The new investment reality:

Why ESG matters

Inframation
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ITPENERGISED GHD Bird & Bird

Contents

Foreword

ESG impacts every stage of the asset lifecycle – from origination to exit. GHD, B&B and ITPE have purposely partnered, recognising the scale of this challenge, and to combine our strengths to market so we may best assist clients in navigating this rapidly evolving landscape.

Even before the Covid-19 pandemic, environmental, social and governance (ESG) issues were rising up the agenda for infrastructure investors. But the pandemic may yet come to be seen as a watershed moment, underpinning an even more fundamental shift towards ESG across every asset class.

After all, the devastating impact that Covid-19 has had on global economies in such a short space of time is a reminder of the power of the unforeseen. The parallels with issues such as climate change are unavoidable, even if the pandemic has taught us that new ways of living and working are possible.

The evidence of our latest research, including a survey completed by 50 investment funds, pension funds, investment banks and sponsors, is that these themes have not been lost upon infrastructure investors. Across the board, investors are more focused on ESG than ever before; many are rethinking their own operating practices while also approaching portfolio strategy with a fresh pair of eyes.

Moreover, investors' views and understanding are evolving at pace. They no longer see ESG only through the narrow lens of climate change. While they remain absolutely committed to the imperatives of decarbonisation, they are focused on a broad palette of issues that span the social and governance aspects of ESG as well as environmental.

For example, 86% of investors say they plan to invest in transport infrastructure over the next three years. Similarly, 82% anticipate making investments in social assets such as educational, healthcare and senior care projects.

Despite this enthusiasm for ESG, some familiar concerns remain. While the investment case for ESG continues to strengthen, many points of frustration remain, particularly around the lack of consensus on basic definitions of ESG and the shortage of data on which to base smart financial decisions.

Regulatory interventions may help – including the Sustainable Finance Disclosure Requirements introduced across the European Union in March 2021. However, there is still no clear definition of what constitutes ESG from an infrastructure perspective, leaving investors to make difficult decisions for themselves.

Nevertheless, as this latest research shows, investors are determined to press ahead. Key stakeholders, from regulators and governments to clients, are demanding this shift of focus; and the opportunities in areas such as digital connectivity and renewable energy are compelling. Infrastructure investors are responding accordingly.

Methodology

This research is based on a survey completed by 50 organisations, comprising 15 investment funds, 15 pension or sovereign wealth funds, 10 investment banks and 10 sponsors or developers. The average respondent's investment in infrastructure in the UK is around £3bn. Investment banks, on average, invest £5.6bn. 60% of the organisations surveyed are headquartered in the UK.

Overview

Investment in ESG funds has skyrocketed in the past year. Yet challenges remain, especially around standards and access to data

It is difficult to overstate the explosion of interest in investment with an environmental, social and governance (ESG) tilt. But while record inflows into equity funds have captured the lion's share of the attention – investment in ESG funds increased almost fivefold in the UK alone last year – the ESG boom extends across all asset classes. In particular, demand is growing rapidly for real assets with a sustainable profile; one recent survey found 91% of institutional investors plan to increase their ESG real-asset investments in the next five years.

Our own research supports such predictions. In this survey, nine in ten infrastructure investors (90%) with holdings across a broad range of sectors said they expect scrutiny of ESG issues during deals to increase over the next three years. That includes 82% who predict that the increase will be significant.

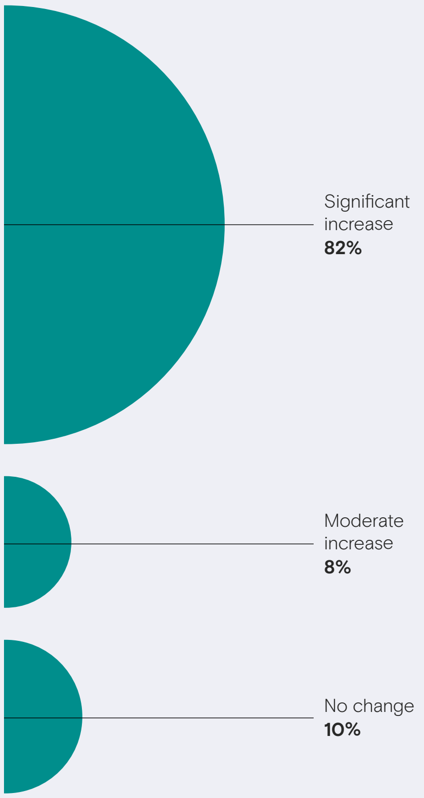
The reality is that ESG is already a central theme for infrastructure investors, with key sub-sectors on the rise. Inframation's data shows, for example, that there were 1,321 transactions involving renewables assets in 2020, 11% up on 2019. Those deals were worth US$194bn, 25% ahead of the previous year. ESG also looms large in new fund launches. This year has already seen KKR raise US$3.9bn for its Asia-Pacific infrastructure fund, with a focus on themes including green energy and environmental infrastructure.

Elsewhere, infrastructure investors are keen to show their commitment to ESG. For instance, Toronto-based Brookfield Asset Management, the parent firm of Canada's biggest infrastructure manager Brookfield Infrastructure, last year hired former Governor of the Bank of England Mark Carney to pilot its ESG strategy.

Top concerns

Infrastructure investors' focus on ESG issues is broad-based. In the environmental sphere, our research suggests the climate change emergency – greenhouse gas emissions and carbon management – is the

How do you expect scrutiny of ESG issues to change in deals over the next three years?



