



**Phelim Bolger,**  
Director,  
IFM Investors



**Jacob Otto**  
Product Specialist,  
IFM Investors

INSIGHT

# Integrating ESG analysis into infrastructure debt investments

Infrastructure assets are playing a critical role in making the economy more sustainable while also delivering secure yield for investors. To successfully navigate the spectrum of infrastructure debt investments seeking capital, we believe investors need to integrate an in-depth analysis of environmental, social and governance (ESG) issues into their screening and due diligence processes.

by Phelim Bolger and Jacob Otto

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DEBT INVESTMENTS

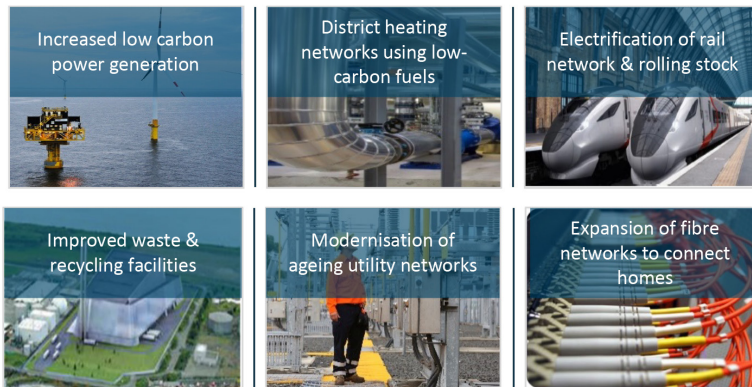
There is clear evidence that society needs to invest in a lower carbon future and ensure future growth is attained more sustainably. Concurrently, the effects of the pandemic on many companies and government balance sheets have been severe. This has brought about a recognition that other sources of financing from institutional capital, such as long-term retirement savings, can play a critical role in achieving the transition needed to avoid the predicted effects of climate change. We believe this is creating attractive investment opportunities for pension funds to finance this transition in infrastructure through debt.

In response to the pandemic, developed

market economies announced almost US\$9 trillion<sup>1</sup> in government spending to 'build back better', with infrastructure spending being a major focus. This is a supportive backdrop for the asset class, and debt markets are increasingly being used to fund the development and expansion of low carbon fuel sources (such as wind, solar, and hydro) and energy efficiency investments (such as the electrification of transportation, and smart metering). We believe these infrastructure assets will play a critical role in making the economy more sustainable while also delivering secure yield for investors.

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<sup>1</sup> As measured by the Advanced Economies in the G20. <https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19>



## Sustainability themes driving infrastructure debt issuance

To reinforce the benefits of sustainable outcomes, we think there are three key ESG related considerations investors should keep in mind when approaching this opportunity and by doing so, help maximise the impact of their capital:

### 1 Look below the surface

To successfully navigate the spectrum of investments seeking capital, we believe investors need to integrate an in-depth analysis of environmental, social and governance (ESG) issues into their screening and due diligence processes. Choosing a “sustainable” sector and indiscriminately allocating capital is not enough. Even though the sector will benefit from a sustainable theme like the energy transition, not every investment within the sector will successfully deliver on return, risk and ESG objectives. Therefore, a disciplined investment approach which integrates material ESG risk considerations is required.



**Analysing ESG factors is not just about investing in greener or more sustainable assets, it is also a key element of managing investment risk.**

Analysing ESG factors is not just about investing in greener or more sustainable assets, it is also a key element of managing investment risk and protecting and enhancing the value of long-lived assets. This is because poor practices in areas such as employee welfare, consumer protection, environmental management and corporate governance pose measurable risks to the viability of a business, and the return delivered by any investment.

For example, we have scrutinized a biomass fired power plant that was genuinely producing energy from renewable sources but the method used had some questionable elements. In particular, the company was shipping millions of tonnes of wooden pellets from the US to the UK each year to use as fuel, and the shipping of that fuel source would have a material carbon footprint. From an ESG perspective, this was unsatisfactory due to the impact on US forest resources and the sheer distance that the fuel was travelling before being utilised.

