EXPERT COMMENTARY

The key to success in this segment of infrastructure is being uncompromising in your ambitions but strategic in the pace and delivery of change, says Valeria Rosati, senior partner at Vantage Infrastructure

Driving ESG excellence in the mid-market

"Are our aspirations for ESG improvement too ambitious? How confident are we, given the company's scale?". Our team was being quizzed by Vantage's equity investment committee on the late-stage, detailed assessment of two separate mid-market investments. We had been progressing work on these exciting business cases with growth potential, solid net-zero investment positioning and energetic management teams. Nevertheless, our due diligence had highlighted areas for improvement in ESG to bring them in line with our standards and strategy.

The mid-market space provides fertile ground for investors with a sustainable mindset to marry attractive, growth-driven investment returns and positive ESG contributions to generate a more sustainable future. However, this requires an active asset management approach and, from a sustainability viewpoint, a solid upfront plan to balance ESG opportunities, challenges and operational priorities.

SPONSOR
VANTAGE INFRASTRUCTURE

Opportunity and challenge

"Opportunity is missed by most people because it is dressed in overalls and looks like work," Thomas Edison famously said. In our experience, the mid-market infrastructure space often provides investment managers with material opportunity to add value by driving best practices in ESG through active asset management. This is largely as a result of three favourable factors: more direct involvement during longer-term investment cycles; an ability to establish a closer working partnership with management teams; and nimbler decision-making structures with concentrated ownership.

While these factors mean that both ESG transformation and ESG value-add can really be achieved, there

are obvious challenges that accompany these tasks.

Resourcing Firstly, the smaller scale and earlier positioning in the growth cycle means that resourcing can be constrained. In the past, we have seen larger portfolio companies state that additional resourcing was the bottleneck to getting started, especially when they initially failed to see ESG as a strategic priority or lacked an ESG culture. They approached ESG as a 'separate workstream' from their day-to-day business and sought internal or external manpower to perform these new ESG deliverables.

For larger companies, extra resourcing can often be approved, given the small cost to value ratio, to get an acceleration in the pace of progress. A mid-market company is even more likely to be faced with resourcing constraints. However, the support cost is more material relative to its size. Furthermore, even after an investment in upfront support is made, the upkeep of ESG continues to require an unavoidable ongoing commitment.

Starting from a low base The second challenge appears when the company's ESG journey starts from a low base. Because the mid-sized companies we target measurably contribute to a net-zero economy, sustainability is often rooted in their corporate mission. However, this may not be matched by the adoption of ESG best practice, their governance structures may be underdeveloped, and complacency or a lack of knowledge can detract from delivery.

While insufficient managerial willingness to improve will constitute a deal breaker, as an experienced and active manager we see a relatively better opportunity to make a difference in the mid-market. Part of our value-creation strategy is precisely to set out an ESG roadmap and provide portfolio companies with the right tools.

Six tips for investing sustainably in the mid-market

1 **Strategy shapes everything**
Do not make the common mistake of engaging mid-market management on processes, disclosures or even structures first. This makes it look like a chore. Start from embedding ESG best practices in the strategy so it emerges as an imperative for success.

2 **Get stuck in**
Be ready to work side-by-side with management and make allowances for a substantial investment of your time and resources, especially during the 100-day plan right after completion.

3 **Balance qualitative and quantitative incrementally**
Phase your data ambitions. It takes time to get everything in place and to collect complete information. Carefully choose the data you need and leverage qualitative engagement.

4 **Reward through progressive targets**
Improving targets over time is more motivating, achievable and less daunting for mid-market management than reaching first place in year one, especially as a company's mindset and culture will not change overnight.

5 **Benchmark carefully**
Small movements can drive big changes for smaller companies. For instance, the departure or hiring of staff could significantly swing the diversity position of a mid-market company. A single construction project can materially increase emissions from the prior year. Make allowances for this in your benchmarking.

6 **Add to exit**
In a world where sustainability is the future, ESG improvements add value at exit. Target, incorporate and track this carefully in your asset management strategy.

Future business growth The third challenge lies, paradoxically, in future business growth, a central pillar of many business cases.

Growth is certainly not an exclusive prerogative of mid-market companies, and both larger scale and mid-sized businesses may have material expansion in their plans. However, their combination of constrained resourcing, lack of readiness and growth delivery means that our ESG priorities and implementation plans must be finely balanced.