The ESG boom extends across all asset classes. In particular, demand is growing rapidly for real assets with a sustainable profile.

leading ESG consideration for infrastructure investors, with 60% picking out this issue. But energy efficiency (46%) and water and waste management (38%) also score highly. All three areas loom large in the renewable energy infrastructure sub-sector.

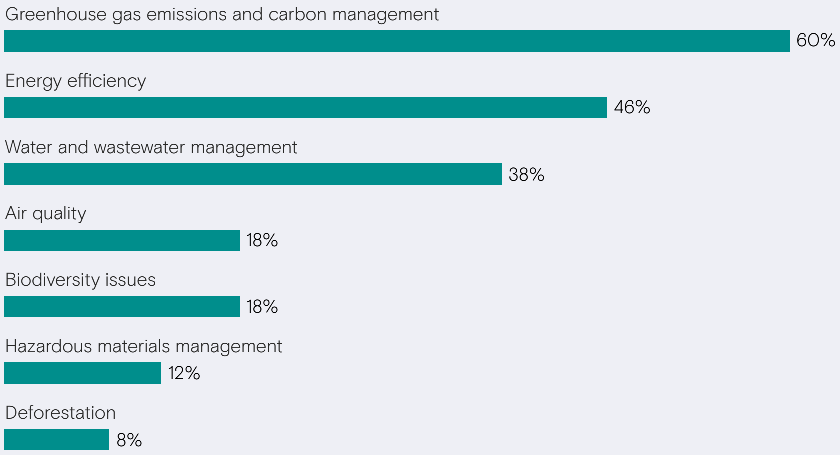
On social issues, the issue of labour standards is the standout consideration for infrastructure investors, cited by more than half (52%). Elsewhere, investors also point to human rights (36%), access and affordability (32%) and fair marketing and advertising (30%) as issues they consider when studying infrastructure projects. Each of these considerations cuts across infrastructure, though the theme of access is particularly key in the growing digital infrastructure sub-sector.

Leading governance considerations, meanwhile, include political influence (60%) and business ethics and transparency (50%). It is also notable that 32% of investors point to supply chain management, significant given the extended supply chain in the infrastructure sector, while 28% cite safety management, a huge issue on so many physical infrastructure projects.

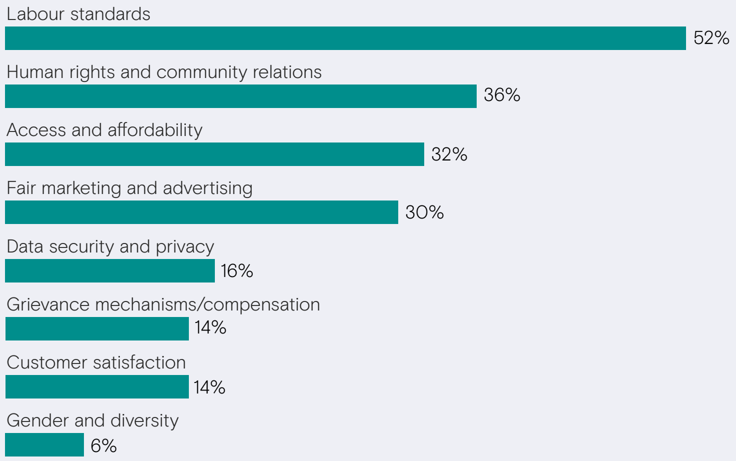
However, despite the growing importance of such a wide range of ESG issues to so many infrastructure investors, it would be a mistake to think that these themes somehow trump investment returns. Almost nine in ten (88%) say portfolio performance is an important consideration as they assess potential ESG investments; that includes 44% who describe it as the most important consideration. A further 34% point to impact risk as the most important factor.

This is not to suggest there is a stark choice to be made between high ESG standards and performance. The overwhelming majority (92%) of surveyed respondents agree that their company has identified ESG performance as instrumental in a clear long-term value creation

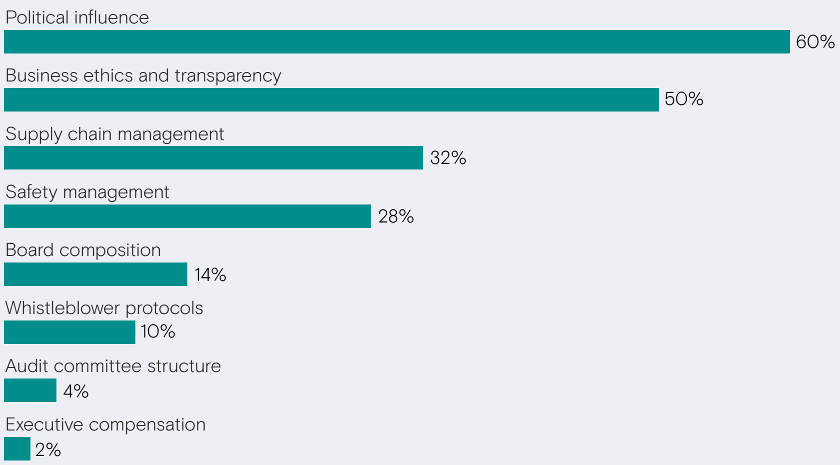
What are the most important *environmental* ESG considerations when contemplating investing in European and UK infrastructure projects? (Select top two)



What are the most important *social* ESG considerations when contemplating investing in European and UK infrastructure projects? (Select top two)



What are the most important *governance* ESG considerations when contemplating investing in European and UK infrastructure projects? (Select top two)



strategy. This includes the 52% of respondents who say they agree strongly with this sentiment. And 92% believe their organisation now takes ESG into sufficient consideration when making investment decisions.

