

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 2: Infrastructure as an entry point to green investing

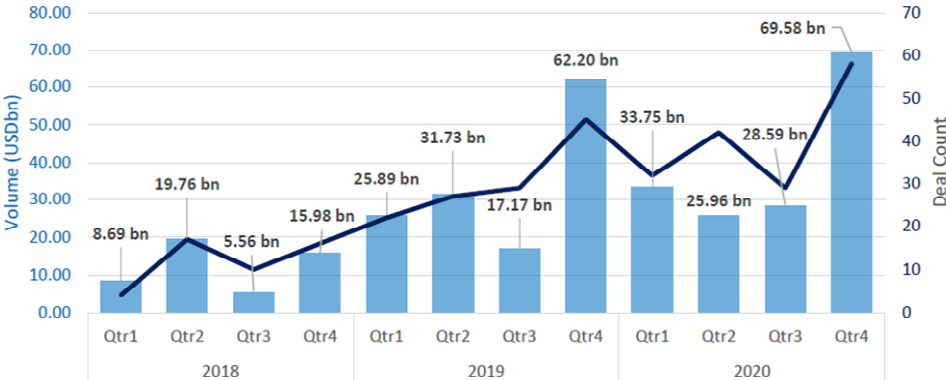
Introduction

As described in Part 1 of this two-part paper, “infrastructure” comprises a broad range of sub-categories, all of which have a direct bearing (whether positive or adverse) on “quality of life” issues for society. Investors in infrastructure projects can often evaluate first-order effects of their investment decisions from the perspective of climate change as well as sustainable development.

The rapid acceleration in demand for ESG, Green and Sustainable investments

Over the past three years, the world has seen a significant uptick in transactions being branded as “green”, “sustainable” or “ESG”, which is an acronym that is intended to identify transactions which are conscious of “Environmental”, “Social” and “Governance” issues. The “Environmental” aspect of “ESG” is the most commonly invoked and captures labels such as “green” or “sustainable”, both of which terms have environmentally conscious motivations at their cores. While there is not yet a uniform global taxonomy applied by financial participants as to what qualifies as a “green” transaction, and while some have been accused of the practice of “green washing” (that is, labeling a transaction as “green” when in actuality it has little to no positive impact on the environment), the market is trending toward a general consensus as to which assets should be categorized as green (e.g., a solar photovoltaic project), which ones are neutral (e.g., a telecom tower) and which should be labeled as “brown” (e.g., a coal-fired power plant).

While regulators begin to sort this out in a more meaningful way – for example the EU Taxonomy – the markets themselves have seen an explosion in growth due to investor demand for green-branded investment opportunities. In fact, according to Loan Radar, global 2020 syndicated green/sustainable loan volumes increased by 14.84% year-on-year to USD157.89bn on the back of 161 transactions, compared to USD137.48bn raised on 124 deals in 2019:



Data Source: Loan Radar – [Data Wizard](#)

Note: Includes all loans linked to sustainability performance measures, typically environmental, social and governance (ESG) performance, corporate social responsibility (CSR) or key performance indicators (KPIs), as well as Green Loan Principles.

Some have already begun work on constructing a uniform framework to quantify these kinds of transactions. On the origination side, Natixis has developed what is branded the “Green Weighting Factor” (“GWF”). Developed in 2018 as one of the first of its kind in the world, this construct was developed to speed up the bank’s transition to sustainable finance by incentivizing Natixis’s “green” business origination, while penalizing loans to “brown” activities. As one of the early movers in terms of its green and sustainable commitments, Natixis will leverage this methodology to align its balance sheet and its investments on a “net zero” trajectory, in line with the Paris Agreement and the +1.5°C objective. The impact of the GWF is twofold: first, it is now a variable in the bank’s credit approval process as to whether to consummate a transaction; and second, if and as transactions are consummated, and as a regulatory framework comes into play, the GWF will impact the composition and performance of the bank’s portfolio on a forward basis.

While Natixis’s GWF model has drawn the interest of regulators and the press alike, the GWF is currently only an internal tool affecting analytical risk-weighted assets (“RWA”) and not (yet) regulatory RWA. As such, the GWF is used by Natixis today as a management tool to incentivize origination of “green” transactions and disincentivize “brown” transactions. In this way, it anticipates the expected regulatory changes leading towards greener economies. The GWF uses a 7-level scale, from dark brown to dark green, which is objective in terms of its application to each proposed transaction. This tool has been adapted to work both with specific transactions, like an infrastructure financing, and more general purposes, such as a corporate loan. “Dark brown” deals receive a negative adjustment of up to +24% of RWA, and “dark green” deals receive a positive adjustment of up to -50% of RWA. As a result, Natixis has received notable positive press coverage of its model, and many existing and prospective clients have requested whether this model can be made available to them in connection with their co-investment in loans originated by Natixis and quantified by the GWF.

