

Is it time to allocate to infrastructure debt?

Institutional investors have long valued core infrastructure for its ability to provide stable, long-duration income with a link to inflation. The essential nature of the underlying assets and services, alongside the often-monopolistic positions that some infrastructure companies enjoy, appeals to investors seeking predictable and resilient returns in times of economic uncertainty.

With increasing sums of capital required to fund projects, infrastructure debt financing that sits beyond banks' capacity and appetite has become more prevalent. We believe this widening funding gap presents an exciting opportunity for investors to allocate to infrastructure debt while targeting attractive risk-adjusted returns.

What is infrastructure debt?

We define infrastructure debt as lending backed by infrastructure assets – typically physical assets that have long lives and generate regulated or contracted revenue streams. Companies that own or develop infrastructure assets are usually financed by a mixture of equity and debt. The level of borrowing by companies can vary widely, depending on operational status, sector and long-term cash flow visibility, but debt would generally account for 30–90% of total capital. An infrastructure company's capital structure may include different forms of debt, ranging from senior secured loans to subordinated and mezzanine tranches, with credit quality spanning investment grade, sub-investment grade and unrated debt.

Banks or institutional investors are the main lenders to infrastructure companies. Lenders usually receive fixed or floating interest payments over the period of the loan, and repayment of the principal when the loan matures. Lenders, however, don't have an ownership interest in the company or its assets. In contrast, infrastructure equity investors hold an ownership interest and generate returns through dividend income and potential capital appreciation of the underlying assets. And infrastructure debt ranks above infrastructure equity in a company's capital structure. This means that debt investors are paid before equity investors and have a senior claim over the asset's cash flows or collateral, in the event of a default.

Responsible investment

Relative to other private debt strategies, such as direct lending, infrastructure debt gives investors greater scope to target better responsible investment (RI) outcomes – particularly by financing assets and projects that support the energy transition.

Environmental, social and governance (ESG) margin 'ratchets' can be incorporated into loan agreements to encourage borrowers to achieve specific RI outcomes. An ESG margin ratchet allows for an adjustment to the loan's interest margin based on whether specified targets are achieved. The mechanisms are typically two-way, meaning that the borrower receives a reduction in its interest margin for meeting the agreed targets, but incurs a higher margin if it fails to do so. Targets can include measures such as reducing carbon intensity and increasing the proportion of recycled materials used. But investors may find it difficult to assess whether the selected targets are sufficiently ambitious and financially material. This creates a need for thorough due diligence, transparent reporting and trust in the investment manager's approach.

“ A ‘higher-for-longer’ base-rate environment supports infrastructure debt yields, where returns comprise a base rate plus a credit spread and an upfront arrangement fee. ”

Why now?

While banks have historically been the main lender in the infrastructure debt market, the capital requirements under Basel IV have accelerated their retrenchment. At the same time, constrained public spending and ever-growing financing requirements have widened the funding gap, creating a supply/demand imbalance and a greater need for private investment – particularly debt capital.

We believe that the current market environment presents a compelling opportunity for investors to allocate to infrastructure debt. With base rates elevated relative to the previous low-rate environment, infrastructure debt currently offers attractive yields and stable income potential. In addition, the increased demand for infrastructure funding supports stable credit spreads.

Furthermore, with the more volatile market we’ve seen in direct lending recently, investors are looking to other private debt sub-asset classes for diversification. We view tangible collateral strategies such as infrastructure debt more favourably, as they can provide reliable and stable cash flows – which is particularly handy during periods of increased market volatility. Infrastructure debt assets also compare favourably in a default scenario: they’ve historically demonstrated lower default rates than equivalent rated corporate credit and higher recovery rates in the event of a default.

Sub-investment grade: why going down the credit spectrum can pay off

Within the infrastructure debt market, we believe the sub-investment grade market presents better relative value for non-insurance investors. Insurance companies (particularly those in the UK and Europe) are big players in the investment-grade market, due to insurers receiving beneficial capital treatment for infrastructure debt under regulatory capital frameworks. This means they can accept a lower illiquidity premium versus equivalent public credit, resulting in a lower absolute return. As a result, investment-grade infrastructure debt can be highly competitive on price. By comparison, the sub-investment-grade market currently has a smaller capital base and can offer more attractive spreads per unit of risk.

Sub-investment-grade infrastructure debt strategies generally target an average credit rating of BB or B+. They can invest across a range of risk profiles, including junior debt issued by stabilised operating companies, senior debt at the holding company level and senior debt for greenfield projects. Sub-investment-grade infrastructure debt strategies typically have tenors of 2–10 years, compared to the 5–40-year tenors usually found in investment-grade strategies.

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At the time of writing, sub-investment-grade infrastructure debt returns are in the range of 7–10% pa net internal rate of return. When compared with the returns of core infrastructure equity (8–10% net pa), this suggests that infrastructure debt may offer a return profile almost comparable to that of core infrastructure equity, but with greater structural protection as debt ranks ahead of equity in a company’s capital structure. This combination of equity-like return potential and stronger structural protection may provide investors with a competitive risk-adjusted return opportunity.

Understanding the risks

Infrastructure debt shares the credit and illiquidity risks associated with private debt, including the possibility of borrower default and the limited ability to sell an investment before maturity.

But there are some additional risks that investors should consider. Political and regulatory risk is one of these: changes to the political or regulatory environment can result in the loss of cash flows to the project, which would in turn affect how the debt is serviced.

Investors should also be aware of demand or volume risk, where infrastructure debt extended on assets with low or no contractual revenues tends to be riskier. Borrowers may struggle to meet interest and/or principal payments if demand or volume for the asset drops.

Gaining exposure

Institutional investors can gain exposure to infrastructure debt by allocating to an infrastructure debt fund. Most of these funds are closed-ended, with a life of 7–10 years. There are some evergreen (open-ended) funds available in the market, and we expect more to launch in the future.

We see infrastructure debt as an attractive complement to both core infrastructure equity allocations and direct lending allocations within private debt. If you're interested in this asset class, please contact the author or your usual Hymans consultant to find out more.



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General Investment Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes but is not limited to equities, government or corporate bonds, derivatives and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of investments. As a result, an investor may not get back the full amount of the original investment. Past performance is not necessarily a guide to future performance.

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