This makes sense. In the energy sector, for example, the future return profile of projects dependent on fossil fuels is uncertain as the world shifts to less carbon intensive sources of energy; the investment case for renewables therefore looks stronger. Similarly, with social issues, the growing backlash against organisations caught up in scandals in areas such as exploitative practices or inequality is reason to consider avoiding projects where the risk of such problems is more heightened.

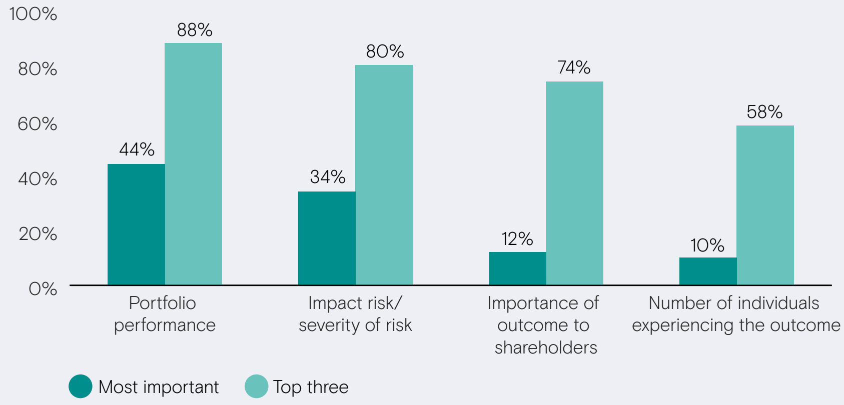
"Organisational resilience, risk management and opportunity identification are all tied to strong ESG performance and strong portfolio performance," says Andrew Bright, Director at ITPE. "You don't necessarily need to be an 'ESG leader' to maximise financial benefit. Instead, we find that a focus on ESG matters which are important to your organisation's operational objectives and stakeholders is central to building value."

Standardising standards

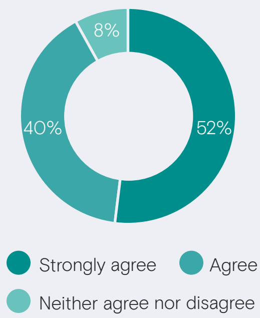
Still, for all the arguments for infrastructure investors to increase their ESG exposures, there are practical challenges to doing so. In particular, many investors bemoan the lack of consistent information on key ESG issues. Some 60% cite the lack of clarity on standards, while 50% point to problems with securing good quality data on sustainability.

No wonder. Research conducted last year by the EDHEC Infrastructure Institute found a remarkable 17 ESG evaluation schemes in use for assessing potential infrastructure investments. Many investors are struggling to work out how to assess the profile of projects from an ESG perspective; even where they know

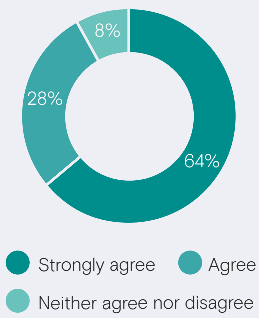
Which criteria does your company use to assess the performance of ESG?



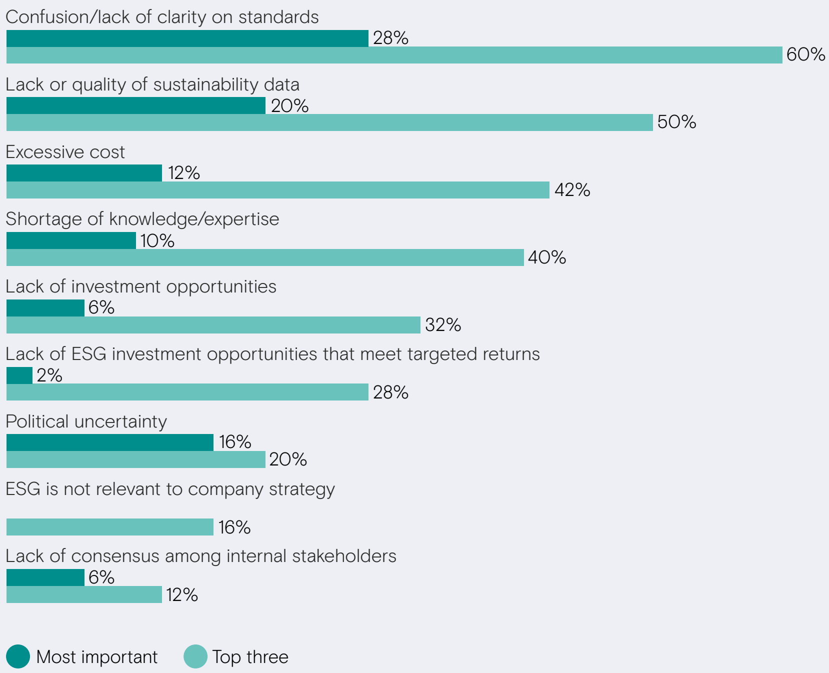
Do you agree with the statement "My company has identified ESG performance is instrumental for a clear long-term value creation strategy"?



