EXPERT Q&A

Demonstrating ESG purpose, policies, processes and accountability is no longer just a positive, it's a must-have, say Arrow Global's Monique O'Keefe and Davide Stecchi

Putting ESG at the heart of investment

Q How can asset managers integrate an ESG strategy into their business and what role should it play?

Monique O'Keefe: There are some fundamental pillars for ensuring the successful design of an ESG strategy and ensuring that strategy is embedded into the business.

The first is purpose. In order to integrate the ESG strategy into your business, the strategy needs to align with the core purpose of your business which in turn drives where you focus your resources.

At Arrow, our purpose is to build better financial futures for our stakeholders, whilst delivering superior risk-adjusted returns to our investors.

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Considering a range of ESG factors allows us to identify, mitigate and manage a wider range of risks, and building ESG factors into our business plans for investments allows us to maximise the value of our investments.

The second pillar is policies. We have a group-wide ESG policy that is integrated into our enterprise-wide risk management framework and risk appetite. All our entities need to comply with that, and it is backed up by a number of other policies setting out our approach to a variety of governance and control issues. Importantly, this includes a responsible investment policy specifically addressing our obligations under our investment programme.

To ensure compliance we have senior executive support and accountability. This is backed up by our quarterly ESG forum, made up of cross-functional senior executive sponsors who ensure the culture of compliance cascades through the business. We also have formal governance structures, with governance committees in our local platforms that ultimately roll up to our Group Audit and Risk Committee, where ESG matters are formally considered.

The third pillar is processes, because ESG policies and principles also need to be integrated into key business processes. For example, one of our key processes is our investment decision-making on behalf of our investors. We own and operate key sourcing and servicing platforms across our jurisdictions in Europe so, when we are considering each investment, we draw on that local expertise to forensically due diligence each investment. This due diligence covers the asset class, but also risk, compliance and legal expertise in the local jurisdiction to ensure we are compliant with all local laws and regulations.

ESG considerations form a key part of the investment committee papers and recommendations and then, once we own an investment, close integration between the investment process and our servicing platforms that manage the assets ensures our policies are adhered to.

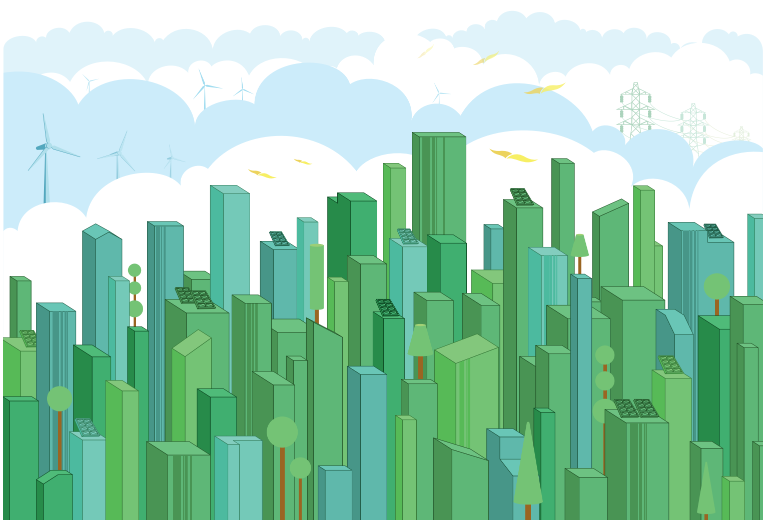
Finally, the fourth pillar is accountability, to ensure our approach to ESG is transparent to our stakeholders. We report on group-wide ESG activities in our Annual Report and report to investors quarterly on our investment activities. To support our ongoing drive for transparency we have recently become a signatory to the United Nations-backed Principles for Responsible Investment and will adopt those reporting requirements going forward.

Q How might ESG change the way investments are made?

MO: Our investment programme needs to deliver investors the ESG attributes they expect in the portfolio. Investors are increasingly wanting to see transparency as to how ESG factors actually impact investment decision-making: both in terms of whether we make an investment or not, and then in terms of any follow-on portfolio management activities.

As Davide mentioned, ESG screening allows us to identify investments that our investors would not want to see in our portfolio. Further granular underwriting and due diligence allows us to make informed decisions on investments and price in any remediation plan required. Once we own an asset, we can consider ways of delivering positive ESG enhancement. Consequently, embedding ESG factors into our decision-making drives long-term success and value.

Ultimately, investments are more attractive if they contain ESG considerations. Taking good governance as an example, an investment that builds in good governance controls will likely suffer less downside risks than one that does not.



Q What factors should investment teams consider when looking at deals, to make sure ESG plays a critical part in an investment programme?

