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How impact credit's financial and sustainability aims go hand in hand

From the Field
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Key Insights

- Fundamental research geared to delivering attractive investment returns must carry equal weight to an impact thesis.
- Sectors where the impact angle is naturally stronger are often those at the forefront of needed sustainable economic or social change, enhancing their long-term financial prospects.
- Renewable energy utilities, real estate, and not-for-profit health care are three sectors that feature businesses with appealing return potential and compelling positive impact characteristics.

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Much of the attention on impact investing naturally, and understandably, zeroes in on major headline issues such as climate change or social inclusion. It is important, however, not to lose sight of the fact that generating attractive investment outcomes is every bit as important to the overall investment case.

Impact investing has a dual mandate. Investment decisions for securities are based on their potential to support a measurable positive environmental or social change and, in equal measure, identifying the prospect of returns (through the traditional fundamental analysis of factors—competitive advantage, balance sheet, cash flow generation, profit margin, and management quality).

A commonly held perception that impact and broader environmental, social, and governance-themed investing restrict the opportunity set is false. While positive impact screening can throw up some sector biases, the impact universe embodies ample scope to add value through active company and bond selection. It also encompasses opportunities in idiosyncratic segments such as emerging market bonds, which are generally more complex but have attractive return potential and are integral in impact investing.

Sectors where the impact angle is naturally stronger are often those at the forefront of needed sustainable economic or social change, making them well positioned from a long-term business and secular perspective.

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> – Matt Lawton, CFA
> Portfolio Manager,
> Global Impact Credit Strategy

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Key impact credit sector investment fundamentals

Renewable energy

- Sector more idiosyncratic amid large-scale investment cycle
- Demand growth driven by data centers and green technology

Real estate

- "Contrarian" opportunities in sell-offs
- Positive trends: demand for data centers, warehousing, and logistics

Children's hospitals (not for profit)

- Strong balance sheets and financials
- Stable income from longer-maturity bonds

As of February 2024.
Source: T. Rowe Price.

Renewable energy utilities, real estate, and not-for-profit health care are three sectors where we see numerous examples of businesses that offer a solid fundamental investment case and appealing return potential, alongside compelling positive impact characteristics.

Renewable energy

Financial returns from the power utility sector are typically predictable and consistent. This is an attractive attribute to credit investors. But the sector is in the midst of big transitions that will result in it becoming increasingly idiosyncratic.

The move from fossil fuels to renewable energy power generation means operational and execution risk will be a key differentiating factor in the coming years. While the impetus for the shift is addressing climate change, companies that are proactive and execute this well should benefit, as we have seen in the recent past.

Enhancing resilience and reliability of power grids will also be important, with ever-growing demand, intensifying climate risks, more frequent wildfires, and the need for efficiency in a world of high-cost-of-living pressures.

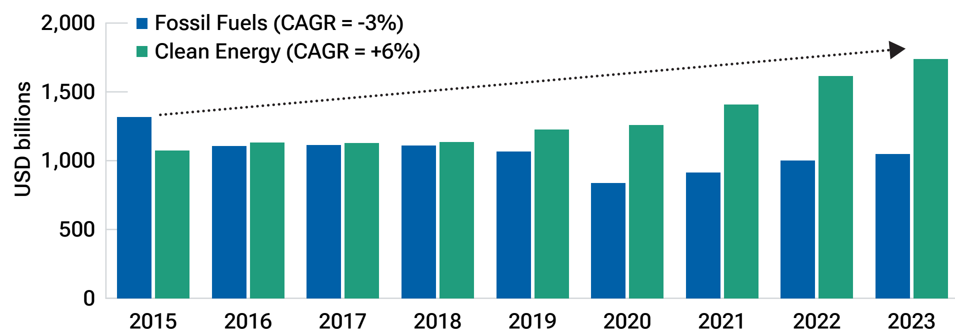
The process will be capital intensive, at a time of higher interest rates and inflation, as well as supply chain vulnerabilities and volatile input costs.

While there is government support, notably a sizable tax credit program under the 2022 U.S. Inflation Reduction Act, undertaking this while maintaining creditworthiness will not be easy. Companies with strong management teams and a strong track record of operational execution and project completion look well placed.

At the same time, the sector has a notable opportunity to capitalize on long-term demand growth with the emergence of new customers, namely data centers, technology-related manufacturing, and vehicle electrification.

Balance of power shifting

(Fig. 1) Investment in clean energy versus fossil fuels



As of December 2023.
CAGR = compound annual growth rate. 2023 data forecast.
Source: International Energy Agency.

Real estate

Unlike utility companies, the real estate sector is more dependent on broader economic factors. This offers the opportunity to take a more contrarian approach and also to tap in to secular economic trends.

Given their sensitivity to economic factors, real estate corporate bonds can experience larger moves than the broader market. This can result in valuations falling too far. During the 2023 monetary tightening cycle, numerous real estate corporate bonds dropped to below par value (the price the issuer will pay for the bond at maturity).

Conversely, real estate assets should benefit during monetary easing phases. But navigating macroeconomic cycles with much accuracy is hard. Carefully selecting companies that can do well over the long term is more reliable, in our view. Solid financials are important, based on balance sheet health and liquidity, particularly factors such as the level of debt relative to the value of property assets, as well as the quality of management, assets, and tenants, and occupancy rates.

More excitingly, parts of the sector provide exposure to positive long-term trends. These include the growth in demand for data centers and warehouse space, driven by growth in online retail and logistics, as well as to cities where growing industries like life sciences and technology have clustered.

Not-for-profit health care

The impact case for not-for-profit children's hospitals and health centers is relatively straightforward—namely, providing health care to children and pediatric health care research. The more traditional financial return perspective is less obvious. While these companies do not typically generate large financial returns, they rely on bond markets as a source of financing, in return offering steady, defensive income streams.

Following the coronavirus pandemic, hospitals are seeing increased patient volumes and easing in labor supply pressures and, therefore, costs, each of which are supportive of the financial performance of these institutions.

These organizations are often well managed, supported financially by state governments and wealthy philanthropic foundations. They tend to have strong balance sheets, holding significant cash balances that amply cover short-term debt liabilities, as well as operating expenses over periods of several months or even up to a year.

The sector typically issues bonds at longer maturities, which, when combined with decent coupon rates, can provide an overall all-weather, strong defensive element to a credit portfolio.

Researching fundamentals and impact potential in equal measure

Capital allocation is an effective and much needed way to drive positive environmental and social impact. But this needs to be done in the right way. Research and investment decisions must be based on sound fundamental analysis and the pursuit of attractive outcomes, partnering capital with a drive for positive change over time.

As these sector examples illustrate, there are ample opportunities in the market to ally impact objectives to sound, "traditional" investment objectives.

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