Do you think your organisation takes ESG into enough consideration when making investment decisions?



What are your organisation's biggest challenges in making ESG-oriented investments? (Select top three)

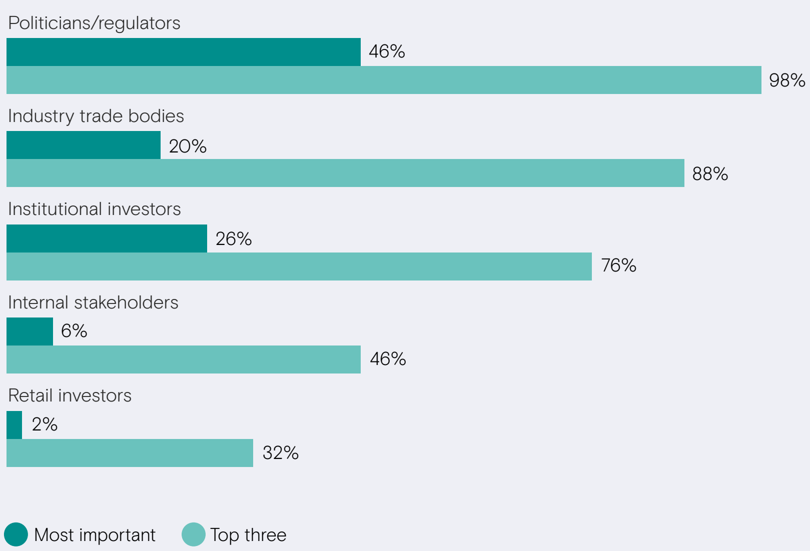


"When it comes to ESG, the investment industry is crying out for clarity. There is plenty of data out there, but investment will only have the teeth needed to make a genuine impact on our world if we know exactly what environmental and social benefits we need to achieve."

Tim Mawhood, Executive Director UK, Europe & Middle East, GHD Advisory

What would push your organisation to have a wider consideration of ESG? (Select one)

Who do you think will drive the application of ESG in infrastructure projects? (Select all that apply)



what they want to measure, finding the data can prove challenging.

The good news is some progress is being made. "Some companies have created benchmark standards when it comes to ESG targets and sustainability; when it comes to company image and reputation, these are the companies that are future-ready," says a partner in an investment fund interviewed as part of our survey. "The same should be followed by others in the industry."

And despite the challenges, the direction of travel is clear – not least given the growing regulatory imperative. More than half the investors surveyed (56%) think regulatory requirements will prompt them to take more heed of ESG considerations. This may reflect March's introduction of the Sustainable Finance Disclosure Requirements (SFDR) across the European Union, requiring providers of financial products to formally disclose whether and how they consider sustainability risks.

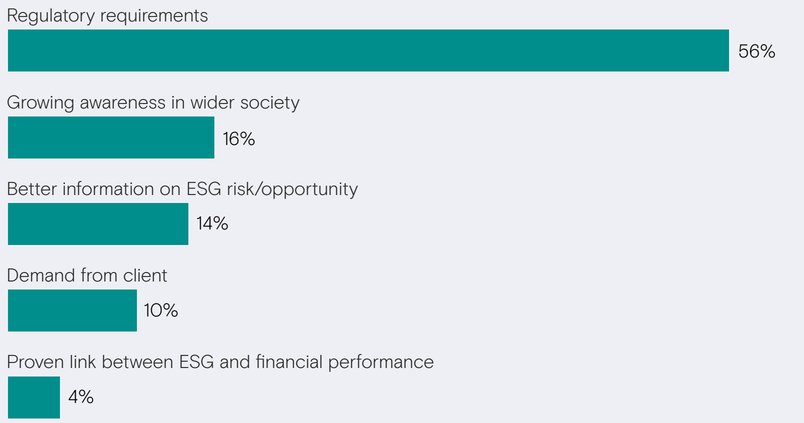
Some participants in this research feel that infrastructure investors are only just getting to grips with this trend. "The lack of awareness regarding ESG compliance and value creation has been a major hurdle," says the head of M&A at one developer. "The government has been announcing new rules, but the effectiveness for the industry is unknown."

But with so many different stakeholders expected to push investors to focus on ESG, the pressure is mounting. These include politicians and regulators, seen by 46% of respondents as the most important actors in driving the application of ESG in infrastructure projects, but also institutional investors (26%) and trade bodies (20%). Indeed, a broad range of stakeholder are expected to push the infrastructure industry towards ESG.

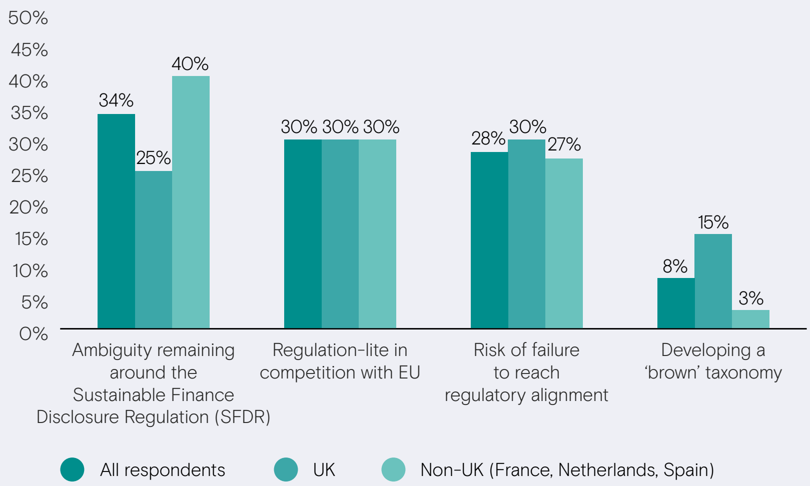
One question for UK infrastructure businesses is how the British authorities will choose to follow the EU's SFDR reforms, with Brexit meaning they sit outside this regulation, at least when marketing in the UK. More than a third of investors (34%) point to ambiguity on this question, while 30% suggest the UK may opt for a regulation-lite equivalent of the new standards. Indeed, amid the broader concern about lack of consistency on ESG standards and definitions, 28% of infrastructure investors are worried about the risk of a lack of alignment between the UK and the EU on this issue.

