E X P E R T Q & A

Now is the optimal time to consider infrastructure debt – it offers stability, diversification and needs a huge amount of investment, says Viktor Kozel, head of infrastructure debt at UBS Asset Management

An interesting time to invest

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Q From an investor perspective, what makes infrastructure debt attractive versus other asset classes?

It is an interesting time to invest in infrastructure as a maturing asset class, particularly as it compares to sister asset classes such as real estate. We see more and more differentiation within infrastructure debt and equity, with more fundraising for specialist funds that present interesting options for investors.

The fundamentals of infrastructure remain very strong, especially given the current difficult macroeconomic and political environment. The stability that the asset class offers is important compared with other asset classes in investor portfolios, with fundamentals including low volatility of cashflows, diversification away from corporate risk, low defaults and high recovery rates in the event of insolvency.

It is also clear that investors are underallocated to infrastructure, which creates an interesting market dynamic going forward.

As far as infrastructure debt fundraising is concerned, we are still in a difficult environment. Even though we know that infrastructure debt is very appealing to investors, there remains a lot of space between the mega-funds and everyone else in the broader infrastructure industry. There has been a bit of a flight to quantity by investors and we see differentiation between the senior and high yield fundraising environment.

Investor allocations in infrastructure debt are prevented by insufficient illiquidity premiums compared with fixed income bonds, which are one proxy for senior infrastructure debt. There are also constraints on investors allocating to illiquid assets rather than with infrastructure itself. Those factors make fundraising challenging, especially for senior debt – we see that among our competitors and among direct investors such as insurers. They have much less capital than they used to on their balance sheets.

On the high yield side, the picture is a bit better. There is still a clear advantage to investing in high yield infrastructure debt versus equity, because returns have compressed for infrastructure equity. Returns have also compressed for private corporate debt and are almost equivalent to infrastructure high yield, so, given the lower risk of infrastructure investments, investors are interested in this space today.

Finally, across infrastructure debt or equity there is a huge amount of investment needed to support demographic change, decarbonisation, deglobalisation and digitalisation. For example, despite weaker infrastructure debt transactions in 2023, activity remained strong in the energy transition (eg renewables) and telecommunication sectors, as investments exposed to secular trends such as decarbonisation and digitalisation still remain popular. In our view, it is a good time to deploy funds in this environment and for debt investors to lock in attractive interest rates.

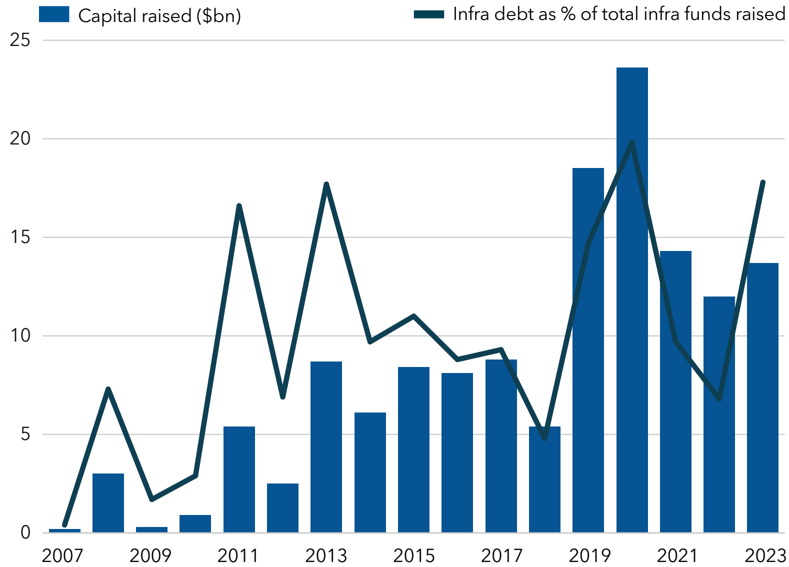
Q What is next for investor allocations, given the growing appetite for infrastructure high yield and sub-investment grade debt?

We are seeing a trend of large funds getting bigger, particularly in the high yield space, and a lot of newcomers with experience in infrastructure equity are also moving into infrastructure credit.

At the same time, we are seeing some problems with certain investments in the portfolios of large managers because the market opportunity is huge but there is a lot of competition so lending standards can sometimes come under pressure. There is a question as to how that will impact the future of the market and affect more disciplined capital providers.

This means some infrastructure debt funds coming from the equity background approach it rather aggressively, almost taking quasi-equity risk, and some investments will go sour. The issue is to what extent that will impact the reputation of the market.

Infrastructure debt fundraising



Source: Inframation

As a senior debt infrastructure investor moving into high yield, our approach is much more conservative. We come into this same space from a different perspective with a view to structure a similarly robust covenant and security package, and have substantial equity buffers to protect the downside.

