Infrastructure debt: The future is green

Sustainability and the energy transition have certainly remained at the forefront of government and public agendas, despite the pandemic. This is particularly true in Europe. It is also true that we're seeing an increasing emphasis on ESG from institutional investors.

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In addition to a long-term trend that has seen investors ever more focused on driving sustainability, an evolving regulatory framework, particularly with the EU Sustainable Financial Disclosure Regulation and the EU Taxonomy, has accelerated that journey over the past 18 months.

This regulation represents a new challenge for the industry because it impacts institutional investors in multiple ways, from the selection of assets through to reporting.

Government commitments suggest that infrastructure projects will remain at the forefront of economic development in the future. Going forward, we expect that sectors such as renewable energy and telecoms, which are aligned with sustainable goals, are likely to create attractive investment opportunities. Moreover, these sectors have the added benefit of resilience, as demonstrated by their solid performance throughout the height of the pandemic.

Interestingly, infrastructure's involvement in energy transition is simply not confined to renewable energy generation. In fact, the phasing-out of conventional energy sources and working within the utilities sector also present interesting infrastructure financing opportunities as well as the future development of green/clean hydrogen as a competitive alternative source of energy and storage solution to the intermittency of renewable energy.

Sectors that combine digital features with green energy and even transportation (such as electronic vehicle charging platforms or more generally green mobility) are all expected to contribute to a more sustainability-orientated future.

The roll-out of 5G technology, and the replacement of existing equipment, will also be a major infrastructure initiative in the coming years. 5G is expected to be up to 20x faster than 4G and should vastly expand the use of connected devices. This could favour the emergence of 'smart' cities and accelerate the transition to self-driving cars, as well as optimise the overall flow of traffic, improving air quality and reducing the number of accidents.

While these projects are vital to the transition to a more sustainable planet, they will not be funded by government spending alone. A significant amount of private funding is necessary to ensure their successful delivery.

Public spending is primarily being targeted towards public health at the moment – coping with the pandemic and supporting the subsequent recovery. The government purse cannot be infinitely extended, so the private sector is needed to take up the baton in the mission to create a more sustainable world.

An increasing proportion of infrastructure funds will need to be dedicated towards supporting ESG and sustainability goals and private markets will need to co-operate with governments if we are to meet 2050 targets.

This includes the social space as well. Assets in the healthcare and education sector have seen recent inflows from private capital and may provide interesting infra debt opportunities for those assets that are meeting infra characteristics such as high barriers to entry, supportive regulation, long term cash flows...

Delving deeper into Environmental, Social, and Governance

While the scope of privately funded, green-focused infrastructure debt will be vast, monitoring, managing and measuring Environmental, Social, and Governance criteria is not straightforward.

Taking sustainability into account, investing in private companies requires a slightly different approach to the engagement and voting practices of shareholders. By being listed, public companies have a duty to report regularly on all aspects of their business. Whereas access to information is not always accessible in private markets. Moreover, an infrastructure project is generally expected to span several decades and sustainability risk factors can impact a borrower's ability to reimburse debt.

Therefore, it is essential for lenders to undertake thorough due diligence on all aspects of a borrower's business including ESG. This can involve measuring the net environmental contribution of a project, considering CO_2 emissions and assessing whether a project is aligned with the Paris agreement.

Ultimately, sustainability considerations must be a core part of any selection process to ensure unsuitable investments are avoided and that projects stay true to their 'green' label.

Opportunities for long-term, patient capital

Infrastructure debt is one of a diminishing number of assets with the ability to provide long-term, resilient and visible cash flow, underpinned by an attractive yield potential and a visible Environmental, Social, and Governance association. Nevertheless, it is an investment option that may not be suitable for all investors.

To achieve these characteristics, a long-term investment horizon is needed and an ability to absorb less liquidity than other asset classes. Such restrictions mean it is an option well suited to institutional investors, specifically the pension schemes and insurance companies that possess a longer-term investment horizon.

Infrastructure debt's diversification credentials provide an added attraction to such investors. Not only can the underlying assets be diversified across a wide range of sectors and industries, diversification can also be achieved through the debt capital structure. For example, senior debt can provide attractive valuations due to its illiquidity premium and low expected loss; while junior debt can offer a higher absolute return while still benefiting from the same resilience of the underlying assets that provide stable cashflows, albeit with an additional layer of leverage.

An expanding investment option

Our infrastructure debt platform focuses on financing a diverse range of tangible assets in sectors including transportation, social infrastructure (universities, schools, hospitals), renewable energy (wind, solar), conventional energy and utilities (heating, gas and electricity networks, waste and water treatment) as well as telecommunications infrastructure (fibre, towers and datacenters). Furthermore, a comprehensive Environmental, Social, and Governance approach is a core and integrated part of our investment process, which in turn is supplemented by our wider dedicated sustainability resources and capabilities.

Infrastructure debt will undoubtedly continue to expand as an asset class and attract more institutional investors. New trends and sectors will emerge not only as part of the world's transition to a more sustainable economy, but also reflecting new digital and technological innovations.

At BNP Paribas Asset Management, we believe this transition will result in a host of exciting opportunities and infrastructure debt will be a key player in the financing of climate-related challenges ahead.

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