The missing link: listed infrastructure in sustainable strategies

By Jeremy **ANAGNOS** & Jon **TREITEL**

Listed infrastructure is the backbone of energy transition strategies, yet is under-represented in ESG portfolios.

Environmental, Social and Governance goals (ESG) and sustainable investing are set to be the dominant investment theme of the next decade. Unfortunately, today's most popular ESG strategies are underexposed to the very asset class that provides the backbone of our energy transition, leads our environmental stewardship, and enables economic growth with a far more efficient carbon footprint.

We find that:

- The top global ESG funds have 5% exposure to global listed infrastructure, even though its companies will invest trillions in capital to enable the clean energy transition and lead the sustainability initiatives that investors care about most.
- Clean-tech exchange-traded funds (ETFs), which offer exposure to sustainability, also tend to over-allocate to commoditized industries with a history of volatile earnings and returns.
- An integrated ESG approach to listed infrastructure, an asset class with steady rates of return and clear ESG themes, is an essential and under-represented component in global sustainable portfolios.

The rise and rise of ESG

Over the last several years, no other theme has seen such asset growth as ESG. In the second quarter, sustainable fund assets grew to $2.24tn, more than double where they started 2020.[1]

We see the market continuing to explode: today, 95% of institutions and high net worth millennials are interested in sustainability and integrating ESG into their investments. Asset allocation continues to shift because of demographics; as the influence of the millennial cohort increases in asset allocation thinking, capital flows will be driven to the causes they care most about: climate change and environmental stewardship.

1 Morningstar, Global Sustainable Fund Flows: Q2 2021 in Review, July 2021.

Why ESG needs listed infrastructure

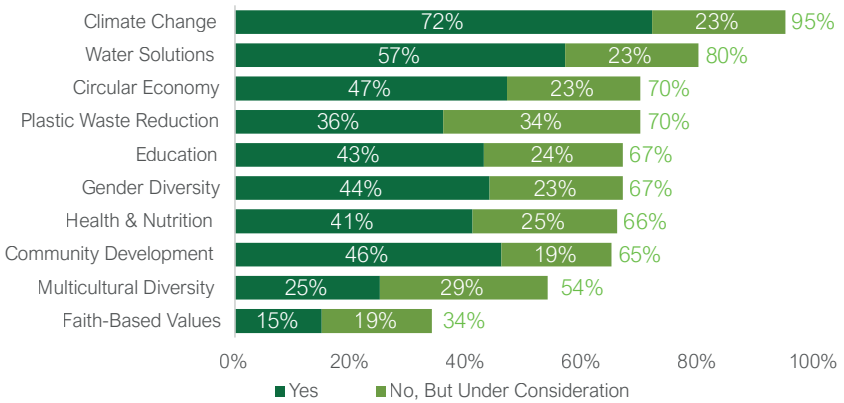
Infrastructure is uniquely positioned to lead and financially benefit from global sustainability initiatives. Electric utilities are at the forefront of net zero action – they are installing solar modules, constructing wind turbines, and upgrading transmission lines to charge electric vehicles and convert our heating to electricity.

Meanwhile, these same utilities are pushing aggressively to shutter high-carbon fossil-based generating stations like coal-fired power plants. Water utilities are upgrading antiquated lead pipes and filter waste to provide clean drinking water. In telecommuting and edge computing, data centers and cell towers are cutting Scope 3 emissions and optimizing logistics, while the rails and roads sector invest to lower the need for long-haul trucking (producing 75% less greenhouse gases in the process) and to reduce congestion.

Investors seeking sustainability and ESG, with a desire to make an impact with their capital, should consider the assets and management teams that will control the initiatives they care about.

