Allianz Global Investors

How integrating ESG can help infrastructure debt investing

As incorporating environmental, social and governance (ESG) considerations into portfolios grows in popularity, U.S. investors are increasingly asking their asset managers how this sustainable approach to investing could benefit various asset classes. In the case of infrastructure debt, the answer is one that most investors should appreciate: Using ESG research to assess infrastructure opportunities can identify risks that might otherwise be missed, potentially bolstering long-term, risk-adjusted returns.

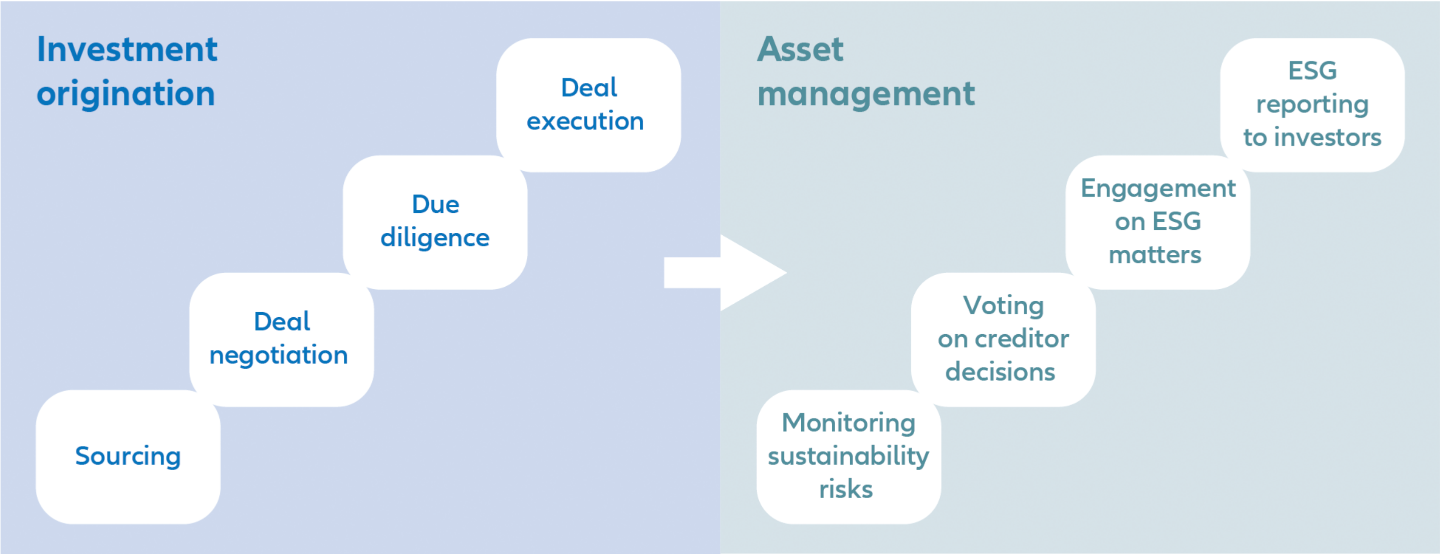
Sustainable investing is popular — 71 percent of institutions want their portfolios to be ESG-compliant by 2030, according to a global survey of 490 institutions undertaken by Allianz Global Investors.[1] However, the rules of the road are only now being set: The European Union is leading the way with a new taxonomy aimed at identifying "sustainable investments," a nascent step toward creating a market-wide standard. Still, many investors remain confused about what exactly constitutes ESG investing and how different asset managers are approaching the issue.

Investors are cautious not to engage with firms that might be "greenwashing" their offerings. So, it makes sense for investors to know in advance what criteria an asset manager uses when choosing investments and for asset managers to be transparent about their process.

As a leader in sustainable investing for two decades, AllianzGI categorizes sustainable investment strategies in three main groupings — Integrated ESG (consistently integrating ESG factors into investment decisions without constraining choices), Sustainable and Responsible Investing (inclusionary and exclusionary strategies that target both financial and social/environmental benefits), and Sustainable Development and Impact Investing (seeking positive change in line with the United Nations' Sustainable Development Goals). Infrastructure debt fits into our Integrated ESG category.

