Secure income and green infrastructure: an unlikely marriage?

How to source stable, long-term cashflows with a strong ESG focus

Investors are under increased pressure to find secure and sustainable income streams, that also respect ESG constraints. **Céline Tercier, Head of Infrastructure Private Debt at Ostrum AM,** explains how infrastructure debt provides an opportunity to do this.

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Green assets are a growing part of infrastructure

Infrastructure refers to anything that is built and operated: it includes roads, railways, hospitals, schools, and power plants. Infrastructure debt finances projects required to build, operate and maintain these assets. From 2017 through 2035, the world will need a total of $69 trillion of investments in infrastructure to support growth projections[1]. Renewables is a growth sector in infrastructure, expanding nine-fold since 2005. As energy and transport are the biggest contributors to CO_2 emissions[2] (69% of the total CO_2 fuel combustion), it makes sense that renewable energy, green mobility and energy-efficient building offer opportunities for investors.

The French Greenfin label was launched in the wake of the Paris Climate Agreement and is indicative of this growing movement. The label requires that the majority of investments in a portfolio contribute to financing a greener economy. It also requires measurement of the environmental footprint of the portfolio, encompassing impact assessments on climate change, natural resources (including water) and biodiversity. Investing in oil, gas, coal and nuclear sectors is prohibited. There is an emphasis on energy transition and green transport, buildings, water and telecoms. Ostrum AM was awarded the Greenfin label for its Essential Infrastructure debt strategy[3]. Tercier explains that "this demonstrates to investors our approach to sectors; the way we integrate ESG into our investment decision making and asset monitoring, and ensure reporting on carbon emissions."

Aiming to reduce the financial risks of green assets

As green assets, and especially renewables, represent a growing part of the infrastructure universe some worry that these investments take high risks for the returns delivered. Investing in renewables doesn't have to be high risk. "The best way to earn money is not to lose any," says Tercier. One way to invest in infrastructure while aiming to reduce the risk of loss is by investing in the financing of infrastructure. Quite simply, debt is less risky than equity. The protection is strongest for senior secured debt instruments; investors have first call on the asset if something goes wrong. For pure infrastructure project finance, if the covenants and agreements have been properly structured, the protections are far stronger than for corporate bonds. Default rates in infrastructure debt are also extremely low, averaging just 0.20% a year since 1983, suffering no spikes even during the financial crisis. The recovery rate when a loan does default is 77.5% on average[4].This ensures that overall losses are minimized and risk-adjusted returns increased. The recovery rate of Ostrum AM's infrastructure debt managers is 100% over two decades[5]. The reason for this is careful structuring and close monitoring. "Our credit documentation asks that the borrower inform us of any problems, propose remedial plans, and allow us to work with them. Plans are validated and we monitor progress," says Tercier.

Deal structure and diversification can mitigate credit risk

"We select transactions with strong covenants to control and protect our investment. If there is a problem, we have a strong security package (especially pledge of the borrower's shares, contracts or bank account) to solve it," Tercier adds. Another way to protect capital and income is by investing only in essential assets with high barriers to entry. Ostrum AM's strategy invests in many forms of transportation infrastructure (including bridges, tunnels, seaports, and railways), but excludes non-essential assets, such as parking lots, which are not strategic. In the renewables sector, Ostrum AM considers all assets essential, including solar farms, wind farms, biomass and energy from waste. All conventional power and natural resource assets are excluded. Healthcare and education facilities are considered essential, while senior housing is not, because of the significant real estate risk. Countries need essential services as part of their sustainable development, so all parties have a strong interest in defending essential assets that encounter problems. This is not always the case with non-essential assets. "Our experience shows that when things go wrong, we can find a solution if it's an essential asset," says Tercier. The next line of defence against capital loss is to be credit-focused and conservative. In the renewables sector technology must be commercially-proven to protect capital over the life of the transaction. The minimum internal scoring for a transaction to be included in the portfolio is BB and the overall strategy must have an investment grade internal scoring. Diversification of risk factors is important to avoid sector or asset-type concentration. Diversification is achievable given the depth of assets available in infrastructure. The difficulty lies in transaction selection and being sufficiently stringent in transaction analysis. "We select only 4% of the global pipeline" says Tercier.

Transparency helps to deal with ESG risks

Financial risks are a critical consideration when investing in infrastructure debt but there are also ESG risks: primarily that transactions are less green than they first appear. A strategy based on project finance transactions, rather than on corporate bonds, enables better control of this. Ostrum AM selects transactions where the issuer must stick to the agreed upon terms. A solar project, for example, must produce green electricity and nothing else. If the asset operator wants to change its business model, it has an obligation to ask the lender. The project finance structure provides useful transparency. "We can be sure that 100% of the turnover of the portfolio come from eco-friendly sources," says Tercier. In addition, Ostrum AM requests specific external due diligence on ESG to identify potential ESG risks and assess its related materiality on the credit risk. Ostrum AM also requests specific covenants and information in the credit documentation on ESG issues in order to have greater control and the adequate level of information to measure carbon emissions and the effective contribution to energy and ecological transition.

Access to deals

Unlike listed assets, infrastructure loan origination requires deep sourcing and structuring capabilities to ensure access to transactions with high relative value. The sourcing network includes industry and financial sponsors and a variety of banking activities operating across regions and sectors. The breadth of the network facilitates access to deals of all sizes, diversifying the portfolio. Experience is essential to successful sourcing. Ostrum AM's former lending-side bankers each have over 20 years' experience, structuring over 300 transactions with a 100% recovery rate5.

A marriage made in heaven?

Green investments are growing fast as governments and investors push for more sustainable practices.

Infrastructure debt inherently delivers stable cashflows and naturally gravitates towards sustainable assets. "Infrastructure debt can appeal to investors requiring both consistent income and ESG-compliant assets," says Tercier.

FOOTNOTES

1 Source: McKinsey Global institute, Bridging Global Infrastructure Gaps, October 2017

2 Source: CO2 emissions from fuel combustion, International Energy Agency 2018.

3 Source: Ostrum AM January 2020. For more details on the label please refer to https://www.ecologiquesolidaire.gouv.fr.
Reference to a ranking, a rating or an award provides no guarantee for future performance results of the strategy or its manager.

4 Source: Moody's default and recovery rates for project finance bank loans study, March 18, 2019.

5 Source: Ostrum AM January 2020.

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