Investment in infrastructure leads the way to net zero

Sustainable infrastructure debt accelerating the way forward on energy transition

When Group Chief Executive of HSBC, Noel Quinn, chair of the Sustainable Markets Initiative's Financial Sector Taskforce, announced at COP26 in Glasgow last year, that a commitment to financing the transition to net zero is essential, he sent a message highlighting the importance of the role that the financial services industry has to play in terms of mobilising finance and working with clients to support their transition. And within the finance sector, few would deny the contribution investment in infrastructure has to make when it comes to achieving our net zero goals.

Over the past five years, investments in infrastructure have grown in prominence amongst pension plans and insurance companies globally. The defensive characteristics of the asset class appeal to institutional investors looking for an attractive long term yield with capital stability, according to Shantini Nair, senior product specialist, infrastructure debt investments at HSBC Asset Management (HSBC AM).

The number of unlisted infrastructure debt funds has increased 28-fold since 2012, she adds, and this boom in infrastructure debt fundraising has manifested itself in a growing number of managers in the space. In an interview with *Asia Asset Management*, Nair cites findings reported by Infrastructure Investor in their II Debt 30 Report of February 2022 that the top 30 fundraisers raised US$139 billion for infrastructure debt in 2022, a figure representing $34 billion more than the previous years total.

"The asset class can be tailored to deliver a range of risk adjusted outcomes, and has demonstrated resilience throughout the pandemic by offering a diverse opportunity set that meets a wide variety of investor needs," she adds. "Increased demand has highlighted the need for thoughtful asset origination, structuring, market selection and careful portfolio construction. Part of our thesis has been to focus on less competed markets, as well as mainstream markets, through our infrastructure debt platform."

Nair notes that infrastructure debt is a healthy solution for insurance companies who are looking for a long-term fixed rate product to match their long-term liabilities. In floating rate format, it is also an attractive option for clients looking to hedge themselves against the current backdrop of rising rates.

In short, infrastructure debt offers a variety of high and low yielding strategies to cater to different risk and reward appetites. These span both developed and emerging markets, and single, multi and local currencies across core, core plus and opportunistic infrastructure market segments, and more recently, with the advent of the EU taxonomy, thematic and impact segment funds. Investors, she says, are also finding that the asset offers lower volatility than more traditional public bonds, which in the current climate are more exposed to a variety of economic risks, while delivering additional returns through the acceptance of the greater complexity and illiquidity associated with investing in private debt.

"As a global US dollar investor we're investing in companies or projects that are providing essential services to the community and helping to deliver sustainable economic outcomes globally," Nair explains. "As the only dedicated infrastructure debt platform within HSBC AM, we have around $3.34 billion of assets under management, which is currently invested across 60 investments worldwide."

Sustainability meets returns

Sustainability is a big part of the programme. HSBC AM's infrastructure debt team of 16 investment professionals is based across London and Hong Kong. The most senior team members have multiple decades of experience in the field. Together they work to evaluate the credit risk of each opportunity, including a thorough review of ESG factors. Nair points out that investments include those in developed and emerging markets, from the US, through to the Middle East, Latin America, and Asia. However, at this stage the team has elected not to invest in the heavily contested European market, at least on the investment grade side. Rather, the team is looking to the continent for its high yield strategy, which is targeting the mid-cap markets, and has identified transactions yielding net returns in excess of 9%.

For Nair, the context of the investable universe has become much more diversified over the past decade. As such, the infrastructure market's positive exposure to important secular trends in the economy, particularly in relation to decarbonisation and digitalisation, is a

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key factor in its growth.

"Sustainability is important to all of our investors and it's becoming increasingly important to their stakeholders. Our objective when considering sustainability in infrastructure debt investment is to reduce investment risk and to provide our clients with the means to assess the impact of their investments," she explains.

But as she points out, investors have a wide range of perspectives on the meaning of sustainability. For some, she says, it's principally a question of climate change and environmental impact. For others, it's about assessing a much wider range of sustainability factors, encompassing not only the environmental but also social and governance factors.

As such, HSBC AM's implementation of a set of sector-specific ESG assessment scorecards enables the team to assess the infrastructure issuer's exposure in terms of risks as well as opportunities. It's a process that she says goes beyond a negative filter, to offer a more forward looking component based on a number of factors such as greenhouse gas emissions, management, workforce health and safety, community, management experience and strategy, ownership structure and corporate governance, the last two elements of which she adds would form part of any traditional toolbox that an investor would look at to assess in these types of investment.

And, while all high level assessments are also compared against the United Nations' Sustainable Development Goals or SDGs, she says the beauty of this sector-based approach is that it allows deeper insight into the types of transactions and sectors. As such, the team takes account of what the future trajectory could look like as a long-term investor where the legal maturity of a project might extend up to 30 years.

In line with the European Union's Sustainable Finance Disclosure Regulation or SFDR, Nair reports that the team is also looking very closely at launching new and innovative sustainable private debt strategies that "meet our objectives in offering carbon footprint measurement to help us and our clients to devise effective investment strategies to deliver net zero by 2050."

"Engagement is key in terms of working with the underlying issuers and borrowers, partnering with them to deliver the level of information that helps to make that reporting possible. We believe that long-term investments can be profoundly impacted by the direct effects of climate change, and by society's response to it, and also by a wider range of environmental, social and corporate governance considerations," she says.

Asset characteristics

ESG assessment, subsequent high level due diligence and ongoing stewardship are the key factors involved in the investment process. Since the team was established in 2018, it has evaluated over 725 potential transactions, investing in just 60 companies or projects since then. Of course, the team has the advantage of having at its disposal the resources of the entire HSBC group behind it, including in-depth ESG-related research carried out throughout the group, such as research on a large number of companies who are major shareholders of infrastructure projects, and assessments of the ESG credentials of the shareholders of the infrastructure borrowers in which these investments are being considered. Post execution, portfolio management consists of regular monitoring of issuers, the industry and new regulations, as well as annual updates of project ESG scores.

A key characteristic of fixed rate investment grade infrastructure debt is that it offers a robust cash flow profile where long-term debt can match an investor's long dated liabilities. Predictable income can be sourced from transactions that support essential services, through social infrastructure, such as hospitals and universities, digital infrastructure such as data centres and telecommunication towers, or, the largest sector of all – the transmission, distribution and generation of energy. It also offers credit risk reduction and as a consequence, lower default rates and higher recovery rates compared to non-infrastructure debt comparable credit, and in terms of diversification, is more resilient to market and credit cycles and has the capacity to deliver an illiquidity premium over listed credit.

"Infrastructure debt is a natural fit for ESG strategies and sustainable outcomes in the long term. Decarbonising energy generation is crucial for achieving net zero and our portfolio today is reflective of these important secular trends in the global economy. We are conscious that some assets are essential to the transition now, but will need to be phased out. Our portfolios will need to make a positive contribution to reducing carbon emissions over time, so it's a journey of evolution in lockstep with the market," Nair concludes.

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