



# Debt and Equity Market Updates

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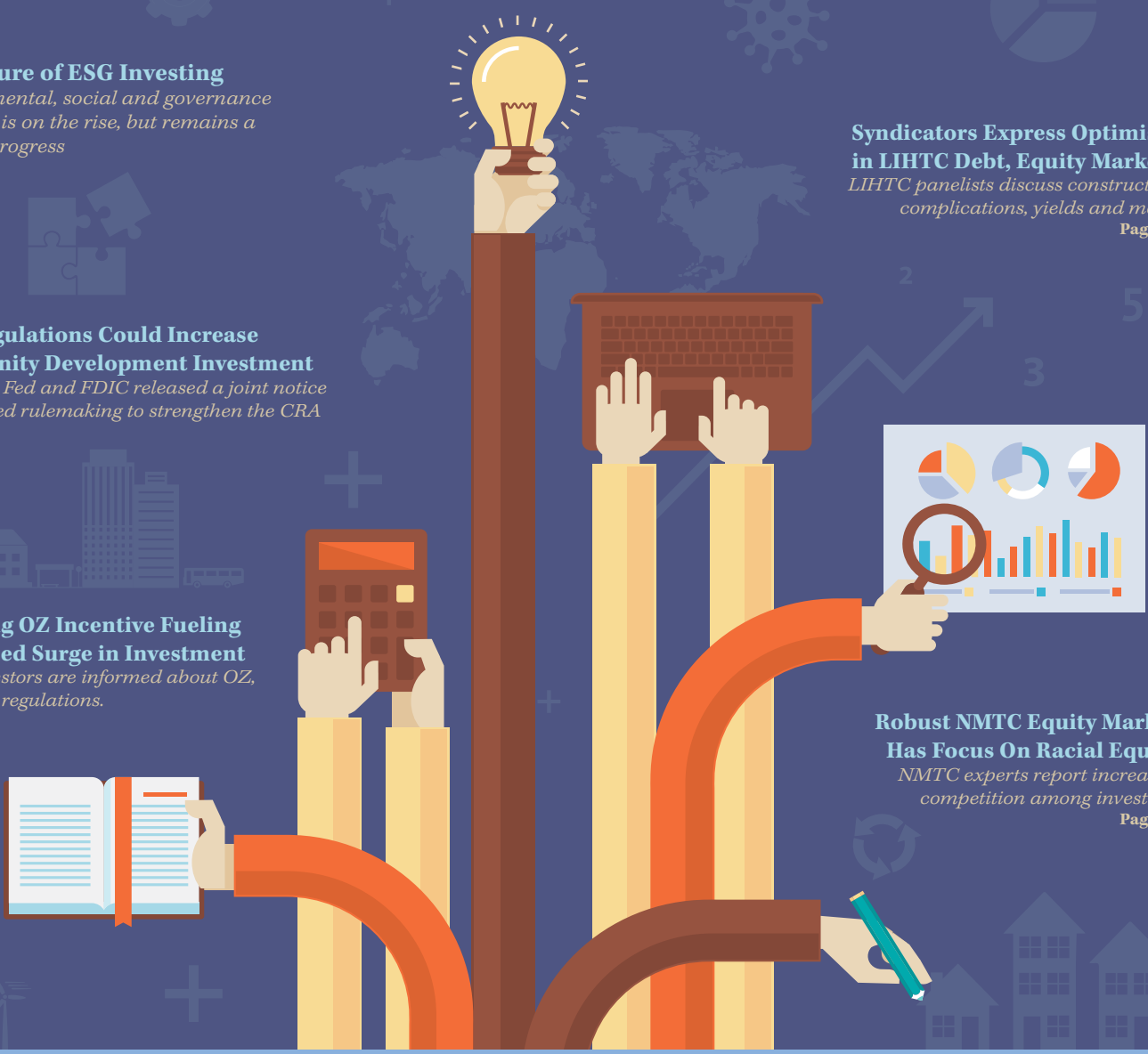
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# ESG Investing: Where it is Now; Where it's Headed; What to Do



MICHAEL J. NOVOGRADAC, CPA

The expanding awareness and interest in ESG—environmental, social and governance—investing could lead to a seismic increase in investor demand for community development tax incentives, but we are not there yet. Syndicators of and investors in community development tax credits report that while the subject is at the forefront of most conversations, ESG motivations behind investment selection remains a work in progress.

