KEYNOTE INTERVIEW

Seniority matters

The only way to truly benefit from infra debt's defensive attributes is to focus on senior secured positions, says IFM Investors' Rich Randall

Investor appetite for infrastructure debt has grown significantly in response to a once-in-a-generation modernisation cycle, together with the need to diversify broader private credit portfolios.

However, while some investors have chosen to pursue mezzanine strategies in the hunt for higher yield, Rich Randall, global head of debt investments at IFM Investors, which has been active in the infra debt space for more than 25 years, believes that taking a senior secured position in the capital stack is how investors can best benefit from the key defensive and diversifying characteristics of the asset class.

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Q What are the trends underpinning growth in infrastructure credit?

It is being driven by both demand and supply factors. In terms of supply, there is a massive modernisation process taking place right now. This, coupled with changes in the economic environment, has created a huge need for infrastructure debt.

The primary drivers behind that modernisation are, of course, the decarbonisation agenda and digitalisation. The combination of those two trends is creating a wealth of opportunities, particularly in the power sector. However, the opportunity set that we see today stretches across all areas from energy to social infrastructure and transportation. I've been active in this industry for more than three decades and this is one of the largest asset rotations and modernisation cycles I have ever experienced.

On the demand side, corporate private credit and direct lending have become mainstream asset classes over the course of the past 10 years. Infrastructure debt has always existed, but the evolution and growth that has taken place on the corporate side of the investment universe means that infrastructure debt increasingly has come to be seen as an important diversifier within broader corporate credit.

We believe infrastructure debt also provides downside protection, and inflation linkage, but above all, it's the diversifying characteristics that are responsible for the level of interest the asset class is receiving today.

Q What risk/return profile do you deem to be most attractive and why?

On the debt side, we invest across both core and core-plus. The reason is that the different strategies appeal to different types of investors. Insurance companies have risk-based capital constraints that favour investment-grade opportunities and lean towards core infrastructure investments with price and volume risk mitigation for the life of the asset.

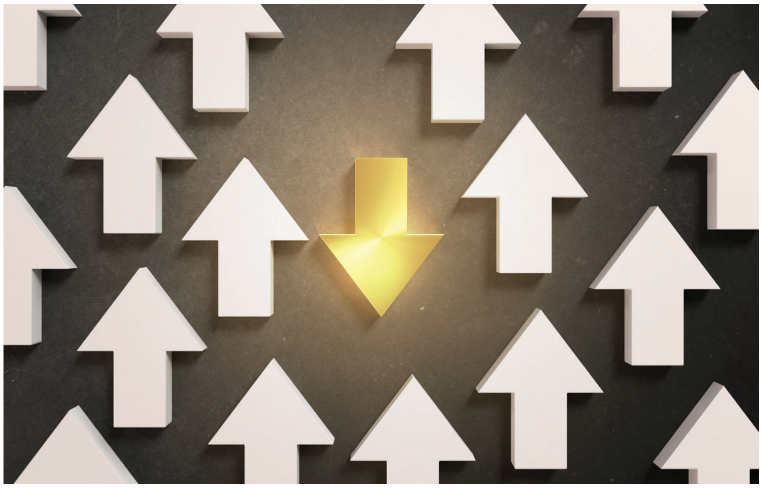
However, core-plus can prove interesting for investors that don't have those same risk-based capital constraints, and that are seeking higher levels of returns. Institutional investors such as pension plans and endowments, as well as family offices, are increasingly displaying appetite for core-plus infra debt strategies.

Q Given the once-in-a-generation asset rotation and modernisation process you described, where are you seeing particularly attractive opportunities to deploy capital?

A global phenomenon that is particularly acute in North America involves the growth of artificial intelligence and the associated demand for digital assets. We are seeing tremendous growth in data storage opportunities and, linked to that, a correspondingly large growth in power generation opportunities too.

There is a massive rethink going on around power supply throughout OECD countries. Not only are energy demands increasing dramatically because of the digital revolution, but there is also growing societal pressure to ensure that energy supply comes from less polluting or renewable sources.

This is creating an interesting dynamic that will result in the continuation of some transition energy sources such as natural gas, which have been increasingly replacing coal over the years. This will also lead to growth in renewables, including solar and wind, as well as in some of the newer technologies that are starting to evolve such as storage and waste-to-energy.