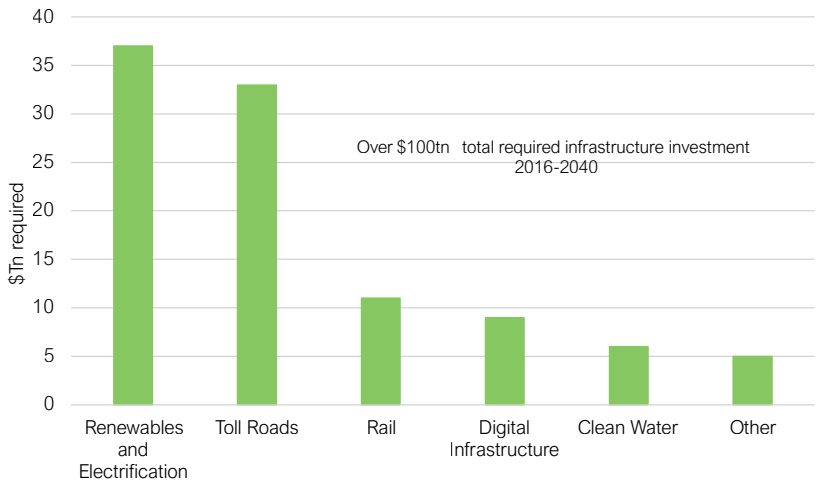
Because of these investments, infrastructure companies should grow their cash flow substantially and sustainably. Over the next two decades, we expect over $100tn in investments across the utility, water, digital infrastructure and transport sectors. Investors seeking sustainability and ESG, with a desire to make an impact with their capital, should consider the suite of infrastructure companies that control the initiatives they care about.

Figure 1: Climate change, water solutions and environmental stewardship key to impact investors



Source: Morgan Stanley, Sustainable Signals 2019

Figure 2: Accelerating need for infrastructure is a multi-decade opportunity



Sources: Global Infrastructure Hub, International Renewable Energy Agency (IRENA) and CBRE Clarion, June 2021

ESG funds lack listed infrastructure while clean sector options are lower quality

Given infrastructure's central role in achieving global sustainability goals, it's unfortunate that major ESG funds allocate so little to the asset class. All in, the top 20 global ESG funds have only 5% exposure to companies leading environmental stewardship and energy transition, while they have a 33% exposure to technology and communications services. This is a clear shortcoming for investors who wish to prioritize climate change, as the companies in listed infrastructure are leading industries that will spend half of every dollar on decarbonization over the next several decades. As an anecdote, one of the largest renewable developers in the world, NextEra Energy, commands a $180bn market cap but still only appears in a minority of ESG funds, whereas Alphabet and Microsoft dominate the lists. While not commenting directly >

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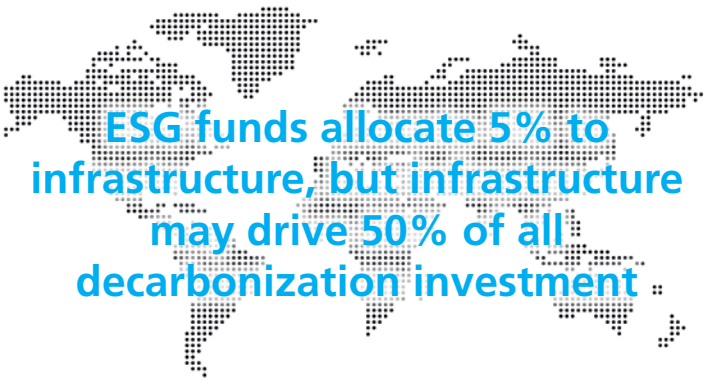
on Microsoft or Google, we would hazard that NextEra, which owns a >24GW renewable portfolio that should double in three years[2], will build more clean energy than the creators of Windows 95 and Gmail.

When we put aside broad ESG strategies and examine ESG and clean-tech ETFs, we find a larger exposure to the energy transition, but also a concentration in businesses with uncertain financial futures. The more popular ETFs have roughly 50% exposure to solar installers, manufacturers, wind turbines and clean EVs – which have a history of booms and busts. By contrast, listed infrastructure companies either have long-term contracts or regulated rates of return, which provide cash flow stability.