Davide Stecchi: ESG should play a role through every aspect of the life of an investment, from origination to underwriting, asset management and monetisation. ESG risks can not only negatively affect the performance of an investment, they can also damage the fund in many ways, including reputationally, and indirectly the investors that entrusted their money to it.

With this in mind, we think about what ESG means and work to identify the risks, which can arise at any point on the investment journey. We are trying to develop an ESG culture, because the right culture is the first and best line of defence.

When it comes to a specific investment opportunity, the first thing we do is ask whether an investment is right for us. There is a screening process with some simple exclusions, but the origination team starts by identifying, highlighting and discussing ESG risks so that they can be analysed before too much time and resource is committed.

Then due diligence, as a core part of the underwriting process, will collect, analyse and assess ESG considerations in more depth, often involving third party advisers. We recognise that ESG risk cannot be eliminated completely, but it can be avoided, mitigated and priced. This is done in different ways, from excluding the asset to employing contractual protections, from resolving the problem if owned to addressing it through pricing.

Any issues are escalated to senior management for a deep dive and are ultimately discussed and approved by the investment committee.

Q How does ESG manifest itself through ongoing stewardship and portfolio management?

MO: We consider our plans in respect of stewardship and ongoing portfolio management before we purchase an asset. They are baked into our business plan for an asset and continue to be key right up until ultimate realisation of that asset.

We consider ESG in relation to stewardship at two levels. First is oversight and governance at the level of our local servicing platforms, and across external service providers, to ensure responsible realisation of our assets. And second is in relation to the specific asset acquired, particularly in the case of assets with some level of transformation or growth strategy. Their granular knowledge of the local environment allows us to react quickly.

An example of both of these can be seen in an investment we call Project Core, involving an acquisition of retail shopping centres. As part of our servicing platform ESG considerations, 2020 and 2021 saw many of our retail tenants suffer significant trading distress during covid, with many having to close for periods of time. In early 2021, we agreed a 50:50 payment forbearance and payment delay strategy with vulnerable tenants to allow them to stabilise businesses during periods of closure. This strategy led to almost €500,000 of credit invoices to our tenants across our rent roll and ensured survival of our tenants' businesses. In the end, it resulted in an overall payment of our tenants above our original purchase underwrite forecast and with tenant replacement costs below our forecast. So, we achieved a social benefit whilst also delivering superior risk adjusted returns to our investors.

Furthermore, as part of asset development ESG considerations, we are currently considering investing additional funds into a partial redevelopment of a shopping centre and some of the ESG items that have been considered include the addition of rooftop gardens to the building, improvements to the energy efficiency of the building, and integration into the town's municipal plan around redevelopment of the downtown area. We hope this will achieve environmental and social benefits while also improving the overall value of the investment.

> *"We are trying to develop an ESG culture, because the right culture is the first and best line of defence"*
>
> DAVIDE STECCHI

Of course, our post-acquisition ESG focus is on both implementing our agreed business plans and having an ability to adjust to real-time ESG events, so flexibility is important. That is where the expertise of our local investment, risk and compliance teams really comes to the fore.

Q How can you benchmark your approach to ESG?

MO: We have signed up to the UN Principles for Responsible Investment as an external benchmark to which we will be measuring ourselves, and our investors have their own reporting and benchmarking requirements that we accommodate. We are keen to have an open dialogue with our investors to share our experiences and incorporate best practices within our business.

We also have a dedicated internal ESG team and use external third-party experts where required. We are currently looking at a number of ESG measuring tools to see whether they would add value to our existing forensic underwriting and due diligence processes and assist with our investment analysis.

Ultimately, to ensure accountability and alignment within our senior executive group, we take a balanced scorecard methodology to how we approach senior executive reward.

Q Finally, has, or will, ESG become a differentiator in raising and deploying capital?

DS: This is an ongoing process but ESG certainly has become a differentiator. Being able to show appropriate policies, processes and reporting was probably a positive in the past, but it is now becoming a must-have. As people become more and more aware, ESG is getting more institutionalised and there are more rules and controls in place to make sure ESG metrics are measurable and reported. That translates into a code of how things should be done, increases transparency and puts investors in a position to ask more questions and more effectively measure the ESG behaviour of fund managers.

In the same way that we focus on ESG when we buy an asset, our buyers are looking at it in depth when we sell assets. It is becoming a fundamental when monetising investments and, while it is an element that has always existed, it is only going to become more objective, more reportable and more measurable.

Aligned with this strong approach to ESG and responsible investment as a whole, Arrow's experienced investment team has executed more than 1,000 deals delivering an average 18 percent gross IRR since 2010, with a sub 1.5 percent loss rate. ■

Monique O'Keefe is executive director, governance and risk and chair of AGGCM Fund Manager, and Davide Stecchi is MD, underwriting, at Arrow Global