Infradebt Ethical Investment Fund 2

Advisory Report

18th October 2019

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BENEFIT TO PEOPLE AND PLANET

7 AFFORDABLE AND CLEAN ENERGY

11 SUSTAINABLE CITIES AND COMMUNITIES

Australian Impact Investments

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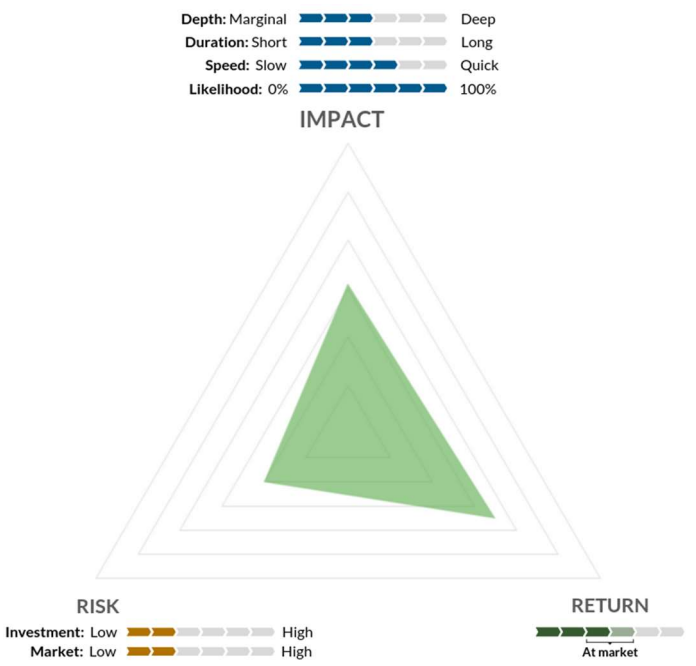
Australian Impact Investments

Investment Overview

Investment	Infradebt Ethical Investment Fund 2		
Asset Class	Diversified Fixed Income	**ESG Focus**	Environmental/social
Structure	Unlisted unit trust	**Target Impact**	Investment in assets that fund projects positively contributing to the environment and society, such as renewable energy, energy efficiciency or social infrastructure
Manager	Infradebt Pty Ltd		
Trustee	Infradebt Pty Ltd		
Target Raise	Up to $20 million		
Target Return	2.25%-2.75% p.a. above the RBA cash rate	**Primary SDG**	Affordable & Clean Energy (SDG 7)
Distributions	To the extent that funds are available, the Fund will pay distributions bi-annually	**Geography**	Australia
Redemptions	The Fund is illiquid, and investors should not expect to be able to redeem their investment prior to the Termination Date	**Impact Asset Framework**	
Investment Term	Fixed Termination Date of 29th February 2024		
Fees and costs (excl. GST)	**Management Fee:** • **0.35%** of gross assets per annum for period from first close to February 2021 • **0.7%** gross assets per annum from March 2021 to termination **Administrative Expenses:** Maximum of 0.05% of gross assets per annum **Investment Expenses:** Cost recovery basis on deployment of funds		
Financial close	Periodic closes until February 2021, with first close scheduled for 29 November 2019		
Minimum Investment	$100,000		



Harm to People & Planet	Avoid Harm	**Benefit to People & Planet**	Contribute to Solutions
H	A	B	C

Executive Summary

The Infradebt Ethical Investment Fund 2 (IEIF2) is the second in a series of 'feeder' funds for the Infradebt Ethical Infrastructure Debt Fund (IEF). IEIF2 will comprise cash assets and units in IEF. Infradebt, as manager of both funds, is looking to raise up to $20 million in IEIF2, complementing the $85 million committed capital in IEF. Inclusive of IEIF2 Infradebt is targeting up to $300 million in IEF by 2023.

IEF invests predominantly in secured debt products for infrastructure assets deemed to have an environmentally or socially positive impact. IEF currently owns 15 assets held against underlying projects involving solar power generation, wind power generation, energy efficiency and social infrastructure (specifically the Royal Women's Hospital in Melbourne). Potential assets in the pipeline include additional solar farm investments, social infrastructure (e.g. hospitals, schools, public venues, social and

disability housing) and property-based investments with an environmental or social impact component. Prohibited investments include fossil-fuel electricity generation and distribution, nuclear power, toll roads, airports and seaports.

