# INFRASTRUCTURE AND THE ROAD TO SUSTAINABILITY

**As the world begins to see light at the end of the Covid-19 tunnel, demand for greener economies, smart renewable energy sources and greater corporate social responsibility is growing stronger. How is the infrastructure sector responding, and are we seeing new types of investors and strategies? We talk to five infrastructure specialists from across the value chain to examine how the landscape is evolving and the rise of dedicated renewables vehicles. A round-table discussion led by Patrick McCullagh, Managing Director of Sales for Europe and the United States at Alter Domus, finds that amid a diversity of opinions, everyone is pointed in the same direction.**

In recent years we have increasingly seen references to 'old infra,' utilities, toll roads, ports, airports, and 'new infra' such as renewable energy, data/fibre networks and electric vehicle charging infrastructure. But according to Ian Berry, Managing Partner at River & Mercantile, the definition of infrastructure is different for almost everyone. While some see infrastructure as involving 'lots of steel and concrete,' Berry sees it differently: "A useful definition is much more about ownership, the rights to operate something that is essential, or a social good." He notes, "When I first started looking at investing in renewable energy more than 15 years ago, it was considered niche. Today it is widely regarded as not only essential core infrastructure but an environmentally and socially responsible choice."

Renewables have effectively developed into a sub-asset class within the broader infrastructure and green energy funds sector, says Ajay Pathak, Partner at law firm Goodwin Procter. "Increasingly managers are raising dedicated renewables-only funds." With larger asset managers in particular seeing strong investor appetite for dedicated sectors and sub-sectors, the renewables trend is set to continue apace. But investors are not turning their back on traditional infrastructure – each can meet different kinds of needs.

Karen Sands, Chief Operating Officer at Hermes GPE LLP, says: "Our investment strategy since 2010 has been on both traditional and new infra investments. We focus predominantly on brownfield opportunities, looking for secure, core returns. As the old-style defined benefit pension schemes mature, they are looking for sustainable, reliable income from their asset allocations, and that is the focus of our infrastructure programme."

Richard Awbery, Partner at Atlantic-Pacific Capital, points out that many larger institutional managers have established dedicated impact allocations to help increase ESG exposure within their portfolios. However, many investors, especially those based in North America, still view ESG as a 'nice to have' and not a main driver." Pathak also sees some hesitancy. "Some are saying they are not interested in renewables as they don't have a great track record, or the focus is too narrow. But there are clearly investors who want to commit to this space. And the need for investment is only going to go up, not down."

Awbery adds: "We have seen a considerable rise in LPs seeking sustainable investments. That said, whilst ESG has become increasingly important as a foundation, the overriding focus remains on returns." Pathak notes that fundraising for renewables has been increasing over the past four to five years with fund managers raising fairly significant capital in dedicated renewables-only vehicles or increasing their allocation to this sector within a diversified offering.

"ESG has always been part of what we do, allowing us to go back to the social contract and the needs of everyday life within infrastructure requirements. Holistic infrastructure investing must embrace social responsibility, and we have an informal social contract that we abide by, particularly in areas such as utilities and energy. We produce a responsible investment report that we share with our infrastructure clients. They are really trying to understand the social impact."

**Karen Sands**
Chief Operating Officer,
Hermes GPE LLP

## RENEWABLES – RISK AND RETURN

Patrick McCullagh notes that Alter Domus is seeing a shift in investor sentiment as ESG continues to gain traction and enjoy positive headlines. "Additional investment decision drivers are emerging, with investors seeking infrastructure investments that do good. And while arguably infrastructure is always doing good, we are seeing an increasing focus on aspects such as carbon reduction and green energy strategies. Demand is clearly there. But how are investors engaging with these aspects and some relatively new technologies?"

What is driving this uncertainty? John Stuart, Managing Director at Low Carbon, sees a lag between investor interest and commitment. "Strong demand is not always matched with capital coming forward," he says. "With renewables perceived as an alternative, specialist area, allocations are still not great and are often missed. Investors are looking to learn but are not yet ready to put capital into the sector."

Stuart sees education as key to unlocking the capital of cautious investors. "There is little experience of investing in renewables, and certainly not over a longer term. Those that came in two or three years ago have not yet seen a full lifecycle of their investments. Much of the early investment was looking at mature renewables with projects providing yield." Stuart notes that while that kind of capital is important, capital is also needed for construction risk, to take late-stage development risk and early-stage development risk.

Sands says that while investing in renewables has always been part of her firm's DNA, they are wary of the new-style infrastructure investments. "There's a large amount of technology that needs to be tried and tested," she says. "When you're looking at more technology-focused investments, there's a huge amount of failure before you actually get to the success. Our view is to let the private equity investors really push the development of the technology, and then you swing it over into traditional infrastructure for contracted revenue returns."

