

## Real Assets

# LISTED INFRASTRUCTURE




## Realizing the potential for sustainable impact

Investing in infrastructure represents a unique opportunity for long-term investors to allocate capital at the intersection of environmental, social, and economic progress. A 2018 study from the Inter-American Development Bank makes the case that infrastructure has the potential to explicitly and directly support progress toward over 70 percent of the 169 Sustainable Development Goal (SDG) targets outlined in the United Nation's 2030 Agenda for Sustainable Development.<sup>1</sup> The Organisation for Economic Co-operation and Development (OECD) calculations demonstrate that nearly seven trillion dollars of annual investment in infrastructure will be required in the coming decade to support economic growth while meeting the SDGs.<sup>2</sup>

### At a glance:

- Listed infrastructure businesses are uniquely positioned at the intersection of environmental, social, and economic progress.
- A bottom-up approach to evaluating sustainability supports the dual objective of delivering excess returns and addressing some of the world's significant social and environmental challenges.
- A targeted allocation to listed infrastructure may support positive sustainability outcomes for clients.

### Exhibit 1: The social and environmental objectives outlined in the SDGs are fundamental for infrastructure companies

Goal	Sample targets and indicators	Potential subsector alignment
 <p><b>6</b> CLEAN WATER AND SANITATION</p>	<p><b>Goal 6. Ensure availability and sustainable management of water &amp; sanitation for all</b></p> <p><b>Target 6.1</b> By 2030, achieve universal and equitable access to safe and affordable drinking water for all</p> <p><b>Indicator 6.1.1</b> Proportion of population using safely managed drinking water services</p>	Water and wastewater utilities
 <p><b>7</b> AFFORDABLE AND CLEAN ENERGY</p>	<p><b>Goal 7. Ensure access to affordable, reliable, sustainable, and modern energy for all</b></p> <p><b>Target 7.1</b> By 2030, ensure universal access to affordable, reliable, and modern energy services</p> <p><b>Indicator 7.1.1</b> Proportion of population with access to electricity</p> <p><b>Indicator 7.1.2</b> Proportion of population with primary reliance on clean fuels and technology</p>	Electric, gas and multi-utilities
 <p><b>9</b> INDUSTRY, INNOVATION AND INFRASTRUCTURE</p>	<p><b>Goal 9. Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation</b></p> <p><b>Target 9.1</b> Develop quality, reliable, sustainable, and resilient infrastructure, including regional and transborder infrastructure, to support economic development and human well-being, with a focus on affordable and equitable access for all</p> <p><b>Indicator 9.1.2</b> Passenger and freight volumes, by mode of transport</p>	<p>All</p> <p>Toll road, passenger, and freight rail operators</p>

<sup>1</sup> [https://publications.iadb.org/publications/english/document/What\\_is\\_Sustainable\\_Infrastructure\\_\\_A\\_Framework\\_to\\_Guide\\_Sustainability\\_Across\\_the\\_Project\\_Cycle.pdf](https://publications.iadb.org/publications/english/document/What_is_Sustainable_Infrastructure__A_Framework_to_Guide_Sustainability_Across_the_Project_Cycle.pdf)

<sup>2</sup> <https://www.oecd.org/finance/Sustainable-Infrastructure-Policy-Initiative.pdf>

## Management compensation and sustainability

The fundamental relationship between listed infrastructure and sustainability is already being reflected in frequent links between management pay and sustainability objectives, and we expect this trend to continue. Among MSCI All Country World Index constituents, 44 percent of listed infrastructure businesses have management incentive pay that is formally linked to performance

on sustainability metrics. For those companies in other industries, just 13 percent of management teams are similarly aligned.<sup>3</sup> Many companies who have adopted sustainability and ESG metrics in management incentives are working to refine and increase the weight of such metrics in total compensation (Exhibit 2). We also expect sustainability considerations to increasingly matter for long-term incentive payments.