This is not to say that businesses or investors should wait for regulatory changes before acting on ESG. "While we maintain the view that a positive and stable policy and regulatory environment supports growth, we also believe that investing in ESG specific projects, assets and organisations and embedding ESG features into projects, assets and organisations can get done notwithstanding the help or hindrance that the regulatory and policy landscape can provide," says Michael Rudd, partner at Bird & Bird.

What would push your organisation to have a wider consideration of ESG? (Select one)



In which way do you think Brexit will affect how ESG is regulated in the UK? (Select one)



"It may seem a daunting prospect, but with the right support and a committed leadership team, embedding the right ESG strategy is undoubtedly enabling businesses across all sectors to deliver sustainable and significant growth, and often facilitating entry into markets they had not previously been able to access."

Stuart Cairns, Partner, Bird & Bird

The impact of Covid-19

Infrastructure investment has been profoundly impacted by the Covid-19 pandemic, yet the health crisis has accentuated the need for investment in certain areas

The Covid-19 pandemic has had a marked impact on infrastructure investors – not just on their own businesses, but also in the context of how and where they are considering making investments. Many believe the investment landscape has now changed for the foreseeable future, thanks to behavioural shifts that will have implications long after the pandemic subsides.

The big picture is that almost two-thirds of respondents in this research (64%) say Covid-19 has had a negative impact on their business, including 58% who describe this negative impact as significant.

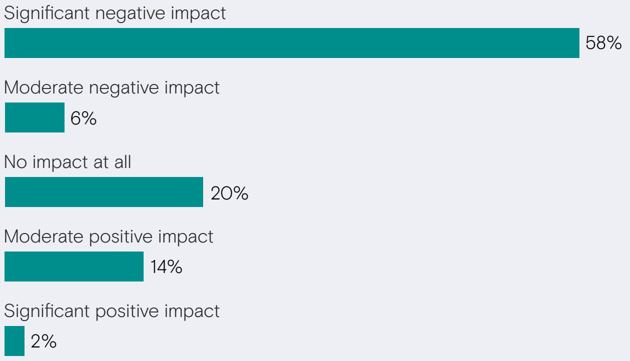
This was inevitable. Inframation's own data shows that fundraising fell in 2020, for the first time since 2011, with funds picking up 28% less. Such data reflects the reality of life during the pandemic. Amid the lockdowns and travel restrictions that Covid-19 has instigated – and at different times in different regions – the practicalities of dealmaking have been challenging, with face-to-face meetings and site inspections often impossible.

Against this context, global unlisted infrastructure transactions totalled US$717.2bn during 2020, a 2% decrease on 2019.

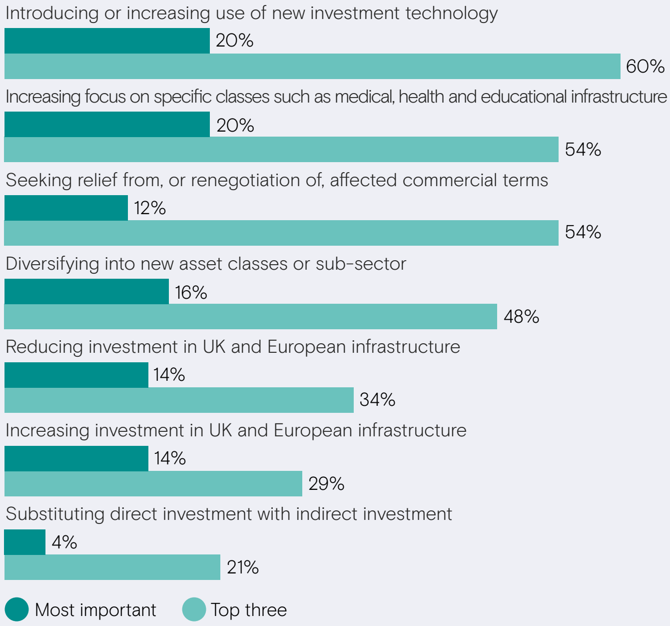
The other issue has been the negative effect on the assets in infrastructure investors' portfolios. In sectors such as transport, commercial property and even energy, where demand has been subdued, returns and valuations have fallen back as Covid-19 has taken its toll.

Investors have adopted a range of strategies to cope with these challenges. Most notably, more than half (60%) of respondents to the survey have introduced new investment technology to power their decision-making. This might include video conferencing and tools such as virtual data rooms that have made it possible to continue transacting – and raising funds – even when parties were prevented from meeting in person.

