KEYNOTE INTERVIEW

Putting sustainability at the heart of infra debt

Delivering strong sustainability performance is a key part of the job for infra debt managers, says Edmond de Rothschild' Jean-Francis Dusch

Sustainability has become an increasingly key concern and goal for infrastructure investors in recent years, especially in Europe. The preoccupation with sustainability also extends into the infra debt space, where ESG KPIs and measure of impact often forms part of covenants with borrowers.

Jean-Francis Dusch, global head of infrastructure and structured finance at Edmond de Rothschild, as well as CIO of infrastructure debt and CEO of Edmond de Rothschild (UK), sees few signs that a backlash against ESG will affect how investors in Europe approach sustainability. In fact, he sees a growing range of opportunities, with sustainability a cross-cutting theme across asset types.

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Q Why does sustainability matter to infrastructure as an asset class?

Sustainability has always been embedded in infrastructure. In the early 90s, when I started my career, you had to respect the Equator Principles, and sometimes projects didn't go ahead if they couldn't comply with those standards. And in the early 2000s, when public-private partnerships were big, ESG was already a very important part of feasibility studies. For example, will a toll road create unacceptable noise? What would be the job creation? Will it affect the flora and fauna?

We talk a lot about the energy transition, but that really started at least two to three decades ago. What we realise now is that sustainability cuts across all sectors, and so does the energy transition. Of course, renewable energy generation is the obvious thing to invest in. But then there's the question of storage and distribution to the grid, energy efficiency, green fuels, green mobility, hydrogen, decarbonisation of utilities and the circular economy.

In Europe, there are new technologies and types of infrastructure to finance, but the topic of sustainability has always been there for those working in infrastructure.

Q Are there differences in how debt and equity investors can approach sustainability in infrastructure?

There's alignment in terms of how you approach the question of sustainability because at the end of the day, whether you're on the equity side or the debt side, you're backed by institutions with ESG goals and convictions, seeking to design and implement a sustainable capital structure to make these projects a reality.

The Sustainable Finance Disclosure Regulation that came into force in March 2021, apply both to equity and debt asset managers/investments. This regulation is designed for institutions who back both equity and debt strategies.

If you think about how to measure the impact, both the equity fund manager and debt holder may apply similar criteria and methodology terms. Equally, as a debt provider committed from inception to energy transition across all sectors, when we finance a project we'll certainly put a lot of pressure on the equity holders to meet ESG criteria and provide us all the data required for us to report comprehensively to our investors. For some utilities, we may want to see certain ESG KPIs, for example, phasing out reliance on fossil fuels over a certain period of time.

Q Which sectors are exciting from a sustainability perspective?

We try to balance our portfolios. For an energy transition strategy, we could build portfolios that are 80 to 90 percent made up of renewable energy generation assets. But we don't do that because our job is also to create sector diversification, therefore we've branched out from just renewable generation. For example, we made an early move into battery storage, focusing on a small plant in Belgium. This resulted in a fossil fuel plant being replaced by a new renewable plant. And in doing so, we contributed to the very important question of energy independence and security.

> *"What we realise now is that sustainability cuts across all sectors, and so does the energy transition"*

Hydrogen is also very interesting. We made an investment earlier this year in green hydrogen that we thought was the right one for our investors after seven years of analysing the sector and at what terms and conditions we would make our first investment within the risk profile of the mandates we're granted.

We had to be careful about how we could mitigate the key risk and structure the debt, taking into account construction risk, the technology and quality of the offtake structure and counter parties. It was also a question of having the right sponsor and sizing the debt in a conservative way even more cautiously as it remains a new sector.

Another thing we did as a first to market was to finance transformation from methane. For example, there are coal mines closed in northern France where captured high-pressure methane has been captured which could be released into the atmosphere. Methane is 84 percent more dangerous than CO2 when released. We identified and partnered with a company that operates on these closed mines to capture and treat the methane to generate energy services such as clean renewable energy district heating.

We like such stories because energy transition is also about transitioning. Being able to transition such sites and generate clean energy services is crucial. It's part of the circular economy and about turning a brown asset into a green one.

Q People often assume that debt investors have less direct influence on the sustainability performance of assets. Is that perception fair?

It's true that we're not going to set the strategic direction because we don't put a management team in place, don't have board seats and don't run the project companies we finance. However, because infra debt is covenanted, which means obligations are placed on the borrower, we'll impose KPIs to force them to achieve some key sustainability goals that are important to us as and our underlying investors.

Then it becomes a question for us as an asset manager to make sure that we have enough voting rights in the pool of lenders. Whether we're sole lender, part of a limited club of lenders or an arranger in a broader syndicate, we'll have reserve rights or veto rights to ensure that, again, we have some control. So, the perception that lenders don't have any influence is wrong to a certain degree.

Debt investors also have the discretion to select assets in line with their investment, ESG convictions and investors goals. On day one, we require borrowers to complete an ESG questionnaire, so that we have the right information before pursuing an opportunity.

Our ESG process starts with the selection of an asset. It then extends into how we may structure specific ESG covenants, how we close the deal, measure the ESG impact of such assets (such as avoided CO2 emissions, alignment to global warming reduction targets, meeting key UN sustainable development goals), monitor it and ultimately report comprehensively to our investors in line with their own internal and regulatory constraints.

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Q Has the ESG backlash had any effect in how infrastructure investors consider sustainability?

Europe, where we've made most of our investments, has been clear that it's betting on the energy transition to support economic growth. And it seems that this bet is paying off. Regulations like the SFDR gives incentives to institutions to provide the additional liquidity that's needed. And if you look at the EU's Fit for 55 package, which aims to reduce CO2 emission by 55 percent by 2030, it proposes €1 trillion of investment, over the next four or five years.

In Europe, the purpose of ESG and the energy transition is not being challenged. The need for essential energy transition infrastructure is not being challenged either.

I think what's a bigger issue is how do you get all the information from borrowers if you want to report efficiently to investors? Taxonomy is in principle easy to comply with but many realised that when it comes to providing all the data that the regulation requires, then it's more challenging. SFDR's directive is also evolving and we're therefore aware that the ESG aspect is still a work in progress and will evolve over time. However, I wouldn't say there's a real backlash against the regulation.

The reporting requirements are also often time consuming. Some of the data we have to compile and provide is quite complex, and some investors may have different requirements. However, as much as reporting requires some work, at the end of the day, we're talking about responsible investments and we have to be disciplined, act as role model and equip ourselves to be able to provide the data.

The appetite from investors for SFDR Article 8 or 9 funds is definitely there and it's growing.

"AI is going to help process all the data that's essential for monitoring more and more complex assets across the whole spectrum of the energy transition"

Q Looking ahead to the next few years, how will the sustainability space evolve?

Everything is going to become even more interconnected. Artificial intelligence is going to help process all the data that's essential for monitoring more and more complex assets across the whole spectrum of the energy transition, whether that's energy consumption, the grid, energy efficiencies or green mobility (such as EV charging networks which rely on a "dedicated" cloud managing all the information on the network).

I think in the infrastructure world, whether you're doing transport, social infrastructure, energy, digital infrastructure or utilities, everything is going to become more interconnected. The smart city is becoming a reality. It's something I've been talking and dreaming about for the past 15 to 20 years. This is, for me, the epitome of sustainability and sustainable infrastructure: to contribute to the construction of a sustainable world that's essential to future generations.