CHRISTOPHER WEIL & COMPANY, INC.
A Wealth Management & Financial Advisory Firm

REPORT & COMMENTARY

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TO: **CUSTOMERS & FRIENDS**
FROM: **CHRISTOPHER WEIL & COMPANY, INC.**

In my last quarterly commentary, I wrote on the emergence of Environmental, Social and Governance ("ESG") criteria as guides for assessing the suitability of proposed investment opportunities. I wanted to make a number of points, some of which it turns out were not made as clearly as initially intended.

So, I set out below what I hope will prove to be both a clarification and an amplification.

1. These are early days yet and there is no common understanding among investors, advisors, academics, financial journalists, activists, regulators and/or other interested parties as to what constitutes an agreed upon set of ESG criteria (or standards or "rules"). There is still a kind of wild-west element to the derivation of these criteria. Different parties focus on different measures, some consistent with those offered by other interested parties, some not; some clearly incomplete; and some in conflict. (A classic example of such a conflict: copper is a key ingredient of certain technologies critical to the mitigation of climate change; copper mining is an environmental "villain"; so, what's the ESG "rule" re: copper?)

2. There has been considerable pushback to the idea of ESG as a component of the investment decision-making process from those who believe that the application of ESG criteria may result in asset underperformance as compared to investments selected using traditional investment selection methodologies (which may not include ESG considerations).[1] At least some of that push back, I think it is fair to observe, arises from sources who have, to put it mildly, conflicts of interest. Many (though not all) of the ESG sceptics represent, for example, businesses like coal and hydrocarbons that would be marginalized in the event that ESG criteria enjoy widespread acceptance. (There is some ambiguity here. Among those who push back are investors or investor representatives who at the same time object to investments in companies whose products or services are deemed to be inconsistent with "community values" [or at least *their* community's values] – gambling, tobacco, pornography, and alcohol are examples – even in cases where these businesses might otherwise be candidates for investment in accordance with "traditional investment selection methodologies.")

3. There are at least two distinct motivations driving the ESG phenomenon, from my vantage point (though other motivations and groupings are both possible and welcome for discussion). In theory, they can be distinguished, but in practice, they tend to overlap. Group One is motivated by a desire to "save the planet"

[1] One of the consequences of being early in the game is that there is controversy as to whether the adoption of ESG investment criteria will negatively impact investment performance (*see*, for example, https://hbr.org/2022/03/an-inconvenient-truth-about-esg-investing). My own view is that, *long term*, businesses conforming to ESG criteria will likely outperform their non-ESG competitors. But how long "long term" is remains an open (and serious) question.

(from environmental degradation, from widespread poverty and hunger, from climate change from inadequate health care … the list goes on). Members of this group recognize that business enterprises, and particularly public companies, "enjoy" a unique position *vis-à-vis* these great issues. In many cases, such businesses may be a significant "part of the problem" (providing inadequate health insurance for employees, generating environmental pollution, exploiting foreign labor, etc., etc.). It is obvious to Group One that an economy consisting of enterprises run in accordance with ESG criteria would contribute meaningfully to "saving the planet." This group further believes that, while enterprise profitability is certainly important, if profitability has to be compromised to achieve a desired outcome, then so be it. The ESG considerations necessarily require sacrificing profit for the sake of (questionable?) social engineering gives rise to much of the opposition to ESG.

Group Two believes that the adoption of ESG criteria (even in their current unfinished state) need not involve a compromise of enterprise profitability. Group Two places a high value on sustainability, for businesses no less than for the planet. Properly managed, good companies get better over time. Warren Buffett believes that the ideal holding period for any investment is forever. I tend to agree. If this is at all correct, then to satisfy a forever hold, the adoption of ESG criteria insofar as company operations are concerned will go a long way towards assuring that company's sustainability.

Why this should be so seems obvious to me. A company whose culture involves environmental sensitivity and concern for the well-being of its employees and the communities in which it operates, one where employees look forward to the workday and are proud of what they do … What is the likelihood of this company being in business for the next five, ten, twenty years and beyond? I'll take that bet.

