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INSIGHT

Infrastructure Debt - Opportunities in the post-COVID recovery

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July 2021

DEBT INVESTMENTS

As the global economy recovers from the COVID pandemic, every sector is being forced to assess how the events of 2020 have impacted their operating environment and what the future may look like for their businesses and society as a whole. Companies and governments are also using the pandemic as an opportunity to re-think how economies operate and focus on rebuilding in a more sustainable way. These trends can be clearly seen in new approaches to remote working and learning, workplace collaboration and commitments to net-zero emissions by 2050.

Recovery efforts are being supported by ambitious government spending plans that focus strongly on infrastructure. For example, the UK government recently announced £100bn in infrastructure type spending for 2021-22 to help build roads, rail and fibre, amongst other investments, to make the British economy more resilient as part of the 'Build Back Better' plan. Similarly, in the US, the Biden administration is formulating ambitious spending plans to upgrade ageing infrastructure, including water, electric and transportation networks. And this is all taking place alongside the transition towards less carbon intensive infrastructure which we expect to accelerate in the years ahead.

The attraction for long term investors

Increasing government infrastructure spending can bolster the whole infrastructure investment ecosystem and create opportunities for long-term debt investors that have been impacted by low global interest rates and the hunt for yield in riskier credits. This is because infrastructure financing is often more heavily weighted towards debt than equity. As government policy and priorities are enacted and we see an evolution in preferences for a sustainable economy, the supply of infrastructure debt opportunities will likely increase.

For investors, the attractiveness of infrastructure debt investments lies primarily in the resilient income they can generate and their relatively low risk profile compared to other similarly yielding fixed income alternatives. The resilient profile reflects the essential role infrastructure assets play in the economies they serve.

In this paper we outline the case for investing in infrastructure debt, the factors »

that enable it to provide resilient income and the relative value opportunities that currently exist in the market.

Infrastructure debt's resilient income characteristics

Infrastructure assets can **provide services that are an essential part of daily life**. The nature of those services means the pattern of usage is often stable and well understood, which helps support the long-term investment case for investing in their debt. Infrastructure assets, such as renewable energy and low-carbon heating, are increasingly playing a role in supporting the transition to a lower carbon economy. We believe this 'essential' nature contributes to the resilient credit characteristics of the asset class.

Infrastructure assets tend to exhibit **monopolistic features**, either through regulatory-based controls and/or high barriers to entry, but the relative strength of these features varies. For example, a regulated water utility can be protected from new competitors by law; a fibre network may, however, be open to competition from other networks and exposed to risks associated with starting a new service. The effects of competition are often mitigated by the high barriers to entry in constructing and duplicating existing infrastructure assets.

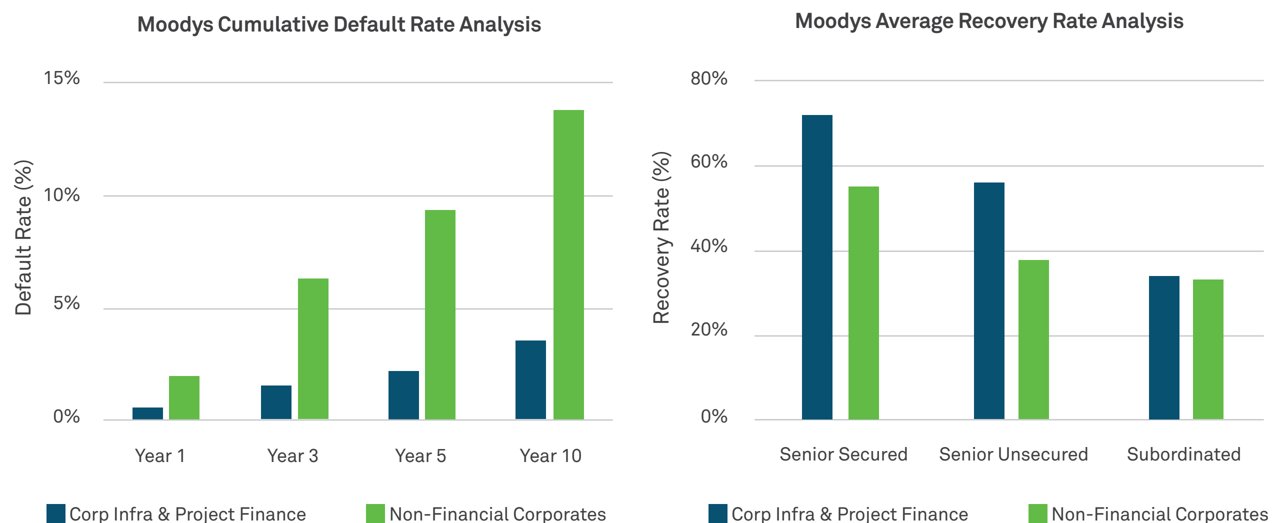
Protective covenants are also an important part of infrastructure debt investing and can provide a range of features to preserve the credit profile of the debt investment. Covenants place limitations on the nature of activity that can be pursued by the borrower, and can require minimum levels of cash flow coverage to be maintained and place constraints on leverage to help keep risk in check. Breaches of covenants can trigger a 'lock-up' of equity distributions and can eventually lead to creditors taking control of the asset. We seek robust credit controls in infrastructure debt investments in contrast to the broader credit market trend of deterioration in covenant protections.