Infradebt prefers secured debt of specific assets, but IEF can also invest in secondary market debt, higher risk mezzanine or unsecured debt on particular projects (limited to 25% of total assets) and overseas infrastructure projects (limited to 15% of total assets). No more than 25% of total assets can be invested in any one asset.

Investment in IEF is difficult for wholesale investors due to the required capital commitment and drawdown schedule. IEIF1 was established by Infradebt in January 2018 at the request of Australian Impact Investments, allowing wholesale investors to gain access to IEF through a feeder vehicle by subscribing capital upfront and allowing Infradebt to manage drawdown requirements. IEIF1 closed in February 2019, and first close for IEIF2 will be 29th November 2019.

Since inception in January 2015, IEF has returned 6% per annum net, and the forecast yield to maturing of the current underlying assets is in the range of 4.5% to 5.5% per annum. This strong performance is, in part, due to Infradebt operating in transaction sizes that, while significant in dollar terms, are too small for commercial banks and where terms can be customised for the borrower.

IEIF1 has returned 5.9% per annum net of fees since inception (representing the period 1st January 2018 to 31 August 2019).

IEIF2 is a continuation of this series of funds and has an almost identical structure to IEIF1. The target return for IEIF2 is 2.25% - 2.75% per annum over the RBA cash rate, which at current rates, equates to a target of 3.00% - 3.50% per annum net of fees. The return target reflects the low-risk nature of the underlying cash flows and the level of security that Infradebt seeks on assets. The credit rating, default rate and recovery rate are expected to exceed those of A-rated corporate debt[1].

The principal risks to investors in IEIF2 are credit risk, manager risk, deployment risk and refinancing risk at exit. To mitigate investment-related risks the Infradebt management team will continue to target diversification across asset type, seek out secured assets or confirmed cash flows where possible and focus predominantly on conservative gearing criteria at the project level. Manager risk is somewhat mitigated by the fact that related parties of the two principals, Alexander Austin and Alex Ramsey, invested $500,000 in IEIF1 and will invest $500,000 in IEIF2, giving them considerable alignment with investors. Overall, we consider the risks to be adequately handled due to the experience of the Infradebt senior management team and their performance throughout IEIF1.

One issue we highlight is Infradebt taking on the position of both the Trustee and Investment Manager. While common in private market transactions at the current scale of IEF and IEIF2, we believe best practice would be an independent trustee and have expressed this concern to Infradebt. Management has acknowledged our concern, confirming that an IEF fund size of $100 million deployed capital makes an independent trustee financially viable, and up to that point, the cost imposition on investors is too high. We understand the reasoning and note that the concern is partly mitigated by an independent audit each year, and an independent trustee will become viable in 2020 if IEF achieves its target capital raise.

In summary, we believe the target return for IEIF2 is commensurate with the risk profile of the current and proposed assets. We are comfortable with the experience of the investment manager and the stated investment strategy. We believe IEIF2 presents a viable opportunity for wholesale investors to gain diversified exposure to a screened portfolio of infrastructure projects that would usually require a much larger commitment on an individual investment basis. We recommend IEIF2 for wholesale investors looking for a capital-stable investment offering regular income, but with the ability to carry an investment that will be illiquid for at least four years.

[1] Based on global research conducted by Moody's https://www.moodys.com/research/Moodys-Infrastructure-sector-has-low-credit-loss-rates-and-stable--PR_370445.

1. Background

1.1 Infrastructure Debt

Traditionally, banks and institutional investors have been responsible for infrastructure financing due to the size of projects and expertise required to underwrite complex transactions. However, in recent years, infrastructure projects have become more widely available to non-institutional investors as governments partner or outsource to private operators.

As the market has developed, so too has the demand for customised debt solutions. Some infrastructure projects – while still sizeable transactions in real dollar terms – are often too small to meet commercial bank criteria, thus providing financing opportunities to boutique debt providers (like Infradebt) who can negotiate a non-standard debt profile that incorporates flexibility on rate, repayment profile, maturity and security. Debt can, therefore, be customised to the project, rather than being subject to standard commercial bank terms.