How would you describe the impact of the Covid-19 crisis on your business?



How are your investment decisions changing as a result of the Covid-19 pandemic?



In addition, 54% of respondents have increased their focus on asset classes likely to have seen positive impacts from the crisis, including medical, health and educational infrastructure. Almost as many (48%) have diversified into such asset classes. Others have taken defensive action, with 54% seeking to renegotiate commercial terms on projects and assets hit by Covid-19.

Inward focus

Looking forward, investors' response to the pandemic is partly inward looking. More than one in four (26%) say their most important shift in priorities will be to focus anew on resilience and scalability, while 24% are introducing operating model changes as their number one imperative. Other crucial internal priorities include becoming more prepared for changing workforce dynamics, including succession planning, and supporting remote working. Clearly, while the next crisis is impossible to predict, investors are determined to become more agile and robust before it hits.

In addition, the pandemic also appears to be changing investors' approach to portfolio strategy, with clear winners and losers within the broad infrastructure approach having emerged.

Among those most negatively impacted is commercial real estate – every single respondent surveyed believes

As a result of the pandemic, how do you envisage your priorities shifting?

that this asset class will be negatively impacted by behavioural change following the pandemic. Most analysts believe that while many people will want to return to the workplace once restrictions allow, they will want more flexibility to work from home at least some of the time; that will reduce demand for office properties.

Similarly, more than nine in ten respondents (94%) believe the hospitality sector will be negatively impacted; it will be some time before hotels, restaurants and other hospitality venues are able to make up for the lost time of the pandemic. Two-thirds of respondents (66%) are also fearful for the prospects of rail infrastructure, with both leisure and business travel curtailed by Covid-19. To make matters worse, the latter may suffer for some time to come, with virtual meetings likely to play a bigger part in business even after the pandemic ends.

Digital acceleration

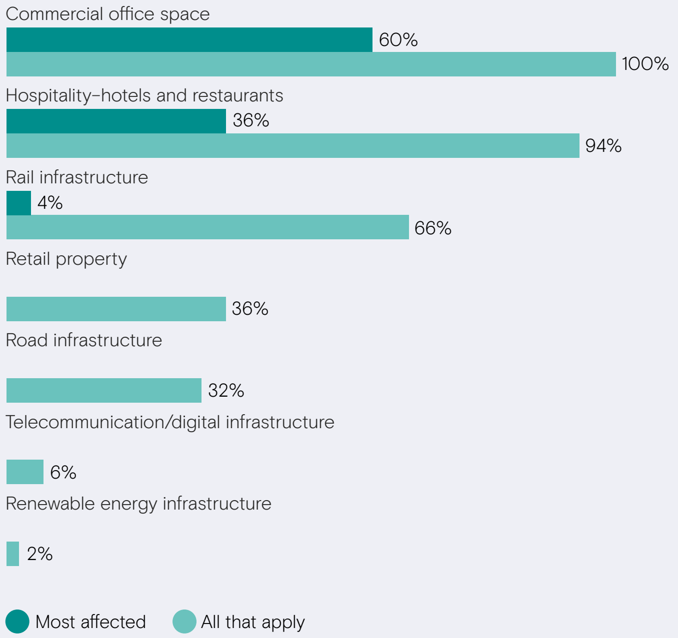
The more positive story is that infrastructure investors also see several sectors where there is considerable scope for positive impact. Almost all (96%) pinpoint digital and telecoms infrastructure as an area of opportunity; with businesses reliant on more virtual working and meeting, and individuals conducting more commerce online, investment in these networks will be crucial.

More digital infrastructure projects will be introduced as a result of the pandemic, predicts the head of infrastructure investments at one investment bank. “Connectivity has become crucial amid the social distancing and the ‘new normal’ conditions, so enhancing digital infrastructure will be prioritised.”

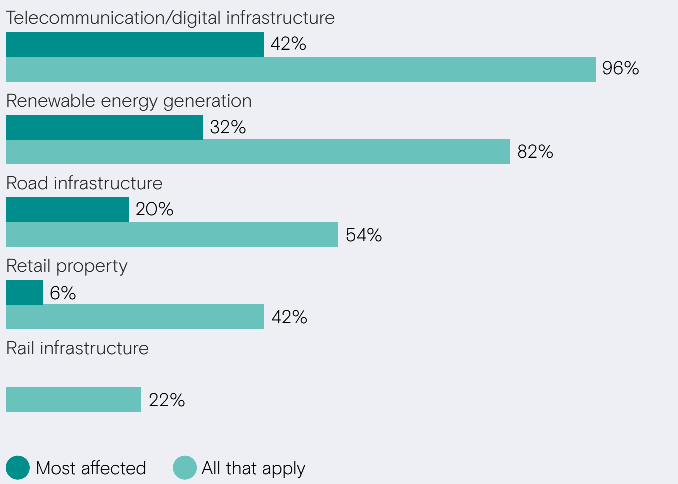
Renewable energy, cited by 82%, is another clear winner. Indeed, the Covid-19 crisis appears to have accelerated the growth of ESG investment – the pandemic has not only highlighted social issues, but also increased the appeal of assets that might offer stability and resilience in the face of volatility.

Finally, investors also believe the pandemic will have an enduring impact on the way people travel. More than half believe the impact on the road infrastructure sector will be positive, as people become more wary of potential crowds on public transport networks.

What types of assets do you think will be negatively impacted by behavioural change generated by the Covid-19 pandemic?