### Exhibit 2: Examples of sustainability-linked management incentives from select listed infrastructure companies

Company	Country/Sector	Incentive plan details
Company A	U.S. / Energy	Environmental and safety performance comprise 10% of Annual Incentive Payment
Company B	Canada / Energy	ESG metrics comprise 35% of Short-Term Incentive Program
Company C	U.S. / Utilities	40% of multiplier for Short-Term Incentive Plan is safety, diversity, environment, and customer focused
Company D	U.S. / Utilities	Non-emitting generation capacity growth comprises 10% of Long-Term Incentive Plan
Company E	Italy / Utilities	A quarter of long-term variable remuneration linked to environmental metrics: renewable capacity (15%) and CO2 emissions reduction (10%)
Company F	France / Transport	ESG performance indicators comprise 25% of both long-term and short-term variable pay of the CEO, and 15-30% of the variable pay of other executives
Company G	Australia / Transport	Short-term incentives are linked to climate-related metrics, mainly Scope 1 emissions reductions achieved through corporate PPAs.
Company H	Hong Kong / Utilities	In determining incentive pay, quantitative targets considered include: (1) Regulatory non-compliance cases; (2) CO2 intensity; (3) Emissions; and (4) Renewable Energy capacity

Source: Company reports. 31 July 2021

## The public company advantage

A single listed infrastructure company may manage hundreds of assets, often in close geographic proximity. These companies are frequently among the largest employers and deployers of capital in their national or local markets, which enables efforts to lead policy direction and champion sustainable development. In contrast, private equity portfolios may comprise only 10-15 assets. Each is likely to be in different regions and entirely different sectors, making a private equity owner less likely to enjoy the influence conferred to large operators.

Private infrastructure may be further disadvantaged when it comes to the potential for sustainable impact because many private equity owners have historically relied on leverage and other financial engineering methods to boost returns. These practices not only put financial sustainability at risk, but they

have real implications for public perception. As an example, the outgoing chairman of UK water utility regulator Ofwat has frequently criticized the complicated financing and tax structures utilized by private equity owners. Listed water utility companies are seen to offer a degree of transparency and customer focus not evident at their private equity-owned counterparts.

Scale, and the positive feedback loop associated with greater transparency, ultimately empower listed infrastructure companies to fund innovation and new project development. One of the top U.S. utilities by market capitalization sees green hydrogen, a carbon-free alternative to natural gas created using renewable energy, as potentially cost-competitive in the 2030–2035 time frame. That’s not stopping the company from deploying hundreds of millions in green hydrogen pilot projects today. Given the company’s track record as a first mover in renewable generation and battery storage, investors are happy to go along for the ride.<sup>4</sup>

<sup>3</sup> MSCI ESG data. FactSet 31 July 2021.

<sup>4</sup> <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/utility-net-zero-carbon-goals-disingenuous-says-nextera-ceo-64516067>

## COMPANY EXAMPLE: Australian toll-road operator

The scale a particular Australian toll road operator has achieved creates several advantages for sustainable development. For one, the company's collection of interconnected assets supports superior data collection. Consequently, the company's traffic modeling has the potential to be more cost-effective versus peers, which tend to hire many consultants to run less powerful models. Competitive processes for large infrastructure projects also generally cater to larger players with significant experience and financial and operational strength, with government tenders often explicitly requiring a degree of scale and/or experience in formal government tenders. Once a project is awarded, the company can access funds through the public markets. Further, the company's long track record in serving its customers strengthens its regulatory relations and enhances its ability to win new projects and to structure attractive concessions and pricing mechanisms. These advantages enable win-win partnerships and create better economics for the operator, which can spur investments in sustainable road designs (e.g., gradients to reduce emissions), better safety and maintenance, future buildout of EV charging stations, and stronger community initiatives.

## The case for a bottom-up approach to analyzing sustainability

In our experience, analyzing a company's sustainability credentials demands a similar level of attention, nuance, and context required to evaluate other aspects of a company's fundamentals. While exclusionary approaches that rely solely on third-party ratings can serve a purpose in some investment strategies, active sustainable investors should be willing to embrace complexity. Differentiated views on sustainability can be both a source of alpha generation and a means of ensuring underappreciated sustainable companies continue to have access to fairly priced capital.