Debt tailoring enables Infradebt to earn a customisation 'premium' that provides:

i. Enhanced returns without a disproportionate increase in risk; and
ii. Diversification in a low interest rate environment to assets uncorrelated with other markets.

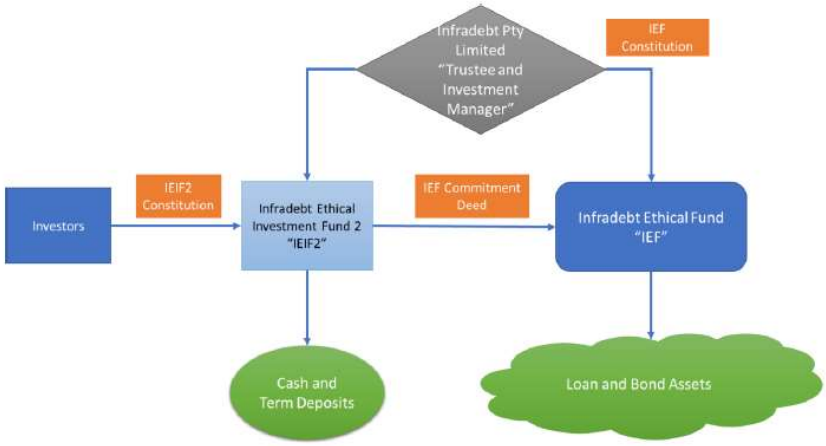
In 2018, Moody's reported that infrastructure debt generally demonstrates better long term credit quality, including lower default rates and better recovery rates, than similarly rated corporate debt[2]. The report, which involved a data set of unrated infrastructure investments studied between 1983 and 2017, highlighted that on average ratings for infrastructure securities were 61% less volatile than non-financial corporate (NFC) issuer ratings. This is predominantly driven by the regularity of cash flows that infrastructure projects tend to receive, and the level of security underpinning the debt issuances, whereby equity and subordinated debt holders incur first losses.

2. Investment Overview

2.1 Investment Structure

Infradebt Ethical Investment Fund 2 (IEIF2) is an Australian domiciled trust that will invest in cash-based investments and units in the Infradebt Ethical Infrastructure Debt Fund (IEF). IEF invests solely in debt held against positively screened assets such as renewable energy and social infrastructure to generate risk adjusted returns above traditional cash and income investments. IEF has a particular focus on projects such as small solar or wind farms as well as smaller social infrastructure or social housing projects, that are poorly served by commercial banks.

Figure 1: IEIF2 Structure



IEIF2 is essentially a 'feeder' fund for IEF and for all intents and purposes, both IEIF2 and IEF ultimately own the same infrastructure assets. It is the second feeder fund introduced by Infradebt following the Infradebt Ethical Investment Fund 1 (IEIF1) being created in January 2018 and closed to new investors in February 2019. IEIF1 has returned 5.9% per annum net of fees since inception (representing the period of 1st January 2018 to 31 August 2019) comprising income and some capital growth in the value of fixed interest bonds.

Infradebt created the Infradebt Ethical Investment Fund series at the request of Australian Impact Investments for the specific purpose of allowing investors who otherwise would not meet the capital and liquidity requirements for investment in the IEF

[2] Moody's Investor Services 2018, 'Research Announcement: Moody's: Infrastructure sector demonstrates low credit loss rates, stable credit quality for $2.7 trillion of rated debt', https://www.moodys.com/research/Moodys-Infrastructure-sector-demonstrates-low-credit-loss-rates-stable-credit--PBC_1143896.

direct, to invest in the IEF through a feeder vehicle. IEIF2 will eliminate the normal drawdown profile of IEF by holding cash assets (cash accounts, high interest accounts and term deposits) managed by Infradebt. Cash assets can be called on to fund the acquisition of further assets when required without the need for capital calls on investors.

