

# Infrastructure as an Asset Class: When Green Could Be Worth More Than Its Weight in Gold

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## ***Executive Summary***

Once an outlier in investment discussions, “infrastructure” has rapidly become a household term over the past 18 months. Simultaneously, “ESG” or “green” investing has become one of the most prevalent focal points of institutional allocators around the globe. Targeting “green” investments and monitoring their impact can be a difficult challenge within many asset classes. Can investors navigate these two simultaneously, and if so, how?

One increasingly popular way is through the private debt channel, and specifically through project finance structures. As most investors do not have the internal capability – or reliable access – to direct origination, investors are often left investing in infrastructure through debt funds, some of which cannot offer investors customizability or consistent assurance as to how “green” underlying investments truly are. But a third, newer option exists: *infrastructure debt co-lending*. Through these bespoke

partnerships with long-time specialists and underwriters of project finance credit, investors can combine access to diversified bank origination with support from a seasoned team, via a separately managed account-based co-lending model. By way of channels of access which enable investors to shape and define the scope of their investments, we have seen that infrastructure itself is inherently ESG-friendly in a meaningful way. Having the ability to assess and craft the environmental impact of a loan at the structuring stage is monumental; and project finance debt which affords access to a green scoring methodology like the “Green Weighting Factor” can be immensely useful to investors planning for stronger regulatory compliance (such as Sustainable Finance Disclosure Regulation in Europe), as well as those seeking to institute their own internal policies on environmentally conscious investing.

In this two-part paper, we first examine the aspects which support infrastructure as a compelling asset class for many institutional investors. We note that private project financings are an excellent means through which investors can access infrastructure investments, and we describe the means by which such investors could gain direct, non-commingled, co-lending access to these transactions. Second, we contend that identifying the most efficient and ESG-friendly methods of access is critical, as investors become increasingly focused on climate change and other environmental considerations. Tools like the “Green Weighting Factor”, combined with ongoing ESG reporting disclosure, help loan originators and investors account for the environmental and societal risks (or benefits) of a project at the outset. We make the case in this paper that private infrastructure debt is a strong choice to help facilitate these motivations.

## **Part 1: Defining the infrastructure asset class**

### **Introduction**

In the seven or so years preceding the Covid-19 pandemic, as shockwaves from the Global Financial Crisis (“GFC”) began to subside, a large number of investors turned their attention to a newly blossoming asset class: infrastructure. The wild volatility and high correlations characteristic of the GFC led to the collapse of global markets and the implosion of many market participants. During the post-GFC era, regulators, market participants and investors determined never to permit history to repeat itself in that regard. Apart from the influence of the many newly-minted layers of global regulation post-GFC, many market participants began to seek out assets which – by their very nature – boast lower correlations and lower volatility, among other benefits. Real Assets generally, and infrastructure specifically, is such an asset class. There was only one problem: access to infrastructure was, and in many cases still is, very limited.

Aside from its high barriers to entry, the asset class requires a significant level of expertise for its true potential to be realized. The events of the global pandemic have now re-tested the core foundations of this asset class. We have seen, once again, that infrastructure is truly a special, resilient asset class. As many major economies begin to exit the global pandemic, the focus on ESG investing is accelerating, and infrastructure is playing a large role in that growth story. In this paper, we detail what “infrastructure” means, what infrastructure as an asset class can offer investors, how and why ESG investing is front and center right now, and why infrastructure is an excellent means by which investors can access ESG investments.

### **The birth of infrastructure as an “alternative asset”**

What is infrastructure? At its most basic level, infrastructure refers to the systems or structures on which a society is built, which enable or facilitate its day-to-day operation. While there is not yet a specific definition of infrastructure, consensus centers around strategic and long-term assets that generate stable cashflows. Typically, these assets are financed on the basis of expected cashflows, rather than market valuation. In fact, due to the unique and sometimes monopolistic nature of these assets, they may not be capable of valuation on a comparative basis. Further, financing of the asset class is often predicated on the acceptance of construction risk (mitigated through contractual protections) and the rejection of technology-related risks. Generally speaking, infrastructure can be organized into a few main categories, such as:

- *Transportation Infrastructure*, such as ports, airports, toll roads, railroads, etc.
- *Social Infrastructure*, such as hospitals, schools, public facilities, etc.
- *Energy Infrastructure*, such as oil and gas storage, pipelines, refineries, etc.
- *Power & Renewables Infrastructure*, such as power generation (including renewable power such as solar, wind, hydroelectric, geothermal, etc.), power transmission, power storage (including battery storage), etc.

