Allianz Global Investors

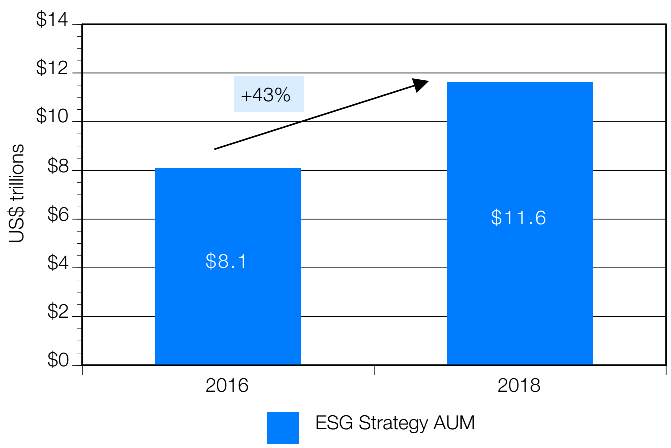
ESG investing with renewable infrastructure equity can produce impact *and* strong returns

When considering environmental-, social- and governance-based (ESG) investing, most investors think about putting in place restrictive investment policies, such as avoiding so-called "sin stocks" that profit from activities considered unethical or immoral. Others often wonder whether portfolios can make a positive societal impact *and* produce robust returns. Now, however, institutional investors can incorporate ESG investing in portfolios even before formulating a socially responsible investing policy. How? By focusing on a "native" ESG asset class, namely renewables infrastructure equity (IEQ) investments backing U.S. renewable energy projects.

This trend is already established in Europe, and now there is a large amount of investment into U.S. renewable energy projects. Europe's renewables industry is so mature that Germany's pioneering "Energiewende" plan to replace traditional power generation with renewables has already made significant progress toward its ambitious target. With green power entrenched in Europe, investor return expectations for renewables on the continent are traditionally perceived in the low single-digit percent range. By comparison, given the younger stage of the U.S. market, we believe that investors can still yield low double-digit returns by making the U.S. power-generation industry greener.

Before examining how the asset class behaves and where it sits in institutional portfolios, it is useful to enumerate just how green the U.S. energy industry is becoming. In the three years to October 2021, the Federal Energy Regulatory Commission predicts 59 percent of new U.S. power generation capacity will come from solar and wind. This transformation is being helped by a pool of cash pouring into ESG-based investing — $11.6 trillion is now invested in the United States based on ESG principles, up 43 percent from 2016 (see chart). Within that, the top criterion influencing decisions in the United States is climate change, which accounts for $3 trillion of ESG assets under management, more than double from two years earlier.

ESG-based investing is growing rapidly, with climate change the top criterion influencing investment decisions



As of October 2018
Source: The Forum for Sustainable and Responsible Investment biennial report

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These investment flows are transforming the U.S. energy mix. By 2050, wind and solar will account for 47 percent of energy production, compared with only 8 percent in 2017. Investors considering changing their private equity energy allocations to reflect this new reality should have plenty of worthy opportunities. In 2017, 51 percent of infrastructure deals were in renewables, up 9 percentage points from 2008, according to Prequin's *2018 Global Infrastructure Report*. This trend should continue, given that the G20's *Global Infrastructure Outlook* forecasts a $15 trillion infrastructure investment gap through 2040, including a $3 trillion shortfall for energy-related projects.

Perhaps that is why Prequin polling finds that many institutional investors are planning to actively increase allocations to infrastructure, generally, and to renewables, specifically. What type of returns can investors expect from this shift? In North America, most opportunities are greenfield projects — wind and solar farms built from scratch in the United States and Canada that typically target annual returns in the low double-digit percent range.

Where do renewables fit in an institutional portfolio? Their long-duration suggests these assets sit with other real assets, such as private equity (especially PE investments made in energy projects) or commercial real estate. However, the asset class behaves differently. First, renewables IEQ assets are not correlated with other real assets because what happens in financial markets has no monetary impact on the wind or sun, the "raw material" for renewable energy production.