IEF will generate distributable income from the interest received on investments plus a return of capital underpinned by bullet payments or amortisation schedules on the underlying investments. The distributable income from IEF will flow through to investors, one of which is IEIF2, and in turn, IEIF2 will distribute income – net of any additional fees – to its investors. Return of capital during the term of IEIF2 will be at Infradebt's discretion, with a goal for bi-annual distributions. It may be returned to investors or it may be recycled back into other assets if Infradebt deems that a better rate of return can be achieved by doing so.

2.1.1 Target Raise

Infradebt is aiming to raise up to $20 million in IEIF2 by February 2021 to supplement the $85 million of committed capital in IEF. The additional capital raised in IEIF2 will increase the range of investments available and improve diversification of IEF. The term of IEIF2 is four years and three months from inception, terminating in February 2024, at which time Infradebt aims to wind up IEIF2 and either:

1. Return all capital to investors if feasible;
2. Offer a subsequent fund for IEIF2 investors to roll into;
3. Call on up to 15% of total commitments of remaining IEF investors in any one year to purchase the holdings from IEIF2. At the target size of $20 million, IEF needs to be $154 million (inclusive of the value of IEIF2) in size to afford full protection to IEIF2 investors under this option. Inclusive of IEIF2 Infradebt is aiming to raise committed capital to IEF of up to $300 million by 2023, so the risk of IEF not being able to redeem all units in IEIF2 would appear remote.

Should IEF be unable to redeem units held by IEIF2 in 2024, the remaining capital outstanding will be returned to investors as the underlying loans in IEF mature. The nature of the underlying assets may mean that the full return of capital will take considerably longer if the maturity profile or amortisation schedule is long dated. IEIF2 is illiquid and there will be no formal secondary market for IEIF2 units. **Therefore, we do not recommend IEIF2 for investors who may require a full return on invested capital within four years.**

2.2 Investment Thesis

Infradebt sees a competitive advantage from operating in a space where debt size is considerable but often too small for commercial banks, and from intermediating customised debt solutions that benefit both the borrower and lender. By offering customised solutions Infradebt can often achieve incremental margin without exposing investors to disproportionate risk. IEF will invest in a range of financing ventures, including public-private partnerships (PPP) where cash flows are often underwritten by a government entity, renewable energy projects across both power-purchase agreements (PPA) and merchant opportunities, and traditional infrastructure projects that fit the ethical/social criteria, but with no particular preference for the type of venture other than risk adjusted returns and the relative value offered to investors. Projects involving merchant agreements or less senior debt security will employ much lower leverage to provide an additional buffer of security in the event of credit default.

IEF targets investments in renewable energy and social infrastructure assets that make a 'positive and sustainable difference to society'. Allowable investment projects include:

- Social infrastructure including, but not limited to, public transport, hospitals and health facilities, research facilities, water or sewerage treatment, schools and educational facilities, convention centres, sports stadiums, desalination, recycling or waste facilities, etc;
- Telecommunications infrastructure;
- Student accommodation and other educational or university facilities – both teaching and research;
- Renewable energy, both grid-scale and embedded, including storage;
- Property investments where there is a significant impact investing or environmental component; and
- Embedded networks and micro-grid infrastructure where there is, or will be, significant use of renewable energy and/or efficiency gains.

Certain assets are excluded from investment, including fossil-fuel based electricity generation and distribution, nuclear power, toll roads, airports and seaports.

We raised the concern that the range of investible sectors for IEF is large with varying degrees of impact and as such, there is potential for the asset base to lean too much towards lower impact projects. We remain confident that Infradebt management understands the need for thorough ethical screening on investments and will continue to develop a genuinely screened fund that has appeal for investors looking to value-align their portfolios. As of August 2019, the IEF portfolio is predominately made up of debt held over renewable energy projects, including solar at the utility and embedded level, and wind power. IEF is also invested in debt associated with social infrastructure and PPPs. Details of the portfolio assets are outlined below.

We consider the current assets are the best indication that Infradebt is focused on ensuring IEF is genuinely investing in debt secured against assets that make a positive and sustainable difference to society. Nevertheless, the potential for a lighter screening regime is a risk that investors need to be aware of. We will maintain regular dialogue with Infradebt, as we have since the close of IEIF1, to provide feedback on the social and environmental impact of assets in the pipeline.