But (I hear you say) sustainability and profitability are not the same thing. Well, consider: sustainability means being here through good times and bad, through every kind of economic condition. By its nature, sustainability involves long-term thinking and planning. A focus on profitability *may* involve these considerations as well, but often does not. Profitability often translates to a preoccupation with quarter-to-quarter (that is, short-term) performance. It is no accident that you never hear the phrase "financial engineering" used in relation to sustainability. You may be able to financially engineer at least short-term profit, but you cannot financially engineer your way to sustainability. I do not want to own a company whose profitability is engineered – unless of course I am interested in taking a profit when a company's stock price reflects the company's current profitability and I have a profit in the stock. But I consider that speculation, and I am an investor not a speculator. I favor long-term investments in good companies versus shorter-term profit-taking strategies because I believe the former has proven more profitable (for me and others we represent) than the latter.

I was in a jocular mood when I suggested that Milton Friedman (of "the only social responsibility business has is to make a profit" fame) might well be a member of Group Two today, particularly if by "profit" he meant something more like what I have called sustainability (which is really another way of saying "sustainable profitability," without which, a company disappears). My view is simple. ESG was originally energized by people in Group One ("Save the Planet") and then adopted by people in Group Two ("Save the Company") who realized that ESG practices contributed to enterprise sustainability, which is to say enterprise ability to sustain profitability. Thus, Group Two membership would, I hope, meet with the approval of Milton Friedman.

But I say again: none of this is easy.

Just in time to accompany this commentary, I came across an investment opportunity that poses an interesting ESG conundrum. Yes, yes: you will say (correctly) that this is not the type of business that would likely be

subjected to an ESG analysis in the first place. It is a real estate partnership (while ESG is normally applicable to corporate entities). It's relatively small (where ESG is normally applicable to businesses with larger capitalizations). It involves few employees (instead of the larger number of employees which ESG-criteria usually assumes). And it is designed for a "retail" (that is, an individual versus institutional) investor. But humor me: because there was one feature that made it worth considering as an example of how applying ESG criteria can be fraught.

The real estate venture in question specializes in acquiring Class C apartment properties (older buildings, lower-income tenants, located in less desirable parts of town, often in need of capital improvements and/or refurbishment) and subjecting them to serious renovation regimes. In practice this means buying at, say, a cap rate of 7.5%,[2] then spending, say, $200,000 on new appliances, paint, landscaping, etc. with the expectation that more affluent tenants will be attracted, rents will go up and the applicable cap rate will go down. If this strategy works, and it usually does, the new rents may increase such that scheduled net income rises to, say, $95,000 and implied cap rate of the property decreases to, say, 6%.

Assuming a loan of 80% loan-to-purchase-price (somewhat higher than typical but built into this amount is a "credit" for expected increase in property value which some lenders will allow), the equity required to purchase and improve the property is $400,000 ($200,000 for the "down payment"; $200,000 improvements). Put all these numbers together and the new property value upon successful upgrades and re-tenanting might be approximately $1.58 million with a "new" cap rate of 6% on a $95,000 net income after expenses. (To calculate the new fair market value just ask … "$95,000 is 6% of what?")

Assume sale of property for $1.58 million. Pay off debt of $800,000. Return equity of $400,000. Voila! $380,000 left over. Note that to illustrate the opportunity I have used an optimistic case. Actual results would differ based on a ton of different variables (cost of money, cost of labor and materials, timing of permit issuance, time to complete renovation, time to rent up). But it is usually true that whoever prepares a *pro forma* for this kind of opportunity will be able to make a compelling case for investment.

