

## SUSTAINABILITY

# Distinctions in the taxonomy of sustainable, impact and ESG investing

What does it mean to invest with purpose? Doing good takes all shapes and forms but ESG integration is critical, says **Craig Cogut**, founder and chairman of Pegasus Capital Advisors



**Cogut:** ESG is a vital part of the 'net' impact equation

"Doing good, it seems, is better than feeling good," said a recent *New York Times* article highlighting research showing that having purpose in life can have profound positive health implications.

That struck an immediate chord at Pegasus, where as a firm focused on both sustainability and wellness (what we call "S+W"), we firmly believe that true well-being flourishes on a strong foundation of purpose. First, of course, we believe that investing in companies with a specific purpose, or "impact", brings our employees and those at our portfolio companies a greater sense of purpose, and therefore, a better quality of life. This is particularly meaningful for us – how can we focus on investing in wellness without taking into account the welfare of our own staff?

In many ways, the article captures the spirit of what we believe and do within the responsible investment industry – one might find instant gratification and evanescent benefits from short-term financial gains, but longer term, our own financial success as asset owners and managers can only flourish if we take a more holistic view at creating shared value. This idea seems to be increasingly embraced by investors, as evidenced by the growing popularity of sustainable and impact investing.

But what does it mean to invest with purpose? The *New York Times* article reminded me of our own journey from sustainable investing, to investing with impact, and critically, investing with an ESG overlay which we believe can serve as a significant risk mitigant and potential value-enhancing approach. As interest in the fields grow, it seems there is a tendency to confuse the terms in a manner that downplays the potential value of ESG in the investment

process. For instance, many news articles seek to examine ESG investing, but actually end up focusing on sustainable investment themes, rather than ESG integration. And some in the impact field have explained that they feel it is enough to focus on impact investing – an overlay of ESG could be too much. In this latter case, it would be inaccurate to call this strategy responsible investing.

For many, including ourselves, sustainability has been a bit of a catch-all term referencing businesses that have positive impacts (eg, renewable energy) and/or selective initiatives to manage your business responsibly (eg, reducing waste in your manufacturing process). Impact, on the other hand, has been about intentionally choosing investments focused on specific outputs and outcomes, and measuring and managing them (so renewable energy is still a relevant example, but with intentionality and outcomes added). Again, there is not necessarily comprehensive ESG integration.

At Pegasus, we've found value in distinguishing sustainability and impact investing from ESG/responsible investing. The differences for us are about efforts to comprehensively apply an ESG lens across all investments, whether those investments have specific intended impacts, or not.

## SUSTAINABILITY, IMPACT AND ESG

While we might be attracted to S+W industries, we seek to do so with a strong commitment to our core values and ESG principles. For instance, renewable energy is increasingly attractive as an investment opportunity with potential for strong returns and is identified as an impact and sustainable investment. Yet, in our approach we overlook issues like human

## A SUSTAINABLE JOURNEY



### SUSTAINABILITY

#### Sub-sectors:

- Energy
- Water
- Food
- Built environment
- Waste & recycling

### WELLNESS

#### Sub-sectors:

- Microbiome
- Sleep & mind-body
- Nutrition
- Wellness destinations
- Complementary medicine
- Brain health

As the global awareness of climate change and health and wellness continue to evolve, Pegasus has recognised the need for solutions to these issues, culminating in an increasing focus on sustainable industries with positive environmental and social impacts. This philosophy is demonstrated by the firm’s increasing exposure to the sustainability and wellness sectors across its funds to the point where 100 percent of its most recent fund is invested in these sectors.

## COMMUNITY ENGAGEMENT

Renaissance Downtowns is focused on combating the harmful impacts of suburban sprawl by creating compact, mixed-use, and transit-oriented real estate developments that provide alternative mobility options for suburbs by encouraging walkability, public transit and biking. Their model also encourages green building design and healthier, more community-based social impact lifestyles. The company is committed to addressing suburban poverty by bringing development to economically troubled communities that suffer from disinvestment, particularly through progressive community engagement model in an effort to support inclusive growth.



**Success story:** graduates of the SEPA Mujer leadership training course, which was supported through Renaissance Downtowns

rights, health and safety of workers, stakeholder engagement and biodiversity, the investment’s integrity of purpose erodes, along with the longer-term success of our investment.

