
Future Returns: ESG Investing in Nonprofit Municipal Debt

The environmental, social, and governance (ESG) investing trend has taken a leap forward recently from a stock-centered approach to include fixed income, but it has largely overlooked debt issued by community-based organizations that can have direct, measurable impact on pressing local issues.

Municipal bonds issued by small nonprofit groups working to bring about change in their communities can satisfy investors' growing appetite for impact investing ideas while paying yields ranging from 4.5% to 6%, says Buck Stevenson, managing director and portfolio manager at Silvercrest Asset Management Group in New York.

In contrast to green municipal bonds issued by large entities such as the Massachusetts Water Resources Authority or San Francisco Public Utilities, many smaller municipal bonds with the potential for social rather than environmental impact—the "S" in ESG—have been strikingly absent from the values-based investing dialogue, Stevenson says, adding that he is working hard to change that.

"We are educating our clients that you don't have to look far to do good in your community," he says. "We're talking about issuers that fly under the radar—you wouldn't know them unless you were in their local area."

Nonprofits Fill Vital Needs With Debt

Community hospitals, charter schools, and organizations providing mental health care and veterans services are among the groups that are typically structured as nonprofit organizations with 501c(3) status, and can issue debt to raise funds for improvements, new facilities, equipment, and other needs.

These services fill a critical need and are nothing new, "but they've never been looked at as an impact investment, which is what they really are," Stevenson says. "We're not reinventing anything; we're trying to highlight the good that these financings do to communities. You can visit facilities and see exactly what your investment built."

Consider the New Dawn Charter School in the Carroll Gardens neighborhood of Brooklyn, N.Y. The school's mission is to draw kids back to school who have fallen out of the education system. Earlier this year, the school issued $20.6 million in 30-year debt to buy and renovate a new facility. The yield: a tax exempt 5.37%.

"This is a very good investment, and to top it off, the school focuses on finding kids who have dropped out and could have had problems down the road," Stevenson says. "It has 300 students with an 80% matriculation rate."

Another example in Silvercrest's portfolio is the Hopeway Foundation, a Charlotte, N.C., area provider of both outpatient and inpatient mental health services that focus on substance abuse rehabilitation, post-traumatic stress syndrome for veterans, and other issues.

A 30-year bond paying 6% is being used to renovate structures on 12 acres and attract top professionals. Hopeway has built referral services in its area, so when hospital services fall short, doctors can refer patients to its facilities.

These munis are considered to be riskier than investment-grade issues, because they are nonrated. But that's typically because they are such small deals, "not because the credit is no good," Stevenson says. "If you're talking about a $20 million deal or a $7 million deal, to pay an extra $100,000 to get a rating doesn't make sense."

Making Sure the Deals are Strong

Due diligence is where Silvercrest's credit research team pulls its weight. Stevenson wants to see a solid balance sheet with manageable debt levels, strong demand, and sustainable revenues. He avoids rules of thumb when it comes to what constitutes too much debt, particularly for health-care facilities because their compensation methods vary. Medicare reimburses at a higher level than Medicaid, for example—so a manageable level of debt will vary depending on the composition of reimbursements, among other factors.

Beyond a financial analysis, Stevenson wants to see a good answer to the question, "Does this facility need to be there?" he says. "If there is a problem and people work together to solve it, that's an important factor that's not going to show on a balance sheet."

Strong community support is a powerful driver of these organizations' success and an important sign to investors that an issuer has the potential to make good on its debt. For example, when the folks in King Fisher, Okla.—a city with a population of roughly 4,900—voted overwhelmingly to raise the local sales tax by 1% to help support their local 25-bed hospital, the resounding support caught Stevenson's attention. The hospital's debt, issued to rebuild its facility, is currently a part of Silvercrest's portfolio.

Really, All Munis Have a Social Bent

Taking a step back from these smaller issuers, which account for about $220 billion, the $3.7 trillion municipal bond market in general can be viewed as strong investments for values-based investors. Muni bonds, by definition, bring about improvements in water systems, infrastructure, schools, and other aspects of daily life.

But it can be harder to feel as connected with, say, a massive international airport renovation than with solving a problem in a community you feel connected to. Says Stevenson, whose firm has relationships with 30 small broker dealers around the country that help scout out smaller deals, "these munis are the 'S' in ESG."

Barron's

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