Here, we highlight several challenges with relying on mainstream approaches to assessing sustainability in the listed infrastructure space specifically, including:

1. Factors of critical social importance like reliability and affordability set natural limits on the pace of decarbonization and electrification. Approaches that attempt to analyze environmental progress in isolation from an infrastructure company's social contributions ignore this reality.
2. Infrastructure companies in emerging markets play an irreplaceable role in the delivery of the SDGs, yet they do not typically screen well when developed market sustainability and ESG standards are applied.
3. Infrastructure businesses typically operate as regulated or contracted monopolies. An economic monopoly is generally a monopoly on social and environmental impact potential, which makes progress the most meaningful driver of investment decisions. The monopolistic nature of these businesses also raises the stakes should a company fall out of favor with the broader market.

### Challenge 1: The 'E' can't be isolated from the 'S'

When it comes to the energy production or consumption, what is reliable, affordable and maintains jobs is heavily influenced by resource availability, weather, policy priorities, customer demographics, and other legacy considerations. These considerations are typically unique to an infrastructure company's service territory or territories and are best analyzed on a bottom-up basis. What may be an appropriate decarbonization pathway for one infrastructure company may not make sense for another. Strict exclusionary mandates may prohibit investment in companies that do not meet certain generic standards for decarbonization efforts, often a percentage of capital expenditures that is going towards renewable energy, or that continue to have a percentage of revenues tied to fossil fuels. None of these factors in isolation consider how an infrastructure company's environmental stewardship is shaped by its social responsibilities, however.

Further, third-party scoring of a company's social contributions typically focuses on factors that can be broadly applied across industries like diversity instead of on factors that are more fundamental to infrastructure companies such as reliability and affordability. Despite these shortcomings, the average infrastructure company does earn social scores from third-party raters that are higher than peers in other industries.<sup>5</sup> However, the weightings or perceived materiality of social factors for an infrastructure company lead to overall third-party ratings that may not reflect the true role a company plays in meeting a community's basic needs.

We broadly anticipate that as decarbonization targets become more commonplace, investor focus will shift towards companies that have a credible plan not only for the environment but also for the human stakeholders they serve, employees and customers. We are already seeing evidence of this trend, as markets that are further along in their clean energy transition efforts are increasingly grappling with how to ensure this transition is a 'just' one.

<sup>5</sup> MSCI ESG Research.

### COMPANY EXAMPLE: U.S. utility company

An upper Midwest U.S.-based electric and natural gas utility holding company has frequently highlighted the challenges associated with full electrification of the heating system in certain geographies, such as in areas where winter temperatures rarely rise above 32 degrees Fahrenheit (0 degrees Celsius). Due to differences in efficiency, the company estimates that a key subsidiary's electric generation capacity would have to increase five-fold to replace winter gas demand. Although the company would be a net beneficiary of full electrification, customer bills would increase 3x. Since the cost to customers is prohibitive, decarbonizing gas is a more viable way forward. Technologies that enable the use of carbon-free alternatives to natural gas at scale are not yet available; however, the company is making exploratory investments with the support of its regulator.

### Challenge 2: Emerging markets companies rarely screen well

Relying on broad-based ESG and sustainability standards can be relatively detrimental to emerging markets companies. Yet, these companies have an irreplaceable role to play in delivering the SDGs.

The weighted average MSCI ESG score for MSCI All Country World Index constituents is 'A' compared to a weighted average rating of 'BBB' for the MSCI Emerging Markets Index. Among transportation infrastructure companies covered by MSCI ESG Research, 15 of 16 companies rated an ESG laggard operate in an emerging market.<sup>6</sup> Emerging markets companies are also disproportionately represented among the Utility sector laggards. The explanations are simple enough. Environmental progress can be heavily constrained by affordability in developing countries and higher growth creates its own challenges when it comes to protecting the environment. We often find Governance scores

are impacted by frequent control by government entities, and disclosures and transparency are often less robust than is typical at developed markets peers.

The generally weaker third-party ESG scores of emerging markets companies can create a marketing incentive for some investment managers to reduce investment in certain countries. Any relative shortcomings of emerging markets companies should be considered alongside their heightened impact potential, however. The different circumstances facing emerging market countries is recognized throughout the SDG framework. Simply connecting a community to clean water and providing access to electricity or data transmission will quickly make the lives of many people dramatically better. Government participation in shareholding structures may even be additive to impact potential in instances where government ownership has positive implications for regulatory treatment and/or ability to achieve scale.

