess the labour rights and supply chain risks within real asset portfolios and projects. Additionally, there is hardly an issue that lends itself more to creating goodwill than upholding labour laws and treating workers fairly. This can be done through the following measures:

- Thoroughly assess the impact of a real asset project on human rights and labour rights. Developers should have a publicly available and frequently monitored labour rights supply chain policy.
- Investors and their agents should conduct due diligence on the labour practices of suppliers and sub-contractors, especially in countries where labour laws may not prohibit child labour or where labour laws may not be enforced by authorities.
- Investors and their agents should ensure a healthy and safe work environment in accordance with international labour standards, not just local standards, which may be lower.
- Ideally, investors and their agents should hire small local businesses to support their development.

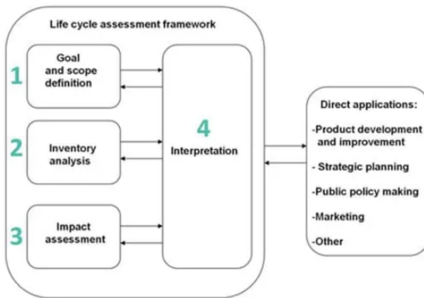
Environmental issues

Environmental issues in the planning and development stage can range from an understanding of risks such as water contamination, management of vulnerable ecosystems and waste recycling, to more comprehensive issues like the impact of climate change on both the operational components of the asset and the long-term viability of the development throughout the asset’s lifecycle. These issues include rising sea levels, heat stress, water stress, flood risk, typhoons and hurricanes.

Environmental impact assessments of the planned project are becoming increasingly the norm and are typically demanded by regulators in the developed world. These impact assessments usually cover the expected use of energy and emission of greenhouse gases of the project. It is also important to think about the climate resilience of building materials and if they can withstand the long-term climate risks of the property. They also typically study the impact of the planned project on local wildlife, as well as valuable resources like groundwater, local lakes and rivers. The impact on local infrastructure in terms of additional traffic is also typically assessed, as is the impact of noise pollution on residents.

Beyond these environmental impact assessments, investors and their agents should consider taking additional measures to reduce greenhouse gas emissions through insulation and other measures designed to reduce energy consumption. Especially in or near urban areas, the improvement of local greenspaces and more efficient land use (e.g. ensuring “walkability” of local areas or easy access to public transportation) can additionally reduce ESG-related risks.

The current gold standard for projects is to engage in a full Life Cycle Assessment (LCA) of the project according to ISO 14040.



Source: ISO 14040 Environmental Management – Life Cycle Assessment Principles and Framework

An LCA assesses different project alternatives and their environmental impact throughout the entire life cycle of the asset. In order to do this, developers need to acquire Environmental Product Declarations from all their suppliers that certify the product standards for all the components used in the project throughout the life cycle.

Conclusion

In this, Part One of the series, we have provided examples of some of the measures which can and should be considered to mitigate ESG-related risks throughout the planning and development stage of a real asset investment. The most important operational considerations in the planning and development stage include land governance, corruption, labour rights and environmental issues.

Adequately considering ESG risks at the planning and development stage of a real asset project can avoid complications later in the process, potentially avoiding hazards and unforeseen costs in the later stages of the project and asset lifecycle.

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