Q How are infrastructure debt funds differentiating themselves from one another in the market?

There are many ways managers are differentiating themselves. We are focused on senior secured debt, up and down the spectrum, whether that is in investment-grade, sub-investment-grade or next-generation infrastructure. We don't see mezzanine debt as a core strategy, although we will invest in mezz opportunistically. We believe that to harvest the defensive characteristics of the asset class, you need to be in the senior secured part of the capital stack.

Many of our competitors are looking for higher yield, equity-type returns, and so choose to play primarily in the mezzanine space. But increasingly we are seeing investors shift towards what we have been doing for the past 15 years, which is to focus on senior secured debt.

Q As a debt provider, how do you decide when the time is right to lend to some of these newer technologies?

That can certainly be a challenge. We found that we were seeing a lot of interesting opportunities that we didn't have the right capital to pursue, given the inherent technological risk. Therefore, we decided to create new products, partnering with firms that have deep benches of expertise, including specialists and scientists who can help us analyse these new technologies to understand not only their current efficacy but also their commercial viability over the longer term.

We have added a next generation infrastructure strategy to our core and core-plus products, allowing us to identify those technologies that are going to prove transformational to decarbonisation and to the energy mix going forward. Just to reiterate, however, we believe it is critical to find partners with that deep sector expertise that also have skin in the game, to help make those technology calls.

Q How does the opportunity set vary between different geographies?

The US has traditionally been an energy market. A lot of the country's social and transportation infrastructure continues to be held by local governments and municipalities. That energy market opportunity set in the US has now been expanded to include a wealth of digital opportunities.

By comparison, Europe has always been a more diversified market because there is more private ownership of social and transportation infrastructure. The third region where we are active is Australia, which has been a little quieter for us recently, but is a similar market to Europe, in terms of deeply entrenched private ownership of infrastructure across the board.

Q How would you describe the interplay of private infrastructure funds and banks?

Commercial banks are still the biggest suppliers of capital to infrastructure. However, in the wake of the global financial crisis, those banks have become more focused on risk-based capital charges. They need to be more capital efficient, which has created a space for institutional investors to take up some of the slack.

This is particularly apparent in the sub-investment-grade category or in situations where sponsors require permanent debt. Banks are good at providing short-term facilities, construction facilities and liquidity lines, but are not set up to make those longer-term loans.

You often hear about institutional managers taking market share from banks in the corporate and direct lending markets, but the situation is a little different in infrastructure. We find ourselves working alongside banks, given that the deals we transact on are often substantial. These assets need facilities that institutional debt providers can't provide, and so there is a symbiotic relationship that exists. Banks and institutional investors more generally work together in a cohesive fashion.

Q How have higher interest rates and inflation impacted infrastructure debt portfolios?

The new economic environment has been net positive for our portfolio. Most infrastructure debt is done on a floating rate basis – SOFR plus spread – which means the all-in return for our investors has increased meaningfully. The investments themselves have fared well because of the inherent pass through of inflationary costs which is built into the revenue contracts. Neither increased costs nor increased interest rates have created any distress. In fact, the impact has been overwhelmingly beneficial.

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"It is [infrastructure debt's] diversifying characteristics that are responsible for the level of interest the asset class is receiving today"

Q Infrastructure debt is clearly an inherently ESG-positive sector, but how do you factor sustainability into your strategies?

We analyse the risk aspect of ESG across all regions, all sectors and all assets. That means assessing both transition risk and physical risk. For example, we consider the risk that the introduction of a carbon tax would have for assets, as well as the phasing out of carbon-based fuels. In terms of physical risk, we consider those risks that could result from any sort of environmental upheaval or volatility.

In addition, we incorporate sustainability goals in some products, depending on the objectives of the investors in those funds. That may include choosing assets based in part on their sustainability attributes. It may mean measuring their emissions as well as other sustainability metrics that align with the client's own motivations. It may also mean linking margins and covenants to those goals. It all depends on what the client is trying to achieve.

Q How optimistic are you about what 2025 has to bring for the infrastructure debt sector?

We are currently in one of the best infrastructure markets that has existed in the past 30 years, given the powerful drive to decarbonise and the proliferation of technologies that exist to help us achieve that aim. ■

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