- *Data & Telecom Infrastructure*, such as data centers, cell towers, fiber optic networks, etc. (but not including the shorter-life technological aspects of these)
- *Water & Waste Infrastructure*, such as water supply, desalination, dams, waste treatment, etc.

These recognized categories, however, have been widened to include “Core+ sectors” which may carry additional risk characteristics or greater cashflow volatility – examples include technology-related infrastructure as well as logistics infrastructure. In the U.S., a wide segment of state or local infrastructure is financed through the issuance of municipal bonds. The municipal bond (“muni”) market – given its typical favorable tax treatment afforded investors – historically has been the principal means by which state and local projects, such as schools, wastewater treatment plants, stadiums, hospitals, universities, airports, and so on, have been financed. Large privately sponsored and privately operated infrastructure projects, however, are typically financed by way of complex “project finance” structures. While some will attempt to lump listed infrastructure into the same bucket as private, unlisted project finance assets, the two are different in terms of how they operate; namely, diversification of business lines and the degree of controls over contracted assets. Listed infrastructure is more akin to corporate debt or equity (as the case may be) and is not the subject of this paper.

The project finance market has always been a private, bank debt market, in its current form, dating back to the 1980s. Given their robust credit and loan management skills, and their deep expertise over cycles of distress and with associated loan workouts, banks became the natural choice for project sponsors and borrowers. Even today, up to 80% of the project finance market consists of bank loans – although institutional investors are entering the space by participating both in the private loan market as well as in public bond issuances. Accordingly, the infrastructure asset class has high barriers to entry; it is a very relationship-driven space and requires high-touch, active management. Fast forward to the years following the GFC, where a combination of new regulatory changes for banks and the emergence of new pockets of capital brought large, non-bank financial institutions (“NBFIs”) into the infrastructure space via three primary channels:

1. *Directly*: some large NBFIs built the internal capability to originate entire project financings and manage those assets on their own books.
2. *Funds*: infrastructure investment funds have emerged over the past decade as the most popular method of accessing infrastructure and other real assets.
3. *Partnerships*: some originators have developed models where investors can partner with and co-lend alongside the originating bank, thereby providing access to the sector and aligning interest with the originator.

For most of the investing world, the latter two options are the most practical, with the second option historically the most popular, and the third option the most transparent and customizable. Natixis, for example, started developing such a partnership model as far back as 2012, and has recently enhanced that model by providing access to full asset management services through Chamonix, one of its affiliates, by way of the use of bespoke separately managed accounts for its clients, effectively creating a “plug-and-play” solution for infrastructure debt and other forms of real asset private debt (known as its “Co-Lending

Platform”). Today, the co-lending activities of Natixis have secured approximately \$10bn of third-party debt capital, mainly from insurance sector investors.

### **What does private infrastructure debt bring to the table?**

Having described what we mean by “infrastructure” and how an investor might access this asset class, we now turn to making the case for the asset class as a sound investment. Considering a primary motivation of investing is to put capital to work for the purpose of generating some level of return, a key benefit of infrastructure is that it boasts a better risk-adjusted return (measured by higher Sharpe ratios) than comparable corporate debt. Various academics and industry experts (e.g., EDHEC*infra*<sup>1</sup>, Moody’s, etc.) have each conducted studies over various time horizons in which a large sampling of unlisted, private infrastructure bank loans were examined through multiple market cycles. These studies support the conclusion that infrastructure debt outperforms comparable corporate debt in the long run on a risk-adjusted basis. This result is likely attributable to the following unique characteristics of this asset class:

- *Higher expected recovery rates and lower loss given defaults* due to the existence of an underlying “real asset” – e.g., a tangible asset such as a windfarm or an airport – coupled with stronger and more robust covenants in the project loan documentation. Contrasted with the corporate leveraged loan space, there are no “cov lite” loans in typical project finance transactions.
- *Non-CUSIP, illiquid nature of the asset class* means there is typically a spread pickup versus comparable listed and/or more liquid assets.
- *Can act as a hedge against inflation* due to both the presence of the underlying real asset and certain contractual provisions in many project financings which provide for adjustments to the income stream over time. In addition, the floating rate nature of infrastructure debt provides some level of protection in a rising rate environment.
- *Is not highly correlated to the market* due to the unique nature of each project financing (no two deals are alike), the strategic, societal importance of many of the underlying assets, the strengths of the contractual framework, and the level of expertise of and close monitoring by the project parties (e.g., the sponsors, independent consultants and lenders).
- *Offers diversification on multiple levels:* geographic, sectorial, currency, offtakers, etc.
- *Is historically less volatile and more stable* due to the buy-and-hold bias of its investors.
- *Offers a wide band of duration*, from 3 years to 30 years or more, which allows certain institutional investors such as insurers and pension funds for example, to achieve liability-matching as needed.
- *Greater flexibility in restructuring and work out* due to the smaller number of participants in a project finance transaction, as well as the philosophical alignment of those participants.

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<sup>1</sup> <https://edhec.infrastructure.institute/>

- *Reduced capital requirements* for certain client types, most notably, insurers.
- *A current, reliable income stream* due to the fixed income-like attributes of the asset class.
- *Reliable deal execution speeds which facilitate capital deployment*, depending on the means and methods of access.
- *The ability to access large volumes with more significant ticket sizes* for those interested, depending on the means and methods of access.
- *A natural companion to ESG* due to the relative ease in identifying transactions having a natural alignment with green, ESG and sustainable priorities.

Almost 18 months ago, our world and our markets began to grapple with one of the most challenging events in recent history: a global pandemic resulting from Covid-19. Equity markets plummeted, and credit spreads widened drastically. By way of illustration, during the 12 months preceding the pandemic, the LSTA/S&P Leveraged Loan Index had been trading within a fairly stable range between approximately 95 and 97. Within a matter of weeks during the month of March 2020, this index fell by 20%, to its lowest level seen since the GFC.

In this paper, we frequently compare infrastructure debt to corporate debt because the two are close cousins in many ways. Yet, there is not a similar widely used infrastructure loan index; so to observe how infrastructure debt performed during the same period, we must look back at our activities in originating, distributing and managing these assets. What we have observed is that infrastructure debt is a resilient asset class. As noted in the list above, the unique characteristics of infrastructure debt help ensure that it is generally insulated from market swings. During the height of the pandemic, infrastructure debt was impacted by supply chain disruptions and employee constraints and labor shortages, which led to the halt in the construction and/or full operation of many projects (these were mostly mitigated through timetable buffers and cash reserves). In addition, as bank funding costs increased due to market events, the cost to project sponsors to consummate new project financings necessitated some transactions being placed on hold. All of that being said, many of these adverse influences were short-lived or of little consequence. For example, the concerns in Q2 2020 over EPC contractors or offtakers declaring *force majeure* under their contracts tended to be a non-event in many instances. On the flip side, in some demand-driven sectors, such as transportation (ports, toll roads, airports, etc.), we saw (and still see) volatility. Political risks were also magnified during this period, as many emerging economies struggled to stay afloat attempting to manage the effects of the pandemic. Although initially we noticed a drop in deal volumes as compared to prior periods, the market rebounded relatively well – especially in North America – by the end of the year.

On the whole, infrastructure fared well over the past 18 months, with far less volatility as an asset class than its corporate counterparts and most banks, insurers and infrastructure debt funds reported little long-term effects on their portfolios.

## **The way forward**

Given the history of the infrastructure market, its typical participants, high barriers to entry and the need for active and informed management of assets, coupled with significant demand for

investable product, innovative solutions that leverage the expertise and relationships of long-time players are needed. In this regard, products built on a partnership model – such as a non-fund, non-commingled co-lending product – enhance access for investors. Additionally, applying well-known and tested structuring techniques, such as CLO technology, to pools of infrastructure debt provides investors with an alternative means of diversified access to infrastructure, along with the option to invest in different parts of the capital structure of the CLO vehicle based upon risk appetite.

As Europe blazes the trail in terms of a more uniform approach to these investment themes, in the U.S., legislators are closing in on an infrastructure bill which looks to be the largest of its kind in U.S. history. We expect significant continued activity in the asset class and are already seeing banks and asset managers staff up in anticipation of the continued growth. In addition, pockets of opportunity exist in emerging markets (e.g., Latin America) as some nations commit to build or rebuild core infrastructure with the help of private investment. As this asset class continues to build momentum, it is a critical time for market participants to consider how infrastructure can play a role in their portfolio, and to begin planning accordingly with an experienced and aligned partner.