2.3 IEF Current Portfolio

As of 31 August 2019, IEF has deployed approximately $51 million into 15 assets. The current assets, which are detailed on pages 14-20 of the Information Memorandum, are highlighted below:

Operational	Location	Asset	Revenue Structure	Debt Type
Amaroo School Solar	ACT	0.6MW embedded solar project	20 Year ACT Government Feed-in tariff	Senior Secured
Brigalow Solar Farm	QLD	34.5MW solar farm*	Merchant	Senior Secured
Chinchilla Solar Farm	QLD	19.9MW solar farm	Merchant	Senior Secured
Epuron – TKLN	NT	1MW embedded	20-year offtake from PWC (NT Govt owned)	Senior Secured
Epuron – Yterne	NT	4MW solar farm	20-year offtake from TGen (NT Govt. owned)	Senior Secured
Epuron – Yularra	NT	1.8MW embedded solar project	20-year offtakes from Voyages Resort with Indigenous Land Corp guarantee	Senior Secured
Mobilong Solar	SA	5.8MW solar farm	Merchant	Senior Secured
Moyhall Solar	SA	5.8MW solar farm*	Merchant	Senior Secured
Swan Hill Solar Farm	VIC	19.3MW solar farm	Merchant	Senior Secured
Infigen Wind Portfolio	Various	556.6MW portfolio of wind farms	1/3 merchant, 1/3 C&I contracts, 1/3 whole of life PPAs	Senior Secured
Savant Embedded Network	Various	0.978MW embedded network	10+ year contracts	Senior Secured
Royal Women's Hospital	VIC	Public Private Partnership	25-year Victorian Government offtake	Senior Secured
NSW Schools (x2)	NSW	Public Private Partnership	100% NSW Government offtake	Senior Secured
Darwin Convention Centre	NT	Public Private Partnership	100% NT Government offtake	Senior Secured

*Under construction

IEIF2 will carry cash investments such as high-interest accounts and term deposits in APRA-approved deposit taking institutions for any funds awaiting deployment into IEF units.

2.4 Forecast Returns

The target gross return for IEIF2 is 2.25% - 2.75% per annum over the RBA cash rate. At current rates, this equates to a target of 3.00% - 3.50% per annum net of fees. This is a relatively low absolute figure but reflects the credit quality of the underlying assets coupled with an initial drag created by cash assets invested in a low interest rate environment.

We note, however, that IEF has returned 6% per annum over the past four years, driven primarily by opportunities in the renewable energy sector, and the current assets have return profiles of 4.5% - 5.0% per annum on a yield-to-maturity basis. IEIF2 returns will always be marginally behind IEF returns due to a slightly higher fee environment and the cash drag.

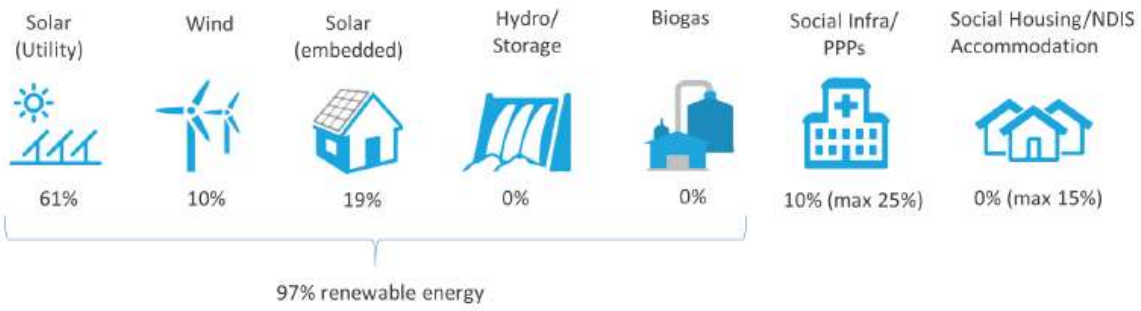
One additional aspect to note is that IEIF2 may report capital gains or losses in its returns at any point, most likely from investment in any secondary market opportunities, which may flow through to annual valuation reports. Unless crystallised by Infradebt through a sale of the assets, we recommend that these capital movements be ignored since both IEIF2 and IEF are illiquid with no formal secondary market for units in either trust, and therefore, will not end up being of benefit to investors. The aim of IEIF2 is to provide enhanced yield over cash, with capital stability and full return of capital based on a 'buy and hold to maturity' strategy, thus any intra-term capital movement will dissolve as underlying assets approach their respective maturities.