Given the capital intensive nature of infrastructure, significant equity commitments are often required from asset owners. This acts as a loss-absorbing layer of capital, with **debt formally ranking ahead of equity** in the capital structure, making debt the natural first port-of-call for infrastructure investors looking for resilient income from infrastructure investments.

The underlying infrastructure assets generally can benefit from a stable cash generation profile due to the essential nature of the services provided. Revenue stability is also often supported by regulatory regimes and/or medium to long-term contracts. This, coupled with the liquidity premium associated with private infrastructure debt, can potentially offer an **attractive, reliable cash yield**.

These features have resulted in superior default and recovery rates associated with

FIGURE 01 COMPARING DEFAULT AND RECOVERY RATES - INFRASTRUCTURE DEBT VS CORPORATE BONDS



Source: Source: Moody's Infrastructure Default and Recovery Rates (1983-2019 (published 9 October 2020).
Past performance does not guarantee future results.

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infrastructure debt investments when compared to similarly rated non-financial corporate bonds as shown in Figure 1.

Taking advantage of relative value opportunities

The pricing of private infrastructure debt has been influenced by low interest rates and a global search for yield like the rest of the fixed income markets in recent years. However, in our view, the global infrastructure debt market remains very diverse, which helps enable active selection among the opportunity set.

Sub-investment grade infrastructure debt is a specific sub-set of the market that encompasses debt assets considered to sit in the BB+ to CCC range, as denoted under various rating agency frameworks. We believe there is a particularly attractive, risk-adjusted opportunity at the upper end of the sub-investment grade range where assets still display certain resilient credit characteristics and yet tend to be of less interest to regulated investors (banks and insurance companies) who have a relatively low appetite for the incremental increase in risk. This segment is also often overlooked by higher return-seeking private credit investors who are more comfortable pursuing higher equity-like risks to maximise potential returns.

While the opportunity is there, identifying the right mix of deals outside the public domain and understanding appropriate risks is essential. It requires close relationships with sponsors and advisors in order find suitable deals, and sector expertise and experience structuring private market transactions to fully harness the opportunity.

At IFM Investors, we have a team of specialists dedicated to the origination and execution of infrastructure debt transactions in the major infrastructure markets of the developed world. The experience of the team and the wide range of deals we consider annually strengthens our ability to assess relative value and find resilient income characteristics for clients.

Waste to energy facilities provide opportunities for investors to benefit from long-term contracted revenues.

Attractive returns hinge on understanding incremental risks

By investing in private market infrastructure debt, long-term investors are seeking to benefit from an illiquidity premium. But what are the other incremental risks associated with moving down the credit spectrum to into BB territory, and how is this consistent with a resilient credit profile? We find incremental risks are worth taking if they are well understood and transactions are structured in a way that sufficiently manages downside risk.