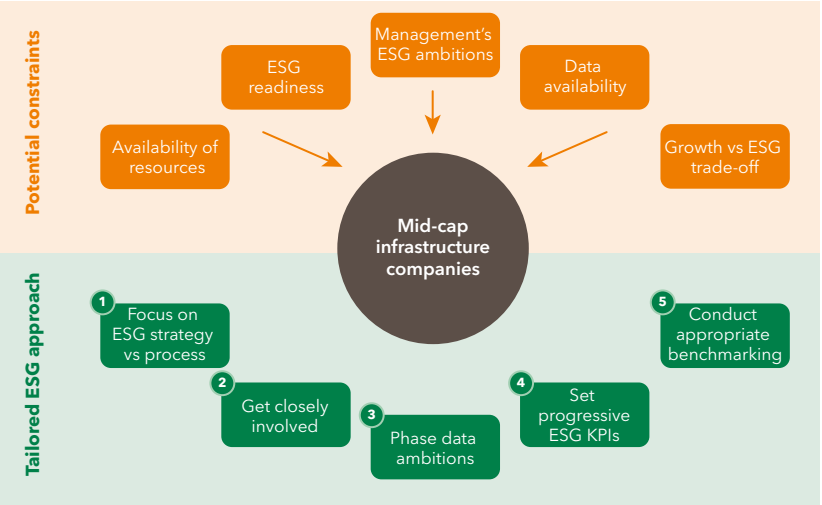
Furthermore, when sustainable companies' operations expand or greenfield construction lies ahead, the year-on-year environmental footprint of an investment may deteriorate during business ramp-up and construction. This makes benchmarking particularly complex in those phases, though not impossible, and longer-term ESG goals need balancing against shorter-term

negative consequences. For instance, a company's growing water consumption may be distorted by the increase in FTEs as operations expand, while consumption per employee shows a decreasing trend thanks to effective resource management measures.

Facing these ESG challenges looks like hard work and this is where Thomas Edison's wisdom comes to life. These challenges are not reasons to exclude sustainable mid-market investments with scope for ESG improvement from a pipeline, but rather to include them. They are opportunities for the investment manager to add value during ownership and at exit, by providing resources, expertise and strategic guidance.

Since 2018, the average GRESB score of our managed portfolio grew from 58 (out of 100) to 95, as alignment to best practices was delivered. We have experienced at first hand that shareholder-driven ESG transformations can definitely happen and bear fruit.

ESG in the mid-market: approach and potential constraints



Source: Vantage Infrastructure

Data – to have or not to have?

A growing thematic in the ESG world is reliance on data to drive investment decision-making and change. Many data-related solutions are emerging to streamline collection and analysis for companies or managers, but they are only as useful as the information they are populated with. Benchmarking assessments seek to provide impetus to data provision and support to standardisation.

Data constraints for a mid-market company will become apparent at the due diligence stage, with three key questions for the investment manager: Is the data available now or will it be in the future? How will I be able to access it? Can I analyse it using the same investment framework applied also to larger companies?

During the due diligence phase of our most recent equity acquisition of a mid-market infrastructure company, we sought to establish alignment of the company's activities with the EU taxonomy using Vantage's in-house EU taxonomy process and tool. As technical criteria are 'pass' or 'fail' in nature, lack of complete data makes the exercise challenging. The task is no easier for minimum social safeguards, where information may be even scarcer, and judgements are required.

The data environment of a mid-market infrastructure company can generally be improved post-acquisition, but this needs to be driven by the shareholders and embraced by management. On the debt side, engagement is key to ESG information access – both pre-investment, when disclosure obligations can be negotiated into lending documentation, and on an ongoing basis through constructive dialogue. The response can be dependent on the willingness and capacity of management to act, but given the typically smaller lending syndicates to mid-market transactions, lenders' ability to steer outcomes can often be more meaningful than when we are one of many voices all demanding different metrics.

> *"ESG challenges are opportunities for the investment manager to add value during ownership and exit"*

Do these data challenges mean that our ESG risk assessment frameworks are also not fit for purpose in the mid-market segment? Or that our requirements for ongoing disclosure need to be downsized?

That is not our experience. We have consistently managed to apply both our equity and debt ESG risk frameworks to companies of different sizes and at varying stages of maturity. We have also not reduced our ESG ambitions and expectations due to size.

But to make this possible, we must be methodical in drawing ESG lessons from the management of broader portfolios and adapting them to each company with a tailored implementation plan.

In conclusion, investing sustainably in the infrastructure mid-market space presents unique opportunities, which outweigh the ESG challenges. ■