Considering ESG risks is especially important for infrastructure debt investors, not least because of the typically long maturities of these deals and the fact that investor sentiment is rapidly shifting toward sustainable investing. If there is one thing that markets have taught us in recent years, it's that once a trend takes hold, it tends to evolve more rapidly than we first expected. This is particularly relevant for deals that have refinancing obligations in the future, which brings into focus the so-called "stranded asset" risk that they may not have access to the capital at that time, leaving the existing lenders with a problem.

Exhibit 1: ESG is integrated throughout the asset-management process for infrastructure debt



As of March 2021. Source: Allianz Global Investors. During any stage of the investment process, the selection criteria may vary from those shown above. The diagrams and statements above reflect the typical investment process applied to this strategy.

Investors can divide ESG considerations into two parts: ESG risk and ESG impact.

ESG risk includes variables that affect the performance of an investment, such as the risk of default. We believe *all* investment strategies should consider ESG risks and mitigate against them.

ESG impact involves the positive/negative externalities caused by the investment. Whether an investor chooses to prioritize ESG impact depends on such things as how an investor balances making an impact against generating financial returns. For example, if there is surplus demand for renewable assets, the pricing of those assets could be compressed versus other infrastructure assets. Similarly, some investors may accept higher risk, such as merchant electricity prices, to invest in renewables. While there is no right or wrong approach, it is crucial for investors to understand the ESG process of their asset managers.

Sustainability cannot be bolted onto an existing investment strategy; it must be fundamental to the investment process, from investment screening, due diligence, negotiation of legal documentation to post-financial close. At AllianzGI, our Integrated ESG approach follows a set process throughout the investment life cycle, from origination to asset management **(Exhibit 1).**

We assess ESG risks during four discrete stages of deal origination:

Sourcing: When sourcing infrastructure debt, we follow specific exclusion criteria. For example, we do not invest in assets generating significant energy from coal. We do not invest in oil and gas refining and are not making new fossil fuel–related investments with maturities beyond certain dates, depending on the specific investor appetite.

Deal negotiation: Once we identify an opportunity, we identify key credit and sustainability risks. If a sustainability risk is considered too high, the deal is rejected.

Due diligence: Over several months, we fully investigate all sustainability risks. If any risks are deemed to be too high, the transaction is canceled.

Deal execution: During legal documentation negotiations, we push to include ESG-related clauses, such as commitments to mitigate potential risks related to environmental and safety regulations.

After origination, we continue to monitor and report on the sustainability of our investments. Here again, ESG considerations can be divided into four stages:

Monitoring: We monitor the key sustainability risks identified at deal closing through periodic meetings with issuers and at least semiannual reporting, and we maintain a watchlist of investments that are deviating from our expectations.

Voting on creditor decisions: We aim to exercise voting rights efficiently, acting on behalf of all our investors as a single voting block.

Engagement: We regularly engage with senior executives at issuer companies to discuss ESG-related matters and concerns.

Reporting: We produce monitoring notes on each asset for our investors semiannually. These include updates on any material changes to key sustainability risks, our proprietary ESG risk score and our E.U. Taxonomy-alignment assessment.

When done with the appropriate attention to detail, taking an Integrated ESG approach to infrastructure debt investments, both while originating deals and managing assets, can produce portfolios with higher potential investment returns than would be the case using traditional financial analysis alone.

Notes: [1] Allianz Global Investors' Sustainability Report 2019, "Demand for ESG investments is growing," p.22

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CORPORATE OVERVIEW

Allianz Global Investors is a leading active asset manager with more than 700 investment professionals in 25 offices worldwide, managing $712 billion in assets for individuals, families and institutions. AllianzGI offers its clients a wide range of actively managed strategies and solutions across the risk/return spectrum and has established expertise in equities, fixed-income, multi-asset and alternative investments.

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