Larger investors coming into the market want to deploy sizeable amounts into single transactions, so there is a need for different approaches. It is important that investors understand how to differentiate between various managers and strategies, and perhaps proceed with caution when looking at some of the more aggressive plays.

Once interest rates start to come down, equity returns don't fully pass through, so we may see a different impact in high yield versus senior debt, which may become a bit less appealing to some investors. But when you compare high yield infrastructure with corporate debt, returns are at a similar level and that speaks in favour of infrastructure.

Q Which sectors are most attractive from a risk-return perspective for a debt investor today?

What we see in the market now is renewables and digital infrastructure dominating activity. Those two sectors are responsible for 60-70 percent of the entire infrastructure debt market in Europe. It is easy to deploy capital at scale and that is why it is appealing to managers, but as a result, the risk-return proposition is less appealing.

We can still find interesting opportunities in those sectors but have to be really selective. We prefer to look elsewhere and consider other sectors, such as transportation, for example, where there is a huge investment need driven by decarbonisation and supportive trends.

Transportation recovered well post-covid and has demonstrated resilience over time, with a lot of attractive subsectors. The methods used to transport goods and people moving forward creates a lot of opportunities to invest and achieve good risk-adjusted returns for debt investors.

We also see an interesting emerging industrial sector opportunity because of the need to decarbonise and upgrade technology across the value chain. That is not traditionally an infrastructure opportunity, but within the sector there are processes with similar

How can a debt investor make an impact with regard to ESG considerations?

Overall, ESG remains one of the key drivers when it comes to new capital allocations and scrutiny of investors and managers. The market still looks very diverse, with no standardisation of approaches or benchmarks. Everyone has to develop their own strategy because we need to invest as much as €700 billion annually into decarbonisation according to the European Investment Bank, so there is a clear opportunity set.

As debt investors, we need to find the best way to approach the market. We are not equity investors, so we don't control the deals that we invest in, but we are typically the majority of the capital. Out of that €700 billion requirement, more than half needs to come from debt and so there need to be standards for debt investors.

We have recently worked with consultants to develop a proprietary framework that allows us to classify debt investments as impact, enabling us to introduce bespoke covenants, bespoke reporting requirements and economic incentives for borrowers. We believe that allows potential investors in our strategies to support the decarbonisation trend.

Impact is not concessionary capital – that is very important. This is about creating a framework and discipline without compromising on returns for investors, rather than prioritising impact over financial returns, and this is the way we see the market moving forward.

"The fundamentals of infrastructure remain very strong, especially given the current difficult macroeconomic and political environment"

characteristics to infrastructure that require specialist investment.

Finally, social infrastructure is another attractive space. With an ageing population and the need for governments to increasingly outsource public services, infrastructure can propose different risk-sharing models. That is still a small part of the infrastructure market today, but it will grow and requires more attention going forward.

What kind of competition is there for deals? Are banks trying to regain market share?

We are certainly seeing some pushback and an attempt from the banks to recapture market share. Over the last few years, institutional investors have increased their share of lending and banks are now maybe more aware of the problem and trying to fight back.

In many cases, they remain aggressive when it comes to pricing, trying to capture share particularly in emerging sectors such as EV charging. There, the risks are more pronounced and it is difficult to find bankable deals, but the banks are doing some of them as pathfinder transactions to build expertise and position themselves for later deals.

It is difficult for us to justify following the same strategy. Banks have different business models and are much more short term in orientation, leaving institutional lenders at an advantage when it comes to longer-term lending and more bespoke structuring.

We have to be more disciplined on pricing because we don't have the same cross-selling business models and have to price the risk in line with the market to give investors the best possible returns.

What does pricing look like in the current market?

We still see some banks being quite aggressive, which is perhaps surprising, given all the Basel regulations imposing constraints on their ability to provide long-term lending. But there are still subsidies available to banks that allow them to be competitive in certain sectors, particularly renewables.

At the same time, we see banks do not have limitless capital. In the Spanish renewables market, for instance, there used to be a number of banks aggressively offering low pricing and looser structuring, but they are not doing that any more.

Also, given the lack of liquidity and the lack of new allocations from investors, there is an impact on the ability of private lenders to provide larger tickets on transactions. In that sense, there is more competition for liquidity and that affects pricing. There are more deals with attractive risk-adjusted returns in the market and some good opportunities to be found.

We continue to see the mid-market as attractive because, with market consolidation and larger funds taking a greater proportion of investor allocations, the market for €50 million to €200 million loans goes under the radar. That represents the majority of the market and still offers a good entry point for sophisticated investors with structuring capabilities to capture additional premiums. ■