The Bridge

Interest in sustainable Alternative Investments (AI) is picking up

Topic of the month January 2014

The Gap

In meetings with institutional investors we have noticed steadily increasing interest in sustainable Alternative Investments (AI). These benefit from strong secular drivers towards higher resource efficiency, environmental improvement and natural resource production. Investors are primarily motivated to identify attractive assets to diversify their portfolios and income streams in light of high valuations in many fixed income, equity and real estate markets. Some also mention expected attractive financial returns for certain strategies, or desire focused exposure to value drivers that may not be found in public markets. For example, a specialized sustainable timberland investment strategy is an opportunity to invest in biological growth while explicitly excluding land price speculation due to potential development.

'One reason for Alternative Investments is to focus on value drivers that may not be found in public markets'

Nevertheless, there is an obvious gap between acknowledged fundamental logic and serious interest in sustainable AI, and the number of investments closed by institutional investors. One explanation lies in misconception: for example, many do not appear to differentiate between *"Clean Economy Private Equity"* and *"Cleantech"*. The former involves managers typically raising fund II or higher to provide growth capital for mature and established enterprises across a wide range of industrial sectors. Portfolio company growth stems from attractive products and services that concurrently offer tangible cost and environment benefits. The most common exits are trade sales. This is vastly different from Cleantech funds focused on capital intensive, early stage technology ventures, often with high valuation multiples dependent on IPOs for exit.

Information barriers and lack of solid processes are another explanation. Often, a new hot topic is effectively marketed by banks and investment managers – posing a challenge for investors without dedicated in-house sector expertise. The most attractive strategies, and specialized boutiques with deeper experience and a longer track record but limited marketing capability, may not be known by investors, especially international ones. One example is a green real estate investment strategy that focuses on undermanaged buildings in good locations with significant potential to materially reduce energy consumption and associated cost, and to generally increase tenant appeal. This contrasts with investing in the much more limited universe of high profile new blue chip developments that represent merely a fraction of the real estate market.

It's mainly about people and diligence

How can this gap be closed, effectively and efficiently? The first building block is management team quality and platform strength. The second building block is diversification, including a variety of asset types and underlying value drivers, strategies, geographies, managers, vintage years and cash flow profiles.

In the fund manager diligence process we want to see a good mix of backgrounds that must include solid financial/Private Equity and relevant industry and local market expertise. We stay away from teams and propositions that appear opportunistic or are overly marketing oriented. Typically we also stay away from first time funds. It is important that a team has demonstrated it can function during ups and downs for a number of years, and typically has had some successful liquidity events. That said historic data for managers investing in less established themes is often limited. In such cases, we investigate the next level of qualitative and quantitative indicators to form a thorough investment opinion.

We prefer asset managers who have conviction that sustainability complements financial and risk metrics (and does not dilute them) and are passionate about investments that improve environmental performance and create financial value.

The third building block is rigorous, structured diligence processes. Thorough investment due diligence must be complemented by separate legal and operational due diligence focusing on manager platform and processes. Consequently we have a four-eyes principle that requires four people to visit a manager on site before investing. Post-investment, ongoing fund manager engagement on investment and operational matters, and regular transparent client reporting, should be a matter of course. Finally, processes must be well documented with adequate detail, and available to clients.

Even when working with a specialist advisor, a client must commit to intellectual involvement and an additional investment in time and money relative to investing in traditional asset classes. And it takes a bit of courage to overcome the gap. Sticking to known territory is easier. But the opportunities for those who have built or found a solid bridge to the other side are very real.

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EBG Investment Solutions AG advises institutions and high net worth families build, manage and grow sustainable alternative investments.

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