E X P E R T Q & A

Since launching Nuveen's North American energy infrastructure credit platform, senior managing director Don Dimitrievich discusses the compelling opportunity for infrastructure debt lending in North America

Decarbonising the energy infrastructure ecosystem

Nuveen's Don Dimitrievich examines why he believes managers who understand the entire energy infrastructure ecosystem and have experience investing through credit cycles will be best positioned to deliver the most attractive risk-adjusted returns for investors.

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Q Given the current uncertainty in the macro economy and investing climate, what are the advantages associated with a credit-focused sustainable energy infrastructure strategy?

In today's environment, many investors are trying to understand to what extent inflation has been conquered, or if it is more systemic, and whether central banks' interest rate policy response will be sufficient to tamp it down. We are also starting to see energy prices increase as the macro environment stabilises, and that could have an offsetting effect on central banks' policy response to inflation. In other words, we potentially have the makings for a macro roller coaster ride.

Given this market uncertainty and the potential for significant volatility, credit with its steady cashflow, collateral protection and reduced reliance on equity valuations, can be an attractive investment strategy to navigate the current market.

Yet even in the face of a potentially challenging market environment, there are secular trends that make investing in sustainable energy infrastructure compelling. Trillions of investment dollars are required to decarbonise the economy, and governments in North America and Europe have passed multi-billion's worth of legislation to spur investment. Investing in a credit-focused sustainable energy infrastructure strategy could allow investors to capitalise on this historic investment opportunity to decarbonise the economy while also providing downside protection against the backdrop of a gathering recessionary storm.

Q A significant amount of capital has been raised by infrastructure funds, much of it with a focus on sustainable

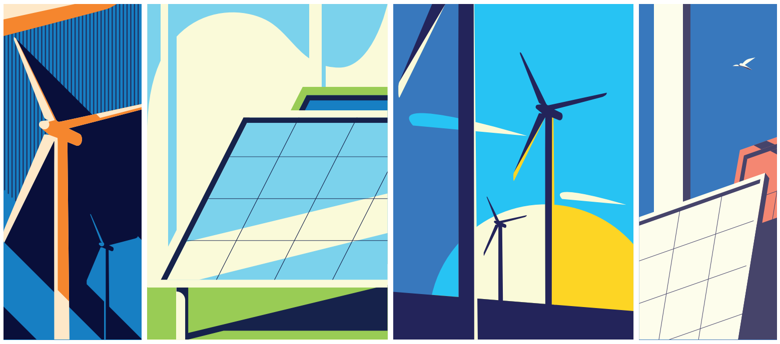
infrastructure – given this backdrop, how do you find attractive risk-adjusted opportunities?

You're absolutely right – the infrastructure asset class has attracted a significant amount of capital over the past several years. We have also seen many new entrants in infrastructure credit, including traditional infrastructure equity investors and private equity players who recognise the opportunity. There's no question the competitive landscape is crowded.

The types of opportunities we're focusing on are not the broadly marketed "on-the-run" deals which often go to the lowest cost of capital with the least onerous covenants but deals with significant project and/or structural or timing complexity requiring exhaustive diligence, a hurdle which most of our competitors are unable or unwilling to meet. We are not tourists in the space; I've been investing in energy and power as a credit investor for almost two and a half decades, and our energy infrastructure credit team are all specialists with deep industry and credit structuring expertise, so we have the relevant experience to tackle this complexity.

Our team's ability to do complex transactions combined with the power of Nuveen's platform enables us to originate differentiated opportunities. Having recently joined Nuveen, my team has directly benefited from the power of the platform. With an infrastructure business managing almost $30 billion, as of Q2 2023, covering everything from investment grade through to control equity infrastructure, there are many ways to leverage sourcing capabilities and internal expertise across Nuveen.

One especially fertile area for deal origination unique to Nuveen is our municipal bonds business, with around $190 billion in AUM as of Q2 2023. Most infrastructure assets have a municipal connection, so we are leveraging Nuveen's leading position and networks of relationships to source differentiated opportunities. Finally, when looking at the competitor landscape, our parent entity TIAA has a history of making LP investments with infrastructure equity GPs, facilitating a close relationship with those GPs too. When their portfolio companies are looking to raise capital, we tend to be the first call due to the institutional relationships.



Q Which areas in sustainable energy infrastructure are the most compelling on a risk-adjusted basis and what risks do you foresee ahead in the years to come?

Renewables generation is one of the core ways to decarbonise the economy and will require a lot of additional capital. However, we are not focused on renewable opportunities that are middle-of-the-fairway as there are lower costs of capital better suited to those.

We seek opportunities with complexity requiring subject matter expertise and that complexity often reduces competition – not everyone wants to do the hard work. This allows us to provide bespoke capital solutions that are flexible and cater to borrower's needs, particularly in areas like energy storage, low carbon fuels or renewable projects that may not squarely fit project finance lenders' financing formula.