So what would it look like to view this venture through an ESG lens? Does this business model serve or violate the "Social" feature in ESG? It aims to "upgrade" between 9,000 and 10,000 Class C apartment units in a number of U.S. cities (and with them, perhaps, the neighborhoods surrounding those buildings). But consider: if the typical Class C apartment tenant is already spending as much as 50% of family income for rent; and a new owner upgrades property to, say Class B, with a corresponding 20 or so percent increase in rents; and the typical tenant cannot afford the increase; then where does that tenant go? Recall that in most urban areas, apartment rents are rising because demand greatly exceeds supply. This is more or less true for those who can afford $5,000 monthly rent; it is absolutely true for those who can afford up to, say, $2,000.

The consequence of moving 9,000 or 10,000 apartment units from Class C to Class B may be to effectively put thousands of people in a condition of serious housing dislocation. Some will find alternative housing (in a market where demand exceeds supply and new supply is agonizingly slow to come on line); some will move in with relatives; some will migrate to areas where housing costs may be lower but wages are lower as well; some will find low-income housing (or end up on a five-year waiting list); some will end up homeless.

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[2] A "cap rate," or capitalization rate, is a way of pricing real estate based on the return on investment a buyer can anticipate from acquiring and renting out the property. If a property has a net operating income of $75,000 and a cap rate of 7.5%, it would be valued at $1,000,000 (75,000 / 0.075 = 1,000,000). In other words, an investor would be willing to pay $1,000,000 for the property because they expect to earn a 7.5% return on their investment.

No one will deny that homelessness is, in many communities, a severe negative social impact. ESG criteria (and, in this case, criteria for determining S) includes concerns about investing in businesses whose products or services tend to undermine the health and well-being of the community. How would the ardent proponent of ESG feel about investing in a real estate partnership that may aggravate what is already a nationwide housing crisis? At the same time, what is the ESG perspective on letting below-par housing simply remain below par?

The easy answer to this ESG conundrum is simply the negation of the ESG thesis: a business is not a social service agency. Let business do what it does best – create wealth – and let government or non-profits provide the social services needed to ameliorate whatever the negative impacts of business operations happen to be. (Put aside for the moment the fact that many people who support this argument also happen to believe in small government and minimum taxation.)

A more subtle ESG approach might recognize that the history of the American economy is full of examples where government steps in to prevent businesses from benefiting from what are deemed inappropriate externalities. (An externality is a consequence of economic activity that affects others but is not reflected in the cost of the goods or services involved. I was born and raised in Los Angeles where policymakers at some point looked up into the smog-choked sky and decided people would no longer be permitted the "externality" of dumping the by-product of cheap, dirty, unregulated internal-combustion engines into the air for everyone else to breathe.) In the case of apartment rehabs, legislators could (and, in fact, sometimes have) decide that part of the benefit of economic activity can and should be shared with those affected (in this case, the tenants who bear the, often severe, "costs" of dislocation) by those who benefit from the dislocation (the new landlord who stands to make a significant profit as a direct consequence of the dislocation). You can imagine a requirement that landlords develop or redevelop new subsidized low-income apartment units equal to, say, 25% of the number of units being upgraded, within a, say, 5-mile radius of the property, providing alternative housing for those who might otherwise be un-housed. (But you can also imagine the real-world obstacles that NIMBY's and government agencies of various sorts might throw up, making the permitting process painfully slow and expensive.)

This apartment rehab business begins to look like an instance of irresistible force meeting immovable object: on the one hand, ESG standards ultimately achieve the status of best (investment analysis) practice while, on the other, owners and managers (and certainly some investors) resist abandoning what promises to be a successful business model. The partnership buying and refurbishing those units is not in the business of disrupting people's lives. It is in the business of exploiting economic opportunities. But as is so often the case (think downsizing workforces and offshoring jobs, among others) disrupting lives and exploiting economic opportunities can turn out to be two sides of the same coin. It's sometimes called "creative destruction."

The power to resolve deeply conflicting interests (and particularly, as in this case, conflicts between public and private goods) ultimately resides with the government. All ESG issues involve deeply conflicting interests. Whether it be big government or small government to which these interests are submitted for resolution, it must above all be a functional government. To which I say, only a bit tongue-in-cheek: "hope springs eternal."

Chris Weil