To be more environmentally friendly, bio-mass companies can use locally sourced fuel that is easy to cultivate. For example, another UK bio-mass company processes 80,000 tonnes of maize and 280,000 tonnes of other feedstock per annum that is locally grown and supplied by another company within the same corporate group. The company coordinates farming operations (sourcing land, farming, harvesting) and logistics operations for the group, including the disposal of digestate to agricultural land. This means the group has a closed loop, fully vertically integrated business model that reduces traditional operational risks, while helping to maximise operational efficiency and financial returns.

### 2 With debt investing, focus your influence during due diligence

It is no secret that equity investors can exert more influence on a business throughout the life of an investment than debt investors. But the strength in debt investors’ approach comes from anticipating this dynamic and using the negotiations that happen during due diligence to ensure ESG issues are addressed.

Infrastructure debt investors are increasingly seeking to work with asset owners who are willing and able to provide reporting on ESG related issues, such as emissions, health and safety and environmental impacts, to name a few. This reflects the growing importance of selecting

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to lend to experienced asset owners in each industry, and those who understand the importance of ESG dynamics to both debt and equity investors. Increasingly, we are seeking to partner with like-minded debt investors that are able to use ESG criteria and reporting as a key point in loan negotiations.

In a recent deal involving a natural gas related infrastructure asset in the US, the loan terms were negotiated so that the borrower was required to report CO2 emissions data on a quarterly basis as part of the operating reports, and to design and implement an agreed Health and Safety Program where there previously was none.

These requirements provided the lenders with the ability to monitor the company and its commitment to emissions reduction and worker safety on an on-going basis. They also provided the company with a better understanding of their businesses which is good for the business, staff, shareholders and other stakeholders.

This is breaking new ground for debt investors who have traditionally had very little ability to influence companies during the life of their investments. Looking forward, debt investors may be able to play a greater role in influencing companies because assets need to be refinanced and debt holders are a provider of capital. This gives them the ability to influence outcomes by withholding capital, or changing the cost of capital.

### 3 The importance of ESG reporting

For investors to look below the surface more clearly, there is a need for borrowers to provide richer data on ESG metrics. There is a hunger for reporting to understand how investors' capital is performing from an ESG perspective. The surge in demand for investment products aligned with sustainability objectives has placed

enormous pressure on borrowers to produce metrics and reports that can demonstrate their ESG credentials. This is a very important and sometimes onerous task, particularly for smaller issuers who are more resource constrained.

As we are all pulling towards common objectives when it comes to sustainability, it is natural to collaborate and for industry standards to be created around how we measure and report ESG related metrics. This standardisation can reduce the burden on borrowers and make interpretation easier for investors. IFM is part of an emerging consortium of infrastructure debt managers seeking to create a standardised ESG covenant package for infrastructure debt issuers to adhere to<sup>2</sup>. This is an effort to set “best practice” for borrowers when reporting on ESG factors and help facilitate compliance with ESG disclosure regulations across various jurisdictions, including impending regulation in the UK.

We have also observed that as equity and debt issuers are increasingly focused on ESG, borrowers are becoming better at reporting on their own. So there are reasons to be positive about the trend towards more detailed and harmonious reporting, but we also believe we should not let the perfect be the enemy of the good. In that vein, we feel there is an opportunity to work with borrowers who have strong ESG practices as they create standards for measurement and reporting.

### Looking ahead

We are excited about the growing spectrum of investments and evolving ESG awareness we see contributing to sustainable themes in infrastructure debt markets. This evolution will support the transition of essential infrastructure and the creation of new, lower carbon solutions for our future.

But even in industries with clear sustainability benefits, like renewable energy, it is still important to focus on ESG fundamental analysis to uncover those investments which can deliver both attractive risk adjusted returns and positive ESG outcomes versus those where green credentials are shallow.

The market is moving quickly, as we all seek to meet the world's ambitious climate change targets. We look forward to being part of this solution by working with our investors and debt issuers together, helping to facilitate the transition in infrastructure to support a more sustainable future for us all. »

<sup>2</sup> <https://gjia.net/feedback-welcomed-on-new-esg-covenant-package/>

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HEAD OFFICE

Level 29 | Casselden | 2 Lonsdale Street | Melbourne | VIC 3000  
+61 3 8672 5300 | [www.ifminvestors.com](http://www.ifminvestors.com) | [investorrelations@ifminvestors.com](mailto:investorrelations@ifminvestors.com)