What types of assets do you think will be positively impacted by behavioral change generated by the Covid-19 pandemic?



> Connectivity has become crucial amid the social distancing and the ‘new normal’ conditions, so enhancing digital infrastructure will be prioritised.”

Head of infrastructure investments at an investment bank

What about the 'S'?

Although ESG has become mainstream among investors, a lack of consensus remains around how to address social issues

The climate change imperative and the hard data available on organisations' carbon footprints have helped investors get a firmer grip on the environmental aspects of ESG, despite the challenges highlighted by this report. Governance, too, is well understood; the first UK Corporate Governance Code was published as long ago as 1992. However, when it comes to social, the 'S' in ESG, consensus on what matters most – and how to assess it – is much more difficult to find.

A multitude of issues are bubbling away. The Black Lives Matter protests of the past 12 months, sparked by the death of George Floyd, a Black American, at the hands of a police officer, have focused attention on racial and ethnic inequality in all aspects of society, including the workplace. Gender is also hugely important to many ESG campaigners – both in the context of a lack of female representation at the top of many businesses, and in broader society; the murder earlier this year of Sarah Everard prompted a national debate in the UK about misogyny. Then there are concerns about exploitative practices: the pandemic has foregrounded the precarious and exploitative working conditions in many industries. Meanwhile, there is concern about global supply chains that include workplace abuses.

However, not all of these issues are cutting through equally. In this survey, 52% of respondents say labour standards are a key ESG consideration when assessing potential in European infrastructure projects and only 6% are concerned about gender and broader diversity issues.

Catching up

The statistics may be set to shift. Analysis from RBC shows that amid the Covid-19 pandemic and the Black Lives Matter movement, the number of US companies discussing diversity, equality and inclusion policies during earnings calls with analysts increased tenfold in 2020. In the UK, larger companies now have a statutory duty to report on gender pay gaps; in the US, regulators are contemplating a suite of potential disclosure requirements on diversity and inclusion.

However, these debates are difficult and sensitive, and these challenges are compounded by issues specific to certain regions. In much of continental Europe, for example, there is cultural resistance to collecting data on ethnic background. More broadly, the jury remains out on which issues ESG investors should focus on when thinking about social questions and how these issues should be weighted. Any standards that may be introduced will need to be flexible and be designed to adapt and evolve.

Outlook

Post-Brexit, the UK is well-positioned to become more attractive for inbound investment, and new initiatives to encourage green investment could help

The stars are now aligning for a more ESG-driven approach to infrastructure investment. The powerful forces driving investors towards an embrace of ESG appear to have been considerably strengthened by the Covid-19 pandemic. And there is good reason to expect a further acceleration in the years ahead.

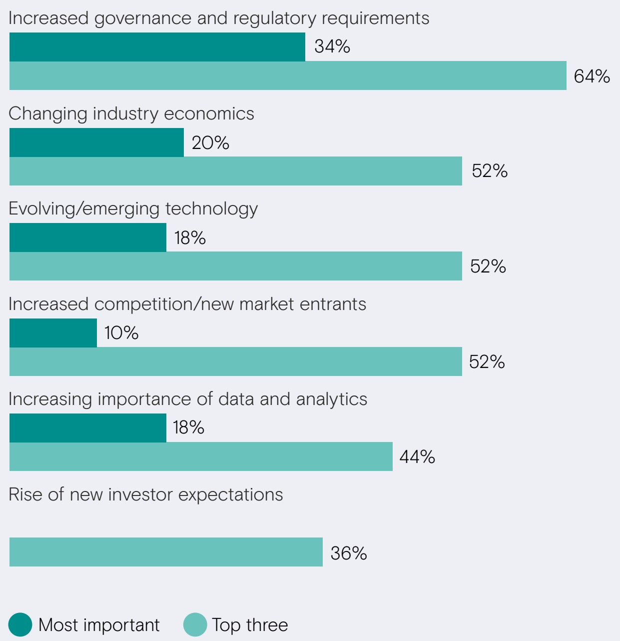
Most obviously, there is the climate change imperative, with the UK's hosting of the COP-24 summit later this year concentrating minds. From an infrastructure perspective, "the theme will be the transition to a low-carbon strategy," says a managing director at an investment bank. "Infrastructure projects are capable of reducing their carbon emissions by working on new low-carbon strategies and this will be given high importance in 2021."

However, other areas of infrastructure will also continue to benefit from the ESG lens. From digital networks that improve connectivity for all citizens to social infrastructure and housing that meet the needs of the population more inclusively, there is every opportunity for investors to respond.

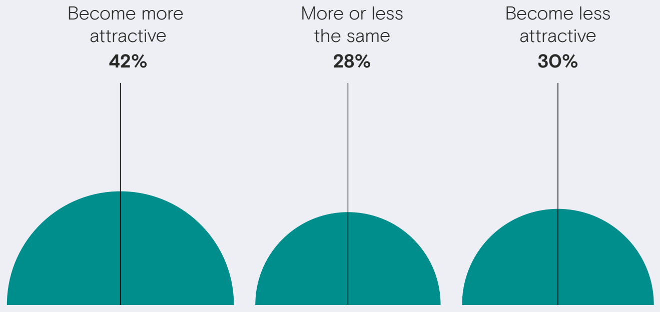
In addition, many infrastructure investors are thinking more carefully about their own practices and behaviours. More than a third (34%) of respondents to this survey pick increased governance and regulatory requirements as the most important driver of structural changes within their organisations over the next three years, some distance ahead of any other factor.

