The road less traveled: Sustainable investing with infrastructure debt

For investors looking to fulfill environmental, social and governance (ESG) infrastructure mandates, some investments are clearly compliant, such as investments in renewable-energy projects. However, some infrastructure sectors are not so obvious; for instance, investors might not consider investments in toll roads or diesel-fueled power-generation plants as suitable. However, infrastructure projects that are not intuitively perceived as “green” can nevertheless have sustainable benefits once investors consider the nuanced details and circumstances of each deal.

On the face of it, you might think that building a new toll road would increase the density of polluting vehicles and, therefore, could have a negative environmental impact. However, consider a different perspective: If a toll road is built in order to connect a low-income rural area targeted for economic development with an industrial port, then the project could be considered sustainable because it would make a meaningful socio-economic impact. How so? It meets several of the United Nations’ Sustainable Development Goals, among them promoting “decent work and economic growth” and advancing “industry, innovation and infrastructure.” In other words, it is the specifics of the project that make it sustainable.

The same could be said of financing a diesel power plant. If the facility will serve as a backup to ensure continuity of electricity supply during times when renewable sources cannot deliver (in a location, for example, where natural gas is unavailable), then it can be considered helpful in meeting sustainable goals. Put another way, if the diesel plant helps enable the addition of new renewable energy to the electric grid and only as a backup when supply falters, then it can, in aggregate, benefit the environment. This is particularly relevant if renewable-energy projects would otherwise not be built without the backup diesel plant providing supply certainty.

These toll-road and power-plant examples are not hypothetical: Allianz Global Investors has engaged in these same discussions with sponsors developing these assets. AllianzGI has been a leader in sustainable investing for two decades. Lately, there has been a rising interest from institutions in sustainable investing. However, the nomenclature being used by various firms differs greatly, at times making it difficult for investors to discern between various approaches. Our experience has led us to categorize sustainable investment strategies into three main groupings: Integrated ESG, Sustainable and Responsible Investing (SRI), and Sustainable Development and Impact investing (see Exhibit 1 on next page). Infrastructure debt fits into our Integrated ESG category.

A growing number of investors are embracing sustainable investing — 71 percent of institutions want their portfolios to be ESG-compliant by 2030, according to our global survey of 490 institutions undertaken last year. However, investors are cautious not to engage with firms that might be “greenwashing” their offerings. As a result, they are increasingly asking asset managers probing questions about how central sustainability is to their investment process. The types of questions institutions are asking include such queries as, “Does your firm have a policy addressing its approach to incorporating ESG factors within the investment process?” and “What ESG-relevant experiences do your risk and investment managers have?”

Answering those questions to the satisfaction of an institutional investor is best done by an asset manager with deep experience in sustainability and by active managers that have the dedicated manpower to weigh the sustainability pros and cons of each possible investment, monitor its performance and hold the issuers accountable. Investors want to partner with an asset manager that can sit in the driver’s seat to help guide their evolutionary journey toward more sustainable portfolios.

Sustainability is not something that can be bolted onto an existing investment strategy; rather, it needs to be fundamental to the investment process. At every stage of a deal — from investment screening, due diligence, negotiation of legal documentation to post-financial close — asset managers must take into account the appropriate sustainability considerations.

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A key characteristic of infrastructure debt investments is the ability to negotiate covenants aimed at ensuring the integrity of the investment through its life. For example, deals in certain emerging economies might need certain explicit covenants, such as demanding that all parties adhere to the minimum social and environmental standards set out in the International Finance Corporation’s Performance Standards on Environmental and Social Sustainability and the Equator Principles. Projects may also need specific covenants related to environmental considerations, construction permitting and post-closing remediation monitoring. These details often require retaining an outside independent consultant to conduct environmental reviews and to ensure that sensitive details are taken care of appropriately, whether that’s acquiring land or finding an alternative habitat for wildlife.

It is also important to assess whether the country where the project is domiciled has good governance and strong institutions. For example, when it comes to infrastructure deals in Latin America, good governance favors working in the six countries in the region that have investment-grade credit ratings: Chile, Peru, Mexico, Colombia, Uruguay and Panama. Governance can be further helped by investing in infrastructure projects awarded through open and transparent procurement processes.

Since the nature of fixed-income infrastructure as an asset class suggests that many projects will be domiciled in emerging markets, adhering to the highest standards of sustainability is especially important. These deals can produce higher potential investment returns than projects with comparable credit ratings in the United States, they historically have had relatively low defaults, and they also add an ESG benefit to portfolios. So, getting sustainability right is more than just doing good; these days, it’s good business, too.

Source: Allianz Global Investors

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Allianz Global Investors is a leading active asset manager, employing more than 790 investment professionals in 25 offices worldwide to manage $619 billion in assets for individuals, families and institutions. AllianzGI offers its clients a wide range of actively managed strategies and solutions across the risk/return spectrum and has established expertise in equities, fixed-income, multi-asset and alternative investments.

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