This has further implications for the termination of IEIF2 in four years' time. If there is an offer to roll funds up into a subsequent fund, then technically this will be a CGT event. However, since there is not expected to be significant capital gain there should be no material taxation impact from rolling up into a subsequent fund. If concerned, investors should seek tax advice on this matter.

3. Impact

Infradebt provides finance to infrastructure assets that drive positive changes to address the issues of sustainability and climate change, such as renewable energy, social infrastructure and property investing where there is a substantial impact or environmental efficiency component. Currently, Infradebt has provided finance for solar and wind projects, as well as for schools and a convention centre.

Figure 2: Summary of IEF Portfolio (as at 31 August 2019)



Infradebt's contribution to these assets is secondary in nature, as it does not control the projects it funds, and the provision of debt is only one component of the capital these assets receive. While Infradebt tracks the environmental and social impact of its assets, it does not consider this to be impact it is generating. As such, we classify IEIF2 against our Impact Spectrum as a fund that Benefits People and Planet.

4. Key Parties

4.1 Directors and Management Team

Infradebt, as issuer of IEIF2, is a specialist infrastructure debt manager and investment facilitator established in 2013, with an AFSL that covers the issuance of managed investment products to wholesale investors, as well as custodial services. Infradebt has traditionally been involved in large-scale transactions covering social infrastructure, buildings, transport, energy production and transmission. Senior management has experience in dealing with both private operators and government, as well as public-private partnerships. The two founders and principals of Infradebt are Alexander Austin and Alex Ramsey. The governing board is also

comprised of Austin and Ramsey, together with non-executive chair Terry McCredden. Austin and Ramsey form the Investment Committee that makes the final decision on investments made by IEF.

- **Alexander Austin (Chief Executive Officer)** founded and controls 92.5% of Infradebt and has significant experience in arranging infrastructure debt from his term at Access Economics (now owned by Deloitte) and as a founding partner of Access Capital Advisers that demerged from Access Economics (and now known as Whitehelm Capital). Over 20 years Austin has advised, originated and facilitated infrastructure debt deals across a range of industries, sectors, geographies and stages.
- **Alex Ramsey (Chief Financial Officer)** owns 7.5% of Infradebt and holds significant infrastructure debt experience having been CFO of Access Capital Advisers, as well as consulting and project development experience from prior management positions.
- **Terry McCredden (Non-executive Chair)** has extensive investment experience in the superannuation industry having been CEO at both Telstra Super and UniSuper, and is now a director of MLC Super and U Ethical (formerly UCA Funds Management Ltd).

The management team has engaged **David Leitch** in an advisory capacity. Leitch has substantial knowledge, extensive expertise and experience in both infrastructure development and infrastructure investing, specialising in analysis of the electricity and gas industry and the implications of decarbonisation of the Australian and global economy.

5. Key Risks

The investment is subject to numerous risks that, either on a standalone basis or through interaction, could adversely affect the performance of IEF and, in turn, IEIF2 and subsequently investment returns. While we have tabled what we consider to be the key risks below, all potential investors should read pages 26 to 31 of the Information Memorandum.

Key Risk	Comment
Credit risk. If an asset is unable to repay its debt, Infradebt's ability to produce target returns or repay investors' capital may be limited.	Numerous factors can impact the ability of a project to service debt repayments: • Internal issues such as a reduction in revenue, damage to project assets or mismanagement • External issues such as a changing regulatory environment, changing interest rate environment, electricity price volatility and general economic conditions. • Counterparty issues whereby entities that have agreed to purchase the output of an asset are no longer willing and/or able to fulfil the contract We believe Infradebt's investment process, including universe filtering, asset selection criteria, due diligence and ongoing monitoring alleviates concerns over credit risk and reduces the potential impact to investor capital. We are comfortable with the management team's ability and understanding of its investment process and have seen this in action since the inception of IEIF1. Infradebt has also been a co-investor or senior lender on other projects we have completed due diligence on, such as the IIG Solar Asset Fund. While past results cannot predict future results, they do give an indication of the level of expertise that a business has in dealing with relevant issues and, in this regard, we are comfortable with Infradebt's proficiency and investment process.