It is no longer a sustainable investment to us as investors seeking a financial return, or to society, if workers aren’t cared for, if host communities are unhappy, or if we sacrifice critical biodiversity. It is like playing a game of “whack-a-mole” – one issue is resolved, but others pop up. And many of these “externalities” can frequently jeopardise the very financial success of the impact investments we are trying to make. Is this responsible and investing with purpose?

The same can be said of any investment in wellness – making a positive impact given a particular illness or ailment is great, but the best results will come from a product that is well tested, has responsible supply chains and good governance, among other factors. This is the point of ESG. At Pegasus, we care not just about impact alone, but making a “net-positive” impact. ESG is a risk-mitigant and potential value enhancer in any industry, whether an investee has the stated intention of making a positive impact with its products or services, or not. As the popularity of impact investing, sustainability and ESG grows, it is important not to confuse their meanings.

## OUR JOURNEY

Like many, we at Pegasus have grown over time in our approach. We first saw the opportunity in S+W industries as a way to make a positive impact while achieving attractive returns. Resource scarcity, resource efficiency, climate change and consumer health preferences were all becoming more sustainable, and identifying a market opportunity, we started to invest with these themes as early as 2000, in our second PE fund. Over time, our experiences in these industries, coupled with increasing research making the case for sustainable investing, led us to the point where our most »

## MAKING A POSITIVE IMPACT



Pegasus has seen some impressive environmental gains by focusing on sustainability and wellness.

- Climatec, an energy service company and a Pegasus portfolio company until the exit in 2015, reduced energy usage by approximately 200 million kWh annually.
- Another portfolio company, Organix, synchronises food waste with sustainable back-end recycling alternatives, focusing primarily on the conversion of collected waste into nutritional livestock feed for farms and feedlots. This diverts waste from landfills, thereby avoiding methane emissions (a greenhouse gas around 30 times more potent than CO<sub>2</sub>). In 2016, the company collected an estimated 400,000 tons of food waste from approximately 7,000 supermarkets and retailers across over 36 US states.

» recent fund is 100 percent invested in S+W.

With regards to ESG, throughout our history, Pegasus has increasingly evaluated such risks and opportunities on a deal-by-deal basis. For instance, investments in companies operating in the industrial sector have typically involved intensive due diligence and ongoing reporting on environmental, health and safety issues, while an investment in a small business services company in a leased office space does not necessarily require such an approach.

Pegasus's success in integrating ESG into the firm's investment practices, combined with the wealth of research and evidence supporting the benefits of formalised integration, led the firm to commence an initiative to formalise and communicate the approach in 2014. This is a critical puzzle piece to purpose, and it was important for us to institutionalise it. As part of this programme, we launched an ESG Leadership

Plan to serve as a guiding aspirational document that lay the foundation for more comprehensive integration.

Toward the end of 2015, we decided to develop an ESG Management System ("ESG-MS"), comprising of policies and procedures to guide ESG practices across the firm, beginning with a focus on the investment process. The ESG-MS, developed in 2016 and launched in February 2017, is an internal-use document that includes guidelines on ESG integration at each stage of the investment cycle, including deal sourcing, due diligence, investment agreements, monitoring and reporting, and exiting. It outlines the relevant policies, roles, responsibilities, management plans, reporting frameworks and performance management structures to guide Pegasus's ESG and impact approaches.

The ESG-MS was developed to provide a more comprehensive framework by which Pegasus can enhance its positive

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environmental and social impacts and strive to mitigate or avoid potential negative impacts of its investments, while seeking to implement good governance structures for the benefit of Pegasus investors in the long term. Various ESG frameworks were evaluated for their appropriateness and applicability to Pegasus's investment strategies and decision-making processes. A policy summarising our approach is now published on our website, and our first Annual Sustainability & ESG Impact Report is also published there. The latter shares a more detailed story of our sustainability, impact and ESG journey, as well as goals for the future. Our ESG-MS is a dynamic document – we are continuously learning and improving.

### CRITICAL PART OF THE TOOLBOX

So why the emphasis on ESG and responsible investment? In impact, we feel the end cannot justify the means. While we are grateful for the increased interest in impact investing and sustainability, these are, as we've learned on our own journey, concepts distinct from ESG, which we believe can be a strong risk mitigant and source of value creation. As the asset management industry looks to impact and sustainability as a source of value, we hope that ESG is not considered a separate strategy or field, but rather a critical part of the toolbox – a lens applied to all investments. ■

*An active philanthropist, **Craig Cogut** founded Pegasus in 1995 and serves as its chairman and president. Prior to Pegasus, Cogut co-founded Apollo Advisors, where he was one of the original partners.*