In parallel, European regulators have been evaluating what is similarly called a “Green Supporting Factor” which would – like Natixis’s GWF – incentivize banks who finance “green” transactions, while penalizing banks whose activities support “brown” businesses, by assigning different regulatory capital charges in respect of such activities. Regulators are still in an information-gathering stage, and numerous banks, insurance companies, investors and other financial markets participants have agreed to provide information and data to help assess whether an industry-wide regulatory capital regime related to climate risk is appropriate. In Europe, the European Banking Authority (“EBA”) has been tasked with this assessment, which is no easy job. For example, some preliminary reports in Europe have found a significant correlation between the energy efficiency of a building, and the probability of default by the borrower under the mortgage secured by such building. To the contrary, however, just because a deal may be a “green” deal does not necessarily mean it is less risky and should therefore attract less regulatory capital. As the EBA conducts its review, some industry groups – such as the European Banking Federation – have proposed their own interim solution: a “Sustainable Finance Supporting Factor”, which would incentivize the financing of assets which squarely fall into the EU’s classification of “sustainable” and which also demonstrate a lower financial risk as a result of that sustainability. At this juncture, there is still much work to be done in order to create a uniform understanding of and approach to “green” and more broadly “ESG” transactions.

Why is infrastructure well-suited to ESG investments?

In Part 1 of this paper, we noted that infrastructure is, in many cases, a natural companion of ESG investing. One key reason is that project financing already incorporates environmental due diligence, and the majority of project lenders are signatories to the Equator Principles, version 1 of which launched back in 2003 (these Principles are currently at version 4). Most lenders, including Natixis, also incorporate additional Environmental and Social screening tools during project assessments. Building off of this risk management framework to incorporate forward-looking factors is a natural next step. In Europe, as in other parts of the world, investors are seeing increasing ESG disclosure requirements. The bond market is now relatively well-equipped to meet these expectations, and the time is now ripe for private debt market to improve sustainability-related disclosure. Due to the high-touch due diligence already undertaken for infrastructure lending, and leveraging its GWF analysis, Natixis is collecting, analyzing and sharing key ESG information with its co-lending clients, and as such, Natixis can add a true competitive edge to its Co-lending Platform and increase its primary syndication volumes.

In Europe, the EU Sustainable Finance action plan leads to new requirements for investors. With the new Sustainable Finance Disclosure Regulation (“SFDR”), which came into force on March 10, 2021, asset managers now must report ESG and climate factors on all their products and funds, as well as at the investment firm level. Undertaking for Collective Investments in Transferable Securities (“UCITS”) and Alternative Investment Fund Managers (“AIFM”) directives will be revised accordingly. In addition, asset owners (such as pension funds, insurance company general accounts, sovereign wealth funds, etc.) and banks will have to review and disclose their ESG and climate risks assessment and mitigation strategy (see the EBA’s advice to the EC on KPIs for transparency on institutions’ environmentally sustainable activities, including a Green Asset Ratio, or “GAR”).

Meanwhile, in the US, both the SEC¹ and the New York State Dept of Financial Services² have begun to survey lenders on their approach to climate risk assessment. We expect the scrutiny in this regard is only likely to increase. Infrastructure is well-positioned to have the available data for differentiating ESG-positive attributes. Additionally, ESG in infrastructure is often thought of as being synonymous with renewable energy (wind farms, solar power, etc.). There are numerous emerging areas, however, that can be key contributors as well. These can include water supply, elements of the circular economy such as waste-to-energy and recycling facilities, as well as enablers of energy production, such as lithium and copper mines (of course the individual assets have to be evaluated on a green cost-benefit basis). Finally, education, health facilities and other social infrastructure continue to be an element of public-private partnerships delivered on a project finance basis in both developed and emerging economies.

Where do we go from here?

In the current climate, where rates continue to stay low, inflation is rising, and a significant portion of the world is demanding more green, ESG and sustainable investments to combat

¹ <https://www.sec.gov/news/public-statement/lee-climate-change-disclosures>

² https://www.dfs.ny.gov/industry_guidance/climate_change

climate change (among other things), infrastructure debt remains an excellent choice to consider. Asset owners and asset managers that are members of the various Net-Zero alliances³ and initiatives struggle to define and standardize their low-carbon investment strategies and their pathways to transition. Disclosure on their investments' carbon footprint is a prerequisite to fulfil this task. As a result, investment products that can advertise strong ESG and climate credentials encounter increasing popularity, from listed securities to alternative and real assets. Market participants who remain silent on ESG will gradually become excluded from competition.

Well-considered approaches to ESG investing ought to include infrastructure as a key asset class, where the benefits of making the “right” decisions may be immediately observable. Navigating this minefield may, however, be best accomplished in conjunction with banks who bring longstanding expertise to this sector and in many cases – prompted both by shareholders and regulators – have been the first movers in thinking through the ESG consequences of their activities and developing frameworks for evaluation. Partnering with these leading institutions at an early stage would dramatically aid less-experienced participants make a difference within their own portfolios and society as a whole, and consummating those partnerships through highly customizable, transparent and aligned investment channels would offer participants an efficient and reliable means to access this space.

³ <https://www.unepfi.org/net-zero-alliance/about/>,
<https://www.unepfi.org/net-zero-banking/>
<http://www.netzeroassetmanagers.org/>
<http://www.unepfi.org/net-zero-insurance>

