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MARKET INSIGHT

The HUB

NEWS AND VIEWS FOR INSTITUTIONAL INVESTORS

Energy transition: matching liabilities and capturing the equity premium

Energy transition infrastructure can match long-term liabilities, generate high yields and lift pension schemes' sustainability profiles

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In the wake of burgeoning unmet pension fund needs – including the need for higher yields, more liability-matching assets – at a time where matching assets are hard to come by – and sustainable investments, one asset class is emerging as a potential solution to all of them.

That asset class? energy transition infrastructure.

How renewables are a fit for DB schemes

As an illiquid asset, energy transition infrastructure is not suitable for many types of investors, but for defined benefit schemes the rationale is strong.

Pension funds are adept at discounting the cashflows relating to the retirement dates of their members, and have widely deployed liability-driven investments to match these expected cashflows. However, as liquid assets become too expensive or too scarce, so schemes have looked elsewhere with illiquid assets, such as infrastructure, used by a growing number of schemes. Energy transition is little different to traditional infrastructure assets such as bridges and hospitals: income from well-structured energy transition infrastructure assets is predictable and can match liability cashflows.

While illiquid debt – as an alternative to liquid debt – is suitable for the purpose, infrastructure equity can be equally suitable. Equity has the advantage of providing higher risk-adjusted returns than debt over the long term.

Most defined benefit pension schemes are used to managing equities as a way of boosting the risk-seeking components of their portfolios. Equity allocations, however, are constrained by volatility, which has the potential to derail a scheme's funding targets. The huge and unexpected plunge in equity valuations in the first half of 2020, when the COVID-19 pandemic exploded, is just one example of highly-disruptive volatility. Although valuations subsequently recovered, a long period of decline can create headaches for sponsors and pose existential risks to both sponsor and scheme.

"An illiquid equity strategy can offer similar levels of returns to listed equities, but with considerably lower volatility," says Thomas Benoist, director, head of French corporate sales at Natixis Investment Managers International. "A energy transition infrastructure strategy can both increase portfolio diversification and decrease scheme risk."

Not least, energy transition infrastructure can satisfy the preferences of sustainably-minded scheme members, can help meet increasing regulatory demands around carbon reduction, and confer wide societal benefits.

Key takeaways:

- An allocation to infrastructure equity can lift portfolio yield by reducing volatility compared to listed equity, better matching assets to liabilities and improving a scheme's sustainability profile.
- Energy transition infrastructure is little different to traditional infrastructure assets such as bridges and hospitals: income from well-structured energy transition infrastructure assets is predictable and can match liability cashflows.
- Sponsors, too, take a positive view on the inclusion of energy transition assets in their DB pension scheme allocations. This desire means trustees and sponsors are often driving the shift in allocations, rather than their local advisors.

Mirova's energy transition strategy

Mirova, the sustainability specialist affiliate of Natixis Investment Managers, initially focused on greenfield renewable energy strategies such as solar and wind projects in mature economies. It has since expanded its remit to address the full panoply of energy transition, including energy storage, biogas, hydro, hydrogen and electric mobility.

Since Mirova's first foray into renewables back in 2002, it has since undertaken more than 175 renewable energy projects, partnering with industrial companies to develop infrastructure across Europe. Consider a recent transaction in the fast-evolving biogas sector. Mirova acquired a 50% stake in Dana Gaz from the French utility company Engie, which runs nine operating units, including seven biomethane production plants with a capacity of 15.5MWg and two cogeneration plants with a capacity of 2MW. The partnership has enabled Engie to accelerate the development of its biomethane projects with the aim of producing 5TWh of biomethane of French origin by 2030.

Meanwhile, Mirova's hydro-electric transaction in Portugal is one of the largest hydro transactions seen in the European market. The deal Mirova helped finance was the purchase of half a dozen hydroelectric dams from Energias de Portugal, worth €2.2bn. Although the price of solar power is very low in the middle of the day, it rises considerably at times where the sun is not shining. At these times hydro power comes into its own and can command good prices.

Allocation decisions are evolving

As the advantages of illiquid energy transition infrastructure become clear, so allocation decisions are evolving.

Globally, pension schemes in developed markets are becoming comfortable with illiquid investments and many have allocations to broad infrastructure strategies. This familiarity means schemes are willing to invest in more niche infrastructure strategies to both increase their exposure to energy transition assets and improve the risk-return of their portfolios.

Sponsors, too, take a positive view on the inclusion of energy transition assets in their DB pension scheme allocations. This desire means trustees and sponsors are often driving the shift in allocations, rather than their local advisors.

"Some advisors we talk to are revising their buy lists and adding more illiquid energy transition strategies to these lists," says James Lindsay, director UK corporate DB and Insurance at Natixis Investment Managers UK.

Catalysts for change

This was the case with a UK defined benefit scheme, which allocated more than €50m to Mirova's energy transition investment strategy earlier this year. The scheme was making its first energy transition energy investment, encouraged by its French parent company which has pledged to become a net zero carbon emissions producer by 2035.

"The key motivators were financial benefits and achieving a strong sustainable footprint," says Benoist. "The Mirova strategy clearly matched these two objectives."

The scheme was already well-funded, with a strong LDI book, so its investment consultant had to be satisfied that the strategy was robust, makes a genuine sustainable impact and is also sufficiently diversified. "One of the issues was that the portfolio is European-focused rather than global," says Lindsay. "But the assets are well-diversified across Europe – which is far from homogenous – and by type, and this was sufficient. "

Stand by for next-generation sustainability

Evolution is natural in pensions, as market structures change and social constructs shift. The growing interest in energy transition infrastructure assets, a key plank in the battle against climate change, is a good example of how financial and societal needs intersect.

In a forthcoming article, we examine how evolution can become revolution, as schemes invest in illiquid sustainable strategies that have not been hitherto considered financial assets. Stand by for next-generation sustainability.

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