Investors in renewables IEQ can anticipate meaningful cash-flow streams from their investment. Returns combine long-term, contractual cash flows from power purchase agreements (PPAs) with money from the eventual sale of the operating assets. (PPAs and stable energy output have historically enhanced the sale price of assets.) Compared with "traditional" private equity, therefore, the goal of renewables IEQ is to deliver contractual, predictable cash flows over the long term at lower expected levels of risk while also having a positive environmental impact.

For investors that want to boost their responsible investing activities, renewables may be a home run, since all renewables IEQ strategies are by their intrinsic nature ESG compliant. Investors can seek out renewables IEQ strategies that are rated A+ by the United Nations' Principles for Responsible Investment, which were established in 2006 to promote sustainable investing practices. (Allianz adopted the PRI pact in 2007, making it one of the earliest asset managers to do so.)

Specifically, renewables IEQ investments are designed to provide affordable and clean energy, provide decent work and economic growth, support industry innovation and infrastructure, support sustainable cities and communities, are backed by responsible consumption and production, help climate action, and advance partnerships for the overall PRI goals. In addition, renewables IEQ strategies can be a particularly good way to boost ESG compliance, especially when the construction of wind and solar facilities is conducted under responsible contracting policies (RCP) that agree to undertake work based on the lowest "responsible" bid.

RCP-compliant projects tend to generate well-paying jobs that bolster local economies. For example, a Jobs and Economic Development Impact (JEDI) simulation by the National Renewable Energy Lab finds that a 200-megawatt solar facility in California could support as many as 4,200 jobs during construction — everything from road and site prep to manufacturing and supply-chain work — and could sustain 135 jobs during operation.

Investors in renewables IEQ projects should be aware of the asset class' unique set of risks. Political risk is the main risk typically associated with renewable energy projects. However, that risk has diminished thanks to recent U.S. tax incentives, and the industry is expected to be further buoyed by Democrats controlling the U.S House of Representatives.

Construction risk is another potentially serious risk. Political and construction risk can be further diminished by using established, specialist construction companies and by working with partners with renewables expertise in the United States and Europe. In addition, working with a partner with deep knowledge of insurance — a key component in renewables IEQ projects — can help get capital to work fast. Established players with a great sourcing pipeline can also provide access to large deal flows.

This opportunity is underpinned by the fact that renewables no longer need government subsidies to be profitable, helped by the cost of solar and wind power in the United States dropping by 85 percent and 66 percent, respectively, from 2009 to 2016, according to an analysis of Bloomberg New Energy Finance data. Now, levelized cost of energy data — measuring where the cost of construction, operation and decommissioning matches the amount of power returned from that investment — reveals that wind and solar operations can be cheaper to run than gas, coal or nuclear power plants.

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Conclusion

Admittedly, determining what exactly constitutes ESG investing can be a bit daunting, given the variety of approaches available. Some investors favor *impact investing,* hoping to make a positive contribution to such things as the global environment — something that renewables IEQ achieves. Another popular approach is *socially responsible investing,* screening out investments in certain activities. Other investors incorporate *integrated ESG* into their overall investment approach — assessing ESG risks and actively using that insight to make better-informed investment choices that could generate excess returns. Whichever path an institutional investor wants to take with regard to ESG, infrastructure equity projects in renewables — naturally "native" ESG investments — can fit all these approaches. It is also among the relatively few opportunities where investors can combine the twin expectations of strong returns with safeguarding our environment for the next generation.

CORPORATE OVERVIEW

Allianz Global Investors, or AllianzGI, is one of the world's leading active investment managers. Employing more than 2,700 people across 25 locations, AllianzGI manages over €520 billion in assets for individuals, families and institutions around the world. AllianzGI offers its clients a wide range of actively managed strategies and solutions across the risk/return spectrum. With more than 700 investment professionals, the firm has established expertise in equities, fixed-income, multi-asset and alternative investments. Alongside an active approach to investment and active engagement with clients, the firm is an active steward of the assets it owns. It aims to incorporate environmental, social and governance (ESG) criteria throughout its entire investment value chain, providing tailored ESG and SRI processes with a broad range of approaches, adaptable to different levels of ESG incorporation and client preferences, enhancing clients' investment decisions while helping create benefits for society as a whole. AllianzGI has been a signatory to the United Nations Principles for Responsible Investment (UN PRI) since 2007.

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