One of the typical advantages of debt investing is its senior position in the capital structure of an infrastructure business, meaning that any income losses experienced will first be borne by the equity holders before they affect contractual debt obligations. However within the debt portion of a business' capital structure there can be further subordination, meaning that some debt obligations will rank junior to other debt obligations and absorb the first losses that could occur to debt holders.

For example, we may seek opportunities to lend at the holding company level (HoldCo) of a business which is structurally more junior to operating company (OpCo) debt in the capital structure. We may do this when we believe the incremental yield potential is attractive and the underlying credit fundamentals of the revenue-generating asset are strong and considered consistent with an investment grade credit profile. An example of such an opportunity is providing HoldCo debt to a waste-to-energy facility that benefits from a long-term concession in the form of waste supply contracts or a regulated utility that benefits from the protections afforded by the relevant regulatory framework.

We may also consider sub-investment grade rated opportunities that are senior

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Battery storage is a relatively new technology that is helping decarbonisie the electric grid.

debt obligations of riskier businesses if they are benefiting from macro and/or regional trends that potentially compensate us for taking on the extra credit risk. Examples include opportunities in battery storage which is a relatively new technology that is expected to play an integral role as countries seek to meet challenging renewable energy targets and provide more reliability to the energy grid.

Integrating Environmental, Social, and Governance (ESG) considerations in infrastructure debt investments

The other notable impact of the pandemic is the increased sense of urgency that is driving governments and companies globally to speed up the response to the world's biggest sustainability challenges. At IFM we believe this creates opportunities for long-term pension capital and the workers and pensioners this capital represents.

Infrastructure assets have an important role to play in addressing these issues as they are estimated to consume about half of the world's consumed materials each year[1]. Significant investment will be needed to transition the world's infrastructure to be less resource intensive. According to the Global Infrastructure Hub, infrastructure investment needs between 2016 and 2040 are forecast to be around US$94 trillion globally but current projections for global infrastructure spending by 2040 only amount to US$79 trillion, leaving a US$15 trillion investment gap[2]. We believe private capital will likely have a significant role to play in filling this gap, and a keen focus on ESG should help ensure it is done in a sustainable way.

The challenge for debt investors however, is that they lend money to companies but do not have ownership rights, hence they typically have less ability than equity investors to influence company management. This suggests ESG analysis for debt investing needs to be concentrated in the investment screening and due diligence phases, prior to entering an investment. This enables the avoidance of investments that might pose ESG concerns in the future. For example, in the past we have discriminated among biomass investments, avoiding those which rely heavily on biomass sources shipped from abroad, and government subsidies which could be taken away. We seek to invest in assets that we believe have a role to play in a long-term sustainable future.

We have observed a significant rise in the number of infrastructure debt investment opportunities that can deliver positive ESG impacts.