### COMPANY EXAMPLE: Chinese utility company

A listed gas utility in China that is controlled by a state-owned entity has historically benefitted from its relationship with its parent company. Over time, the connection has helped the listed company strengthen its relationships with local governments and acquire and invest in attractive city gas projects in growing Tier 1 and 2 cities. In a period of industry consolidation, the company has created synergies with sub-scale gas distributors whose returns have been pressured by stricter regulations and China's push for lower energy costs. As coal still fuels more than half of China's electricity production, natural gas plays an important role in the country's decarbonisation and energy transition. Further, the company is also a natural investor in innovative businesses that add value to its customers across the residential, industrial, and commercial segments while helping them to reduce their carbon footprints. These include the sale of energy-efficient gas appliances, renewable energy projects, and EV charging and hydrogen refueling stations.

<sup>6</sup> MSCI ESG Research. Industry Report – Transportation Infrastructure, July 2021. ESG laggards are those with a rating of BB or below.

### Challenge 3: Monopolies require unique considerations

When it comes to listed infrastructure companies, we generally find that an economic monopoly is also a monopoly on social and environmental impact potential. In most cases, progress towards environmental and social goals stem from ongoing collaboration with regulators and users of the infrastructure and are a by-product of a company's social license to operate. Sustainability efforts are even explicitly incentivized through many regulatory frameworks. In the U.S., certain utility companies have the potential to earn financial incentives through achieving specific energy efficiency goals, adopting electric vehicles and heat pumps, and reducing peak electric and gas consumption, among other metrics. Likewise, many European utilities receive preferential allowances for capital expenditure related to smart meters or other technologies that facilitate reductions in energy usage.

In our view, infrastructure companies are not only best positioned within their respective service territories to champion environmental and social progress, but it is rare that another company is able to jump in if this potential is not realized. Actively limiting investment in enablers of scope 3 emissions—gas distribution utilities, long-haul gas and oil pipeline operators, airports, among other examples—misses this point. An infrastructure company that enables scope 3 emissions today is the same company that has the monopolistic power to facilitate the transition away from reliance on fossil fuels. If public equity investors shy away en masse, a company may have challenges remaining well-capitalized and ultimately delivering on its impact potential.

At Principal, we believe we have the responsibility and benefit of maintaining our own views of a company's ESG and sustainability practices. We are happy to engage in constructive dialogue with management teams of companies that are at the earlier stages of their sustainability journeys, and to consider how a company's bottom-up circumstances may lead to a less predictable—but no less valid—approach to sustainability. This may result in owning companies that are temporarily out of favor with other market participants, and companies whose sustainability credentials are not yet reflected in market valuations. We believe this approach is what enables us to invest in companies that contribute to social and environmental progress while still delivering strong excess returns.

#### COMPANY EXAMPLE: Diversified transportation infrastructure operator

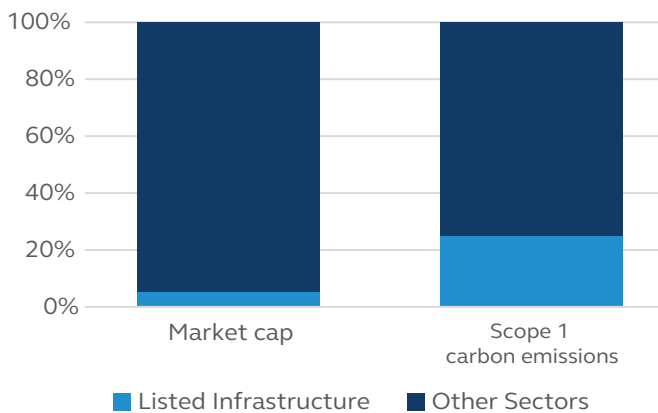
A French transportation infrastructure operator that manages dozens of airports worldwide, frequently cites its ongoing engagement with local governments and major airline partners to examine the changes needed to its infrastructure to support the deployment of sustainable aviation fuels, in particular green hydrogen. There will be a need for new facilities to produce, store and distribute greener alternatives, and the company's airports will need to maintain the ability to supply both jet fuel and sustainable fuels during a lengthy transition period. At one of its airports in France, the company is working closely with the local government to support the first phase of green hydrogen adoption in aviation, with plans to make hydrogen fueling available for trucks on-airport. Subsequent phases will support green hydrogen as fuel for platforms and other jet bridges, and perhaps by 2035, for aircraft. Airbus expects its hydrogen concept aircraft will be available for passenger services around this time. The company is also pioneering the concept of utilizing the land that typically surrounds its airports for safety purposes to produce renewable energy. At another of its European airports, the company expects it can rely on solar panels to power all on-site operations and the excess can soon be sold back to the surrounding communities. Finally, one of the airports it manages in Brazil has achieved many environmental firsts in the local market, including its own solar generation, zero waste to landfill and zero liquid waste, with 100 percent of treated wastewater recycled.