“It comes up 100% of the time in discussions, but how big a focus it is varies,” said Bryen Alperin, director of renewable energy and sustainable technologies for syndicator Foss & Co. “For some groups, it’s icing on the cake, for others, it drives why they’re investing.”

The change has been meteoric, moving from the shadows to center stage.

A late-2021 survey by independent investment firm The Private Office showed that 41% of respondents said ESG was very important to their investment strategy, a jump from 24% a year earlier. A report by French corporate and investment bank Natixis revealed that the percentage of institutional investors with an ESG element to their strategy rose from 65% to 77% from 2019 to 2021.

“Today, it’s very, very important,” said Melanie Beckman, chief ESG officer and director of tax credit investments at tax credit syndicator Monarch Private

Capital. “Two years ago was a different story. I think COVID, along with a new administration, has thrown ESG to the forefront.”

The emphasis on ESG investment for existing investors—and the potential for bringing in new investors motivated by such investment—means stakeholders in various community development tax incentive worlds are working hard to keep up.

## ESG: The Definitions

To better understand the potential of ESG motivated investing, we must start with defining the meaning of various terms. We must level set.

Environmental (the E in ESG) focuses on the conservation and improvement of the natural world. For investments, this includes examining an investee’s carbon footprint—which can range from funding a business that contributes to an overall net reduction in

societal carbon emissions to selecting a business that has a smaller carbon footprint than another.

Social (the S in ESG) is concerned with people and relationships. For investments, this includes accessing the investee's effects on a broad range of social issues—racial, LGBTQ+ and gender equity; access to healthy housing, food and water; income equality and much more. Generating positive social impacts includes providing facilities (including homes) that benefit underserved communities and financing organizations that work with such populations.

Governance (the G in ESG) concerns standards and recommended practices for operating a company, including business ethics, risk management and assessing the purpose of an organization and how it impacts society.

From an investment perspective, a critical issue is the lack of shared definitions and universal metrics.

### **Rising Profile for Traditional, Nontraditional Investors**

ESG has a rising profile for traditional tax credit investors—primarily banks and insurance companies.

Maria Barry, community development banking national executive at Bank of America, says investors are working to create the best ESG platforms—which could lead to more such investment. She shared a recommended practice.

“As you build an ESG strategy, you’ll notice that many issues are related,” Barry said. “Ensure that your strategy recognizes the complexity and intersectionality of these issues and addresses root causes. For example, lack of access to housing correlates to intergenerational poverty and racial inequality. If your goal is to drive greater racial equity, affordable housing may be a key pillar of your strategy.”

Zack Boyers, president and CEO at U.S. Bancorp Community Development Corporation, said his organization has always valued ESG investments.

“We haven’t changed our tax credit investment approach as a result of ESG because we’ve always been focused on projects with environmental and social impacts,” said Boyers. “We are seeing increased interest in tax equity across product types due to the alignment to ESG. It is driving a need to measure and track financial and sustainable benefits more closely, which we believe will help set standards for the industry.”

Tax credit syndicators say emphasis on ESG investing has increased—although receiving Community Reinvestment Act (CRA) credit and achieving an adequate financial return are preeminent, particularly for investment in equity for low-income housing tax credits (LIHTCs), new markets tax credits (NMTCs) and historic tax credits (HTCs).

“For banks, it’s CRA credit,” said Erik Wishneff, chief executive officer at tax credit syndicator Brian Wishneff & Associates. “I suspect that’s because CRA is regulated. Banks get reviewed on their CRA performance.”

Beckman agreed.

“CRA might be [most important for LIHTC properties], then return, then the social aspect,” Beckman said.

It’s important to note that the CRA is a social impact program designed to encourage banks to increase equality and investment in low- and moderate-income communities—a primary goal of ESG investment. So CRA- and ESG-motivated activities are not at cross purposes.

ESG investing could also soon be more of a driving force, thanks to a proposal made March 21 by the

Securities and Exchange Commission that would require registrants to include certain climate-related disclosures in their registration statements and periodic reports.

For some investors, ESG is the top factor. Alperin said the increase is especially obvious with nontraditional investors in tax credit equity—he said ESG is a major driver for many of those companies.