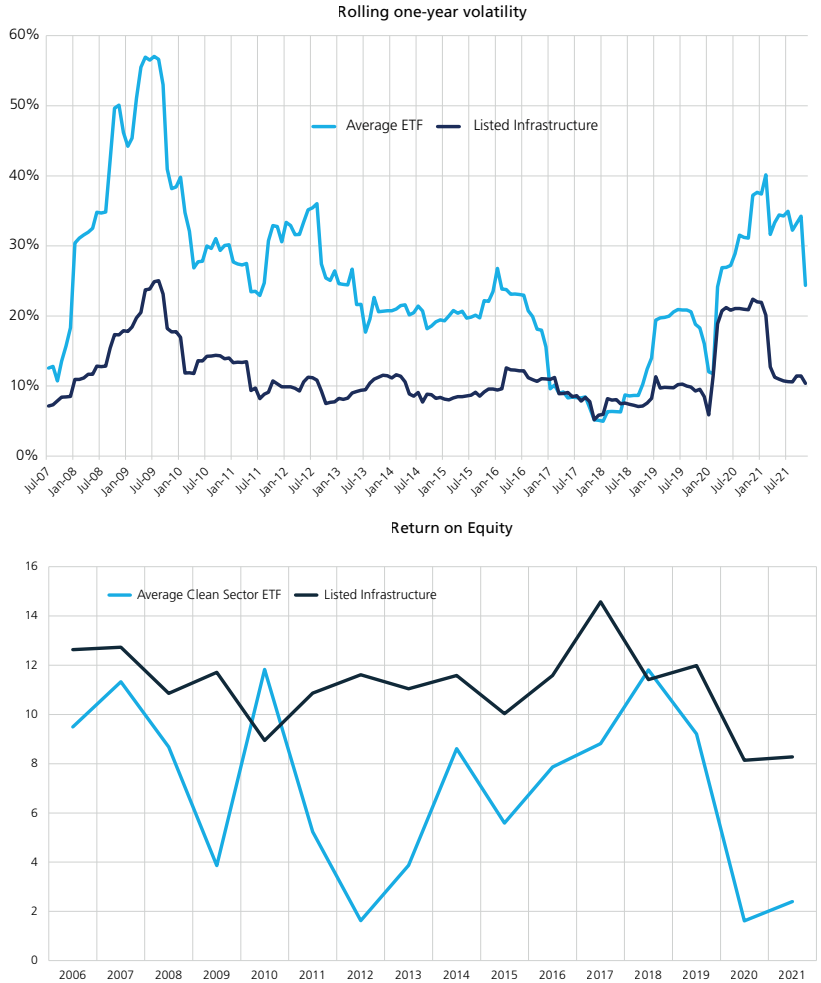
Cyclical clean tech tends to make money on energy transition only once, with each sale of a car or solar panel, whereas listed infrastructure will earn on a renewable asset for years. Tesla and the module makers might be the hares in an energy transition race, but infrastructure is the tortoise: it is the steady and secure way to invest in energy transition while offering an attractive and growing income yield.

Figure 3: ESG strategies are missing infrastructure



Source: MSCI, BNEF 2021 Energy Outlook, IRENA 2020 Global Renewables Outlook, and CBRE Clarion. ESG exposure in infra represents cross holdings between the 20 largest ESG funds as ranked by MSCI in April 2021 and the FTSE 50/50 Global Core Infrastructure Index. Infra's share of decarbonization spending represents the share of renewables, transmission, and infrastructure spending required to achieve decarbonization per IRENA forecasts.