Manager risk. A breakdown in Infradebt management abilities, such as key person loss or a business sale to another manager, could adversely affect performance**.**	Austin and Ramsey own 100% of Infradebt and both have confirmed they have no intention to relinquish control of the business (though this is, of course, no guarantee). The risk is also partly mitigated by the fact that related parties of the two principals invested $500,000 in IEIF1 and will invest $500,000 in IEIF2, giving them considerable alignment with investors.
Drawdown rate by IEF. If capital invested in IEIF2 is held in cash assets for an extended period of time, this may diminish potential returns.	IEF investors, of which IEIF2 is one, commit a maximum amount of capital that can be drawn by the IEF as and when needed. Capital invested in IEIF2 will, therefore, be kept in cash assets until it is required by IEF. Pipeline assets and estimated investment schedule are known to Infradebt and the management team is aware of the dangers around cash drag, hence IEIF1 was closed in February 2019 when the pipeline at the time was fully invested. Now that the pipeline has opened up again Infradebt is raising funds for IEIF2 on a new schedule. Nevertheless, investors should be aware that projects can be delayed for a variety of unforeseen reasons which could result in cash being held by IEIF2 for longer than expected, negatively affecting forecast returns.
Refinancing risk/ limited liquidity of investments. Infradebt may be unable to draw down sufficient capital in IEF to repay investors in IEIF2 upon the Termination Date.	Due to the illiquid nature of the underlying assets and no formal secondary market, there is very little ability, other than an agreed transfer to another entity, to exit IEIF2 until the termination in February 2024. Full capital may not be recouped until much later, depending on the maturity profile of the underlying assets. Given the forecast growth profile of IEF, and our comfort with the abilities of the Infradebt management team, we believe that refinancing risk is low probability. Nevertheless, we reiterate the only mitigation strategy is abstention if the investor's portfolio cannot carry an asset that is illiquid and will not return capital for 4 years or more.
Construction and 'greenfield' assets. Assets under construction may fail to reach practical completion, leaving Infradebt to manage out debt in order to recoup capital for investors. This could be a lengthy and costly process.	IEF can invest in assets with construction or 'greenfield' risk, meaning there is potential for projects to fail to reach the operating phase. As a result, there may be limited, restricted or no capacity to generate revenue and thus service debt. Infradebt has two key strategies in place to offset this risk: 1. A Draw-down schedule of cash whereby funds are remitted to the project in stages, holding back full investment until the project is complete. Although this means cash may be left in a low interest rate environment for longer than expected, it minimises capital risk produced by delays or development problems. In many cases, the Infradebt loan will not commence until the project is complete, reducing yield in the event of delays but eliminating development risk on capital. 2. Establishing security over assets at a conservative gearing ratio. Infradebt expects most, if not all, assets will be secured over underlying project assets. Thus, in the event a loan needs to be called the underlying asset value should be sufficient to protect IEF as the senior lender. Where loans are unsecured, subordinated, development or mezzanine, Infradebt will secure various covenants designed to minimise the risk to investors. Higher potential returns will be on offer for higher risk debt, but exposure to these assets is limited to 25% of the portfolio, and in discussion with Infradebt we expect that the final exposure will be lower than this limit.

6. Conclusion

IEIF2 presents an opportunity for investors to gain exposure to a diversified portfolio of infrastructure assets offering regular, stable income with strong capital stability and that create 'no net harm' or positively contribute to environmental or social impact. Infradebt has a solid track record and we are comfortable with their capacity to deliver on the stated investment strategy, including target returns of 2.25% - 2.75% per annum over RBA Cash Rate, which are reflective of and appropriate for the low risk nature of IEIF2.

We recommend IEIF2 as a viable inclusion in a portfolio allocation to Diversified Fixed Income, where illiquidity for four years and potentially much longer in adverse circumstances, can be tolerated.