We also think there is tremendous opportunity in the onshoring of the entire sustainable energy infrastructure supply chain. The Inflation Reduction Act includes incentives to bring that to the US, so we are looking at financing solar cell manufacturing facilities, for example. Those opportunities with an infrastructure and corporate credit component really play to our strengths.

We are also seeing opportunities in low carbon fuels and in digitalisation. For example, one potential investment seeks to convert old mineshafts into green data centres. There are fibre cable investment opportunities in connection with onshore and offshore energy projects. These opportunities are often interesting, drawing on both our traditional energy and our significant sustainable energy experience.

Coming back to the theme we discussed earlier, large amounts of capital have been raised for infrastructure over the past several years. Many investments will be made that may not play out as investors expect which will present rescue financing opportunities for us. While some companies will prove not to have a reason to exist, others will have good assets with the wrong balance sheets, giving us an opportunity to provide rescue financings or help restructure troubled companies with attractive assets.

Q Are there areas or asset classes that you avoid?

The decarbonisation journey is still relatively nascent, and some new entrants might not appreciate the full extent of the risks associated with such investments – so we are seeing a blurring of credit risk and what traditionally would have been described as equity risk. When an investment case relies on unproven technology or project economics assume future cost efficiencies or underlying commodity appreciation, we find such opportunities suitable for an equity strategy instead of credit.

Similarly, a technology that has a long construction or development period, or where there is significant reliance on supply-chain considerations isn't attractive for us. For instance, there is a lot of interest in green hydrogen as a solution for industrial processes that use hydrocarbons. While the technology to generate and use hydrogen is well established, there are challenges with pairing together all the constituent elements from renewable generation, to maximising electrolyzer run-time to locating the project close to the industrial application and having the midstream infrastructure to support hydrogen transportation. We'd like to see those projects become economic in the coming years before we invest.

Finally, anything that is binary from a regulatory perspective is also something we would avoid. There is rightly a lot of interest in investing in projects that will reduce carbon emissions, but equally important, the project must be commercially economic on a standalone basis. Accordingly, we avoid investments in low carbon-intensity projects that rely solely on regulatory incentives.

Q How do you incorporate responsible investing considerations in your underwriting analysis?

Responsible investing is part of our underwriting DNA and is not a separate process. In every investment, whether it touches a hydrocarbon molecule or not, we require a targeted reduction of CO_2 emissions.

> *"Managers that have the restructuring expertise to navigate the inevitable cycles and who understand the entire energy complex, not just sustainable energy, will generate the most attractive risk-adjusted returns"*

That means every investment must have some element of quantifiable milestones and objectives in the documentation that incentivise parties to achieve CO_2 reductions, which make commercial sense for the borrower and support those broader objectives.

Q When investors assess infrastructure debt asset managers, what factors or considerations should investors focus on; are there metrics that are under – or over – appreciated in your opinion?

Track record, investing strategy and team experience are paramount along with the quality and culture of the investment team. Since the Great Recession in 2008 – putting aside the one-month blip before the Federal Reserve intervened during covid, we have had a historic expansion in the credit cycle that has not tested the discipline of managers – it's been a Goldilocks environment.

For that reason, it's critical for investors to understand the manager's ability to both mitigate risk at deal inception, but also manage that risk over the life of the investment, especially in situations where the investment has underperformed, or if we find ourselves in a recession. In those situations, employing additional management focus and/or providing additional liquidity, and/or calling upon restructuring expertise will drive a successful investment outcome.

Having invested for over two decades in both sustainable energy and traditional energy, the latter of which has experienced several cycles, arguably historic in nature, I have seen my share of cycles. Being able to step in and restructure an investment is a critical skill, especially for a credit strategy. Investors should carefully assess whether the manager has a proven track record in restructuring credits since many infrastructure managers that have solely focused on sustainable infrastructure may lack that experience given the constructive credit cycle we've had since 2008.

One other related consideration that is often overlooked by many investors is the recognition that sustainable energy infrastructure is part of the broader energy complex. An understanding of the inter-relationships between hydrocarbon commodities and sustainable energy and the trends and relationships that drive them is critical to making the best risk-adjusted investments.

My team's experience and understanding of traditional energy, power markets and the entire energy ecosystem give us unique insights into what we believe are the best opportunities going forward. By having a deep understanding of the entire energy complex, we are able to reduce both the number of known unknowns and the unknown unknowns, maximising our ability to make attractive risk-adjusted investments.

I'm convinced that over the next five to 10 years, managers that have the restructuring expertise to navigate the inevitable cycles and who understand the entire energy complex, not just sustainable energy, will generate the most attractive risk-adjusted returns. ■