Matt Reilein, president and CEO of National Equity Fund, a nonprofit affordable housing tax credit syndicator, says that when nontraditional LIHTC investors inquire about affordable housing, it is generally because it applies to ESG. “We’re seeing non-bank investors asking more about our investments and starting to invest because they see [LIHTC investments] as a fit [for their ESG goals].”

### **Tax Credits: Clean Energy at the Forefront**

As you might expect, clean energy tax incentives see the most interest from ESG-motivated investors, since the E in ESG provides a direct connection to clean energy by allowing investors to offset their emissions.

“It’s very attractive to corporations to be able to [offset] their carbon footprint, achieve some of their environmental goals and also be able to generate a return off those investments,” Beckman said.

That’s as close to a universal view as you’ll find in community development finance related to ESG: Clean energy benefits most from investor focus on ESG. While the social impacts of affordable housing, community development and historic preservation are linked to ESG, the driving force of ESG motivations for these industries are harder to clearly identify.

“I think with all real estate-based credits, it requires further evaluation of the underlying project, instead of assuming that the development is going to check that box,” Wishneff said.

ESG investing hasn’t had as great a discernible impact in those areas, although it’s increasing. Syndicators know it’s important to have an answer ready.

“The clear entry into talking about ESG to potential LIHTC investors is that housing is foundational to all sorts of social opportunities for families and individuals,” Reilein said.

Wishneff said NMTC investors are naturally inclined to focus on measurables as desired by the Community Development Financial Institutions Fund. He said HTC investors often consider their investments as part of an ESG plan, but with more of an emphasis on social benefits, as in affordable housing.

“For historic, you can get some of the E part with the reuse of a building, but beyond that, it’s all about the underlying project,” Wishneff said. “Not all projects are equal.”

### **How to Measure?**

While clean energy properties have readily available metrics to assess the environmental aspect of ESG, participants in other incentives are having to find a way: Calculating the internal rate of return (IRR) on a property is a math issue; measuring a CRA score is a strategy issue. Improving ESG performance is more nebulous.

Beckman emphasized that there’s no uniform set of guidelines or tools to measure various impacts nor how often to measure them. She said that while there are attempts to measure environmental and social impact, governance evaluation is still evolving.

In the LIHTC world, Reilein said the responsibility for providing metrics falls on the production side: “It’s incumbent on us as an industry to be able to make the case and articulate clearly what the social impact is, what the benefits of our investments are so investors can start to determine the value they’re going to place on those ESG outcomes,” he said.

Reilein said industry groups are working toward those standard measurements and that it's reasonable to think that within two years there could be industry standards to measure affordable housing ESG.

That is an important evolutionary step.

“Without that infrastructure of standards, it's hard for an investor to figure out the value,” Reilein said. “I believe we have a fantastic story and a really strong position within the social aspect of ESG, but we need to be able to consistently share it.”

### ESG as Negative Motivation

While most participants view ESG as an opportunity to increase investment in community development tax incentives, Alperin pointed out the other side.

“For some traditional investors, concern for ESG may come from a risk perspective,” Alperin said. He cited the consideration of investing in IRC Section 45Q carbon oxide sequestration credits for a coal plant. “An investor may be concerned that it's for a coal plant and they don't want to touch coal,” he said. “They don't want to be seen as keeping a coal plant open.”

### Forefront of a New Wave

Regardless of the hurdles and challenges, ESG investment is here to stay.

Already a significant force in green energy tax incentives, it is gaining momentum in other community development incentives. CRA credit and IRR remain the primary drivers of much investment, but the growing importance of ESG investing keeps increasing. Within a generation, Reilein expects every investor to have an ESG component in their analysis. Beckman said this is just the start.

“We're on the very forefront of this new wave of what the new world is going to be,” Beckman said. “Sustainability is the new norm. It's going to take a few years until everyone's comfortable with what they're disclosing and measuring those initiatives and tracking whether they're achieving those goals.”

Wise participants in community development incentives recognize the truth: ESG investing will play an increasing role and preparation by creating standard measurements and emphasizing the environmental, social and governance benefits of any investment will only gain in importance. So will being able to translate the risks and opportunities of various community development incentives as well as being able to connect those risks and opportunities to the larger ESG landscape. ❖

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