Sands explains that the firm's strategy is driven by demand from investors who are looking for steady yield. "Our view is that the demands on the marketplace have been pretty much the same over the past decade. However, there is a growing awareness and understanding of 'new' infrastructure, and the different types of returns that are out there. People are becoming more sophisticated and knowledgeable."

Ten years ago, UK solar was a new sector and Low Carbon, as an investor committed to climate change mitigation, was a pioneer in the market, examining investment structures and trying to understand the investment risks. "It was about being an early mover – putting together a package, a project that was investable" says Stuart. "To do that you need to build up your technical knowledge, to be aware of those risks if you are making the market." Berry adds: "My team was also on the leading edge of UK solar a decade ago, and I agree that's one of the key challenges for managers and investors backing managers. If you wait for universal acceptance of newer sectors then an adequate return can be made, but not a high return."

> "Technology is more a risk when you are at the early stages of financing it. We came into two areas of renewables relatively early and accepted the tech risk. That risk no longer exists in those sectors. And while hydrogen will become more mainstream, the early movers in that space must understand the tech risk and structure an investment proposition that takes account of the risk."
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> **John Stuart**
> Managing Director, Low Carbon

## ESG LOOMS LARGER

"Are we seeing different types of investors moving into infrastructure market – perhaps family offices with a new generation coming in, bringing new values and looking towards a greener future?" McCullagh asks. "I think a lot of the capital raised for dedicated renewable funds is still coming from the traditional institutional investor base," Pathak says. "But you're also seeing corporate or strategic investors pivot, seeing this as a way forward. For example, Shell is very significantly focused on funding and developing green energy. Likewise, sovereign wealth funds are recognising the shift to a greener future." Stuart notes: "For family offices or endowments, it is a great asset class to meet the needs of that capital."

> "The US hasn't traditionally been a big source of capital for European energy and infrastructure fund managers. But that is slowly shifting, and we are starting to see some US endowments, partly because they are thinking more proactively about things like ESG and are starting to show interest. If that really gathers momentum, we are talking about opening up a significant amount of capital which to date hasn't been there for European funds."
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> **Ajay Pathak**
> Partner, Goodwin Procter

Awbery says his firm has become increasingly active raising funds for co-investment alongside primary fundraises as well as capital for single asset transactions. "There is still interest from investors to gain access to infrastructure via the more traditional fund route. However, there is a number of LPs seeking "direct" exposure to assets. We have facilitated discussions with pension funds, fund of funds, insurance

companies and other investors with managers and operating partners. LPs are seeking to partner with managers that have sourced, structured and will manage the assets, but who are, importantly, also investing their own capital. Alignment of interest is key."

McCullagh asks what kind of LPs are looking at co-investing with an asset manager that has perhaps built and operates the plant. Says Awbery: "For a direct deal, we engage with the more established and sophisticated investors; those that have experienced in-house capabilities to underwrite a single investment. Not only is it a different mindset to fund investing, there is often an element of speed required, especially if participating in a live transaction. Under-resourced and less experienced teams are simply unable to meet these accelerated timetables which can be as little as six to eight weeks."

"We have typically seen investors participating in co-investment with existing managers in their portfolio. Extensive diligence has been conducted on the firm and team for the fund commitment so when it comes to underwriting an asset, they are focused on exactly that – the attractiveness of the opportunity. In this competitive market and with the increased appetite for co-investment/direct exposure, LPs are starting to use these transactions as an opportunity to build relationships with new GPs. However, the work required to get comfortable with an investment becomes considerably more complex."

**Richard Awbery**
Partner, Atlantic-Pacific Capital

## ON A CONSTANT PATH

Amid growing demands for a greener, more sustainable future, infrastructure as an asset class remains an attractive opportunity for all types of investors: solid yield, high-risk new tech, or single asset direct investment. While ESG characteristics are certainly becoming more important to investors, they are not currently dominating their investor profile or needs. But renewables in particular are moving mainstream more quickly than in the past.

Today, with a greater understanding of early-stage tech risk, and a structural response to that risk, investors are keen to learn more. As their knowledge grows, so too will their investment appetite. Infrastructure does not really fall into 'traditional' and 'new' infra. It is just infrastructure – the resources, networks, buildings, utilities, technology, and energy sources that are needed today to build a brighter tomorrow. We are all moving in the right direction, albeit at different speeds and different ways, but there is still a long way to go. *

"The reality at the moment is that the people who can produce the glossiest ESG reports are deemed to be the best. And that's a big problem, because big companies produce really nice reports. They can demonstrate that their impact figures are better than last year; that they've contracted to use only renewable energy and that they've installed electric car charging in their car park. Those things are great, but fundamentally most of those assets emit enormous amounts of carbon during their construction. These infrastructure businesses still have business plans that rely on the burning of fossil fuels – by their users (cars using toll roads; shipping using ports; aircraft and cars using airports, etc.) to be profitable."

**Ian Berry**
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