## Consider a targeted allocation to listed infrastructure companies

Listed infrastructure companies typically represent less than 5 percent of major stock market indices. In addition, generalist ESG index providers and investment strategies are increasingly adopting structural underweights to the most carbon intensive industries as the basis for their ESG credentials. This suggests that listed infrastructure companies may be even more underrepresented within a broader global equity allocation going forward.

A targeted allocation to listed infrastructure may also be of specific appeal to investors focused on contributing to absolute carbon reduction. The latest data shows that those same listed infrastructure companies that represent only a small component of the broad market contribute more than a quarter of scope 1 carbon emissions today, and thus represent a major source of opportunity for impact.

### Exhibit 3: Potential for carbon emissions reduction is greater among listed infrastructure companies



Source: Company reports, 31 July 2021

In percentage terms, the average listed infrastructure company has already committed to reducing carbon emissions by 52 percent, and we expect the vast majority of companies will commit to further reductions on a net zero pathway in the next few years. MSCI's ESG research further indicates that carbon emissions management is generally stronger among listed infrastructure companies than among firms across other industries.<sup>7</sup>

More broadly, relying on sector specialists may lead to better engagement outcomes. We find that company executives are most likely to respond to constructive dialogue after we have demonstrated a deep knowledge of their business and respect for the trade-offs inherent in their efforts to strive for progress along all three pillars of sustainability. They also appear more willing to provide meaningful access to their sustainability leaders—whether typically market-facing or not—if they believe the conversation will be mutually beneficial. Establishing these relationships requires regular discussions over the course of many years, a near impossibility for senior decision makers on generalist investment teams despite best efforts. Further, the nature of the relationships maintained by sector specialists facilitate the ability to have a voice greater than that implied by percentage of ownership.

In cases where investment team members support more than one strategy, each may integrate ESG and sustainability considerations to different degrees. Individuals responsible for manager selection should seek to understand how key investment personnel allocate their time across strategies. Ideally, portfolio managers and analysts will be adequately incentivized to spend their time on those strategies that specifically incorporate sustainability into their investment objectives. Elements of a manager's background—including education, certifications, prior professional experiences, and investment team diversity—should also demonstrate an enduring commitment to ESG and sustainable investing. Investment team diversity, in particular, is frequently linked to strong investment performance, and we suspect diversity of thought may be even more important when the stated investment objective is to deliver strong financial returns alongside positive social and environmental contributions.

### Final thoughts

Listed infrastructure represents a unique opportunity to invest in a subset of public companies that have long track records of delivering positive financial and social outcomes while acting as stewards of the environment. Infrastructure has the potential to contribute to over 70 percent of the SDG targets, and ongoing investments in innovation and increasing management alignment to sustainability metrics leave listed infrastructure companies well-positioned to fulfill this promise. Still, mainstream approaches to analyzing sustainability may not fully capture important aspects of a sustainable infrastructure company's value proposition. We believe that an approach that embraces proprietary views on sustainability can support both alpha generation and enable out-of-favor companies to continue their efforts to achieve positive social and environmental outcomes. Dedicated listed infrastructure investment teams with a differentiated ability to analyze sustainability and ESG topics may be best positioned to execute such a strategy.

<sup>7</sup> MSCI ESG data. FactSet, 31 July 2021.

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