The UK's green revolution
The UK has an opportunity to capitalise on infrastructure investors' increasing desire for an ESG tilt. For one thing, in the post-Brexit environment, 42% of respondents believe the UK will become more attractive for inward investment; only 30% expect desirability to diminish. The most compelling projects are therefore in a strong position to command attention.

What factors will most likely drive structural changes at your organisation over the next three years?



How do you see the UK market developing post-Brexit in terms of desirability for inward investment?



In this regard, the UK's ten-point plan for a green industrial revolution, unveiled by the Government in November 2020, is well-timed. The strategy paper sets out how the UK can "build back better" from the impact of Covid-19, with an emphasis on areas such as renewable energy, clean transport, the natural environment and green finance and innovation.

Infrastructure investors, in a strong position to support this strategy, are impressed by the vision. In this research, almost three-quarters (72%) of investors agree with the focus of the Government's plan, including 16% who strongly support it.

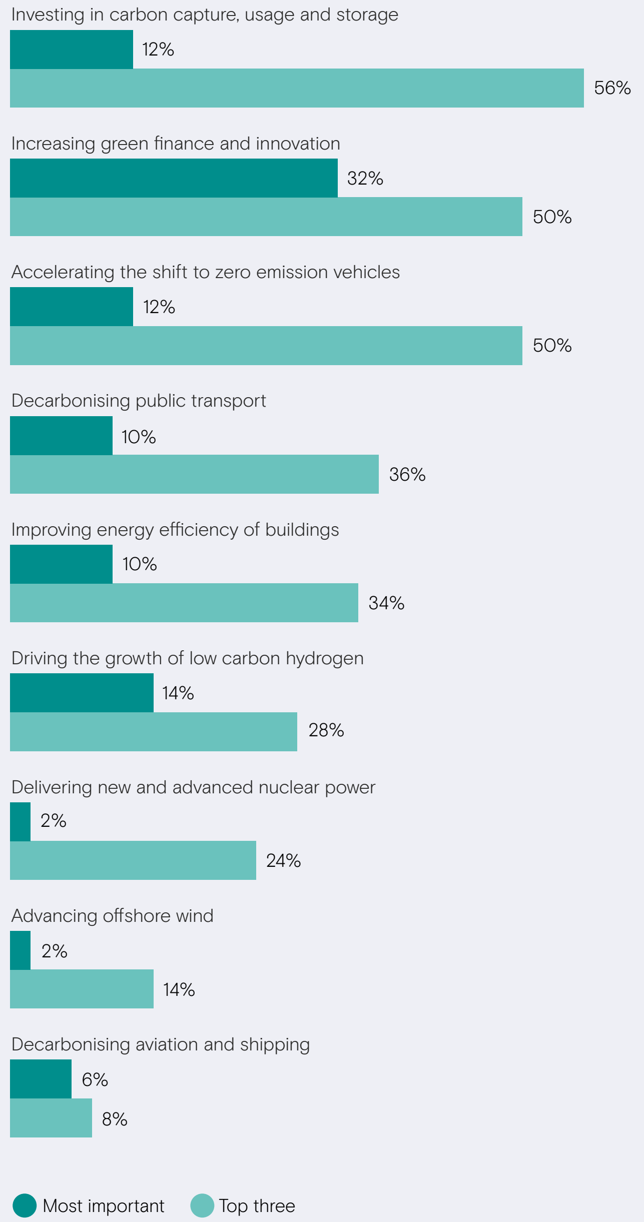
There are certainly elements missing from the strategy that investors regret. "It should have included solar power and investment into solar technology," says the chief investment officer of one investment fund, while the managing partner of a rival fund complains, "initiatives directed to the agriculture sector could have been included".

"The government are clearly serious about the UK leading the pack when it comes to sustainability, but they cannot give with one hand and take away with the other," says Tim Mawhood, Executive Director UK, Europe & Middle East at GHD Advisory. "To deliver the ten-point plan, a huge amount of investment will be needed, but hitting green energy organisations with a six per cent hike in corporation tax will mean less money going towards offshore wind, network upgrades and all the other things we need to slash our carbon footprint."

Nevertheless, many respondents are excited by the opportunities for investment that the Government's initiative could create. In particular, almost a third of investors (32%) pick out green finance and innovation as the area where the UK's ten-point plan will be most important in driving investment. But low carbon hydrogen (14%), zero emission vehicles (12%) and carbon capture technologies (12%) are also seen as likely contenders for being the biggest beneficiary. And at least some additional investment is predicted across a broad range of areas.

Against this backdrop, the stage is set for ESG strategies to make further inroads into infrastructure investment during the year ahead – and beyond.

Where do you think the UK's ten-point plan for a 'green industrial revolution' will drive significant investments?



> "Navigating ESG – including regulatory, market, technology, and reputational aspects – can be difficult as there is no 'one size fits all' approach. Reflecting on broad organisational questions about drivers or incentives, stakeholder expectations and goals can help to articulate a strategy."

Katie Jeffery, Associate, ITPE

About

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We are a global professional services company that leads through engineering, construction and architectural expertise. Our forward-looking, innovative approaches connect and sustain communities around the world. Delivering extraordinary social and economic outcomes, we are focused on building lasting relationships with our partners and clients.

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