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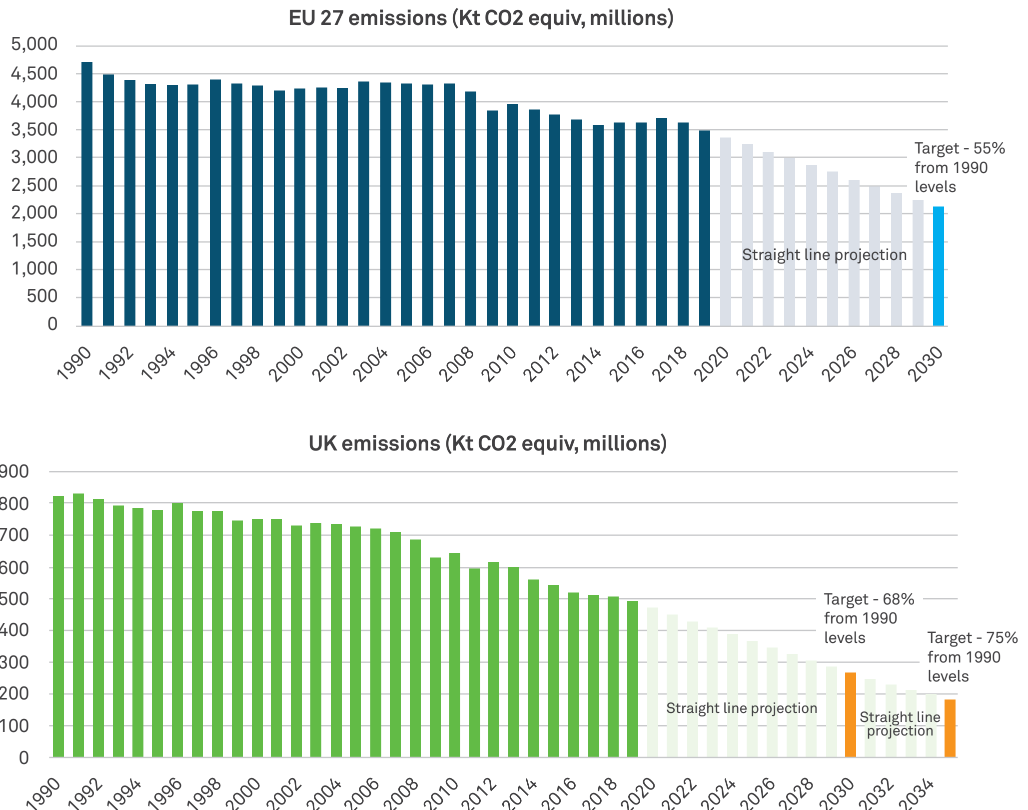
Decarbonising power, heating and transport

In recent years, we have observed a significant rise in the number of investments within the infrastructure debt market that can deliver positive ESG impacts such as the decarbonisation of power, heating and transport. This is consistent with actions taken by governments and other organisations aiming to achieve interim country emissions targets for 2030, on the ultimate path to be carbon neutral by 2050 (see Figure 2). The UK has gone a step further and set an additional ambitious target to achieve a 78% reduction in emissions by 2035[3]. Looking forward, we expect this trend to continue, as countries seek to achieve these goals, and investor scrutiny over ESG factors increases.

[1] Global Infrastructure Hub, infrastructure monitor, insights, 28 June 2021. https://www.gihub.org/infrastructure-monitor/insights/infrastructure-consumes-more-than-half-of-the-world-s-materials/
[2] Global Infrastructure Hub, forecasting infrastructure investment needs and gaps. 30 June 2021.t https://outlook.gihub.org/.
[3] This target is against a 1990 baseline.

FIGURE 02 EU 27 AND UK EMISSIONS REDUCTION TARGETS



Source: European Environmental Agency, gov.co.uk (press release 20/04/2021), European Council (press release 17/12/2020)

We observe that strong investor demand for renewable energy infrastructure debt deals has resulted in the emergence of a "green premium", making some renewable energy investments relatively expensive. However renewable energy is not the only infrastructure sector contributing to lower emissions. There are an increasing number of deals associated with the decarbonisation of heating and transportation sectors, such as heating networks based on low carbon fuel sources, and electrification of rail networks.

Understanding ESG related risks and opportunities, and assessing relative value in highly sought after renewables, are some key challenges for investors in the current market. However, we believe that infrastructure investments do have an important role to play in a more sustainable future, and strong relationships between investors, managers, sponsors, and governments should help enable infrastructure debt to contribute towards building that future.

The road to a more sustainable recovery

As we rebuild globally in the wake of the pandemic, there appears to be a strong desire to do so in a way that is more efficient and sustainable. Investments in critical infrastructure serving global economies are set to play an important role in the economic recovery and the transition to a less carbon-intensive society.

As this transition ensues, the debt-led capital structure of many infrastructure assets should mean there will be increasing investment opportunities with resilient income characteristics. But not all opportunities are equal, and having a thorough understanding of the risks, and experience investing in critical infrastructure sectors globally are key to helping investors harness relative value.

We believe there are many opportunities that can generate resilient income for the long-term investors we represent and we seek to carefully identify, structure, and analyse those investments that can transition the global economy to a more sustainable future.

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IFM-19JULY2021- 1706228

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