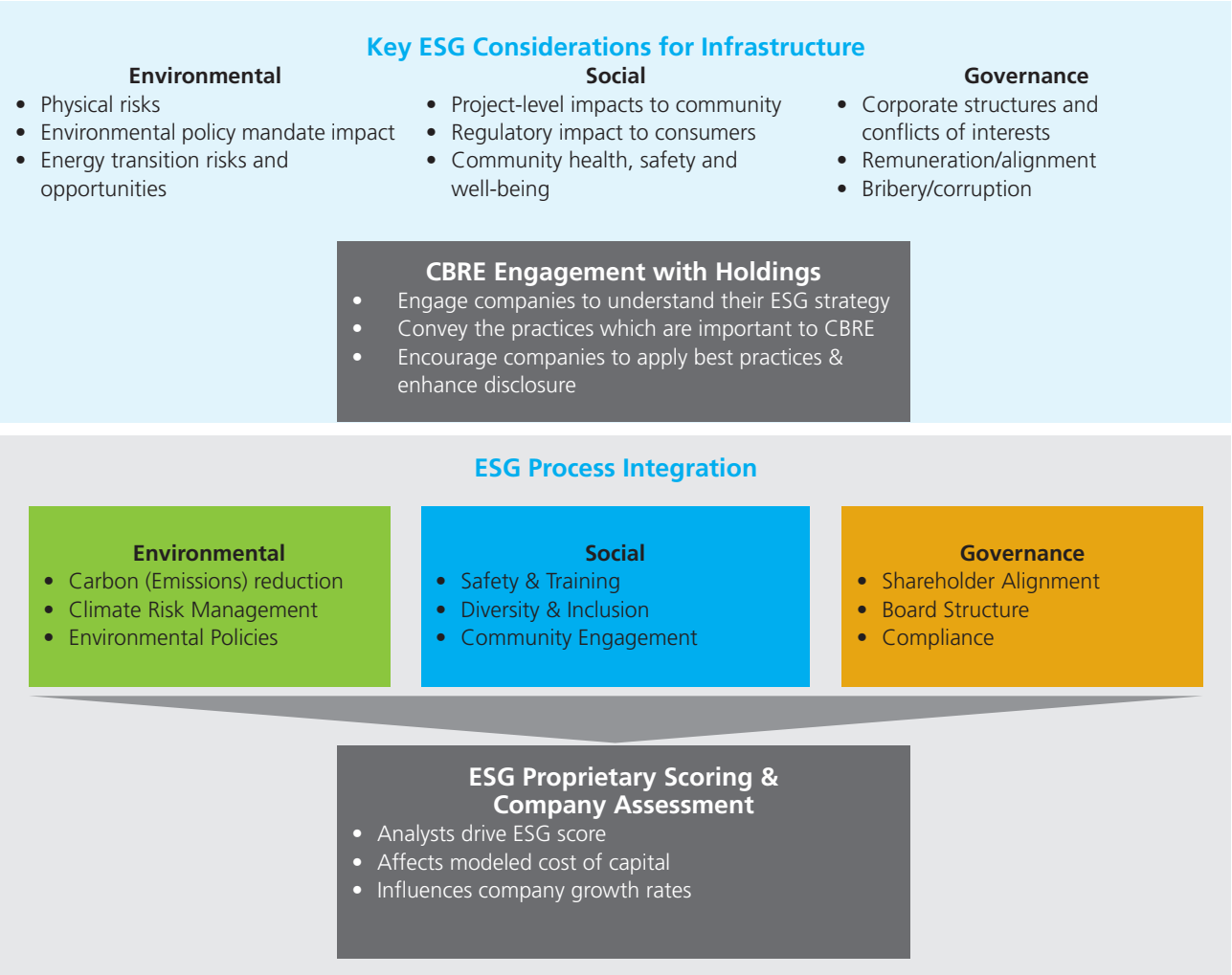
Figure 4: Compared to infrastructure, clean sector funds have seen dramatic volatility in total returns and profitability



Source: Rolling one-year volatility ROE of the MSCI Global Impact ETF, iShares Global Clean Energy ETF and Invesco Wilderhill Clean Energy ETF vs. the FTSE 50/50 Core Index

2 Based on the NEE Supplemental Resources packages as of 6/30/2021 outlining generation across Florida Power and Light, Gulf Power, and Nextera Energy Resources. Forward expectations based on Energy Resources Development Program as of August 2021.

Figure 5: Key focuses for infrastructure and ESG integration assessment:



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Benefits of ESG integration for investing in listed infrastructure

We believe that ESG factors are intrinsic to the assets underpinning the listed infrastructure market. Our companies are exposed to unique ESG risks and opportunities. Infrastructure assets cost billions to build and run for decades. They impact society every day. They are exposed to physical risks (such as wildfires, flooding, and earthquakes) and transition (obsolescence) risks.

At the same time, the opportunities for growth from the deployment of renewables and the upgrade of energy grids are tremendous. Socially, infrastructure has a powerful impact on community health, safety and well-being, while in governance, infrastructure assets tend to split corporate ownership, which creates opportunities for conflicts and shareholder misalignment.

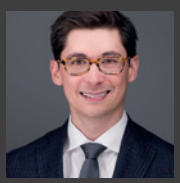
We consider ESG issues not only to build an ESG score, but also to drive valuation: our underwriting affects company growth rates, cost of capital, and intrinsic valuation. We choose to emphasize investments with secular, sustainable, growth themes, while our analysts actively engage with management to understand ESG strategy and convey best practices important to CBRE and our investors. >

Listed infrastructure offers an unparalleled exposure to environmental stewardship and energy transition.

Listed infrastructure fits the bill

When we examine the sustainable investment market and consider what investors care about most, we see global listed infrastructure as an essential, under-represented, asset class for ESG portfolios. Listed infrastructure offers an unparalleled exposure to environmental stewardship and energy transition with a chance for investors to make an impact while earning a compelling total return derived from secure cash flows that should grow for decades.

An integrated ESG approach to infrastructure aligns portfolios with sustainability goals and captures important fundamentals that are unique to the asset class. Over the next several years, we are excited to see infrastructure grow alongside and within sustainable investment strategies.



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A PUBLIC DISCLOSURE ESG Index 2021 — GLOBAL LISTED INFRASTRUCTURE ORGANISATION — GRESB INFRASTRUCTURE

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