Talking Points

Infrastructure debt in a COVID-19 world – June 2020

COVID-19 has placed stress on certain infrastructure companies, with little visibility as to when they can get back to "normal."

Liquidity reserves will need to be replenished, capex programs re-started and dividends resumed.

Equity sponsors may be reluctant to sell or dilute equity in this environment making debt solutions attractive, especially mezzanine which can be more flexible to sit alongside existing financing arrangements.

Overview

So far in this crisis, infrastructure debt looks to be weathering the storm better than wider corporates, mirroring the experience in the great financial crisis (GFC). It is still early days though and some sectors look particularly under stress. We see an opportunity but are also aware of the risks and the need to select assets that can withstand another wave of infection and a lower growth environment.

Senior and mezzanine infrastructure debt have experienced significant growth over the past decade and now form an important part of institutional investors' portfolios. Prior to the GFC, infrastructure financing was predominately provided by banks. Infrastructure debt as an institutional asset class emerged to fill the gap left by banks who were hit with higher capital charges making it difficult for them to make long-term loans.

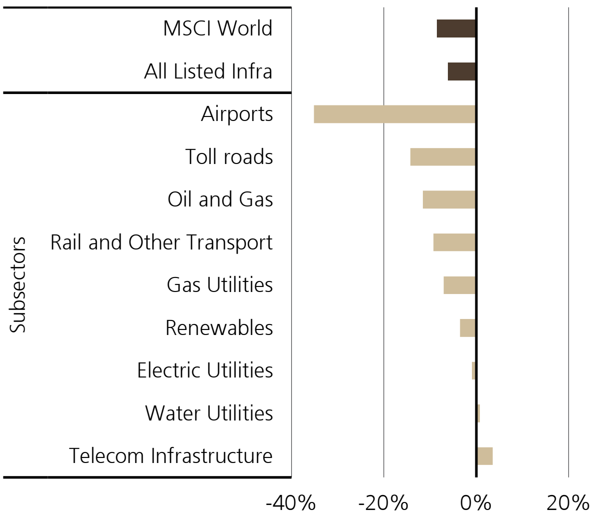
The attractiveness of the infrastructure debt asset class has been further boosted by both ever-declining fixed income yields, and the change in 2016 to the Solvency II regulation to reduce capital charges for insurance companies and regulated pension funds for investing into the sector. This change was introduced to reflect infrastructure debt's lower risk versus equivalently-rated corporate debt. Studies from Moody's show comparatively low expected loss rates for infrastructure bonds and loans relative to corporates over the period 1983-2018 (see Figure 2). Unlike corporates, infrastructure credits did not see a spike in defaults during the GFC. However, the combination of COVID-19 and the sharp drop in oil prices have created unprecedented conditions for the infrastructure sector making it more challenging to predict how the asset class will fare this time around.

At a high level, infrastructure assets tend to benefit from high EBITDA margins which will allow businesses to recover quickly once revenues return. However, this crisis requires more granular analysis and we have already seen a wide range of outcomes by sub-sector. COVID-19 creates both challenges and opportunities for senior and mezzanine infrastructure debt providers. It is useful to look at this crisis in its phases: Phase 1 "emergency" with pathways out of lockdown emerging; Phase 2: "reopening"; Phase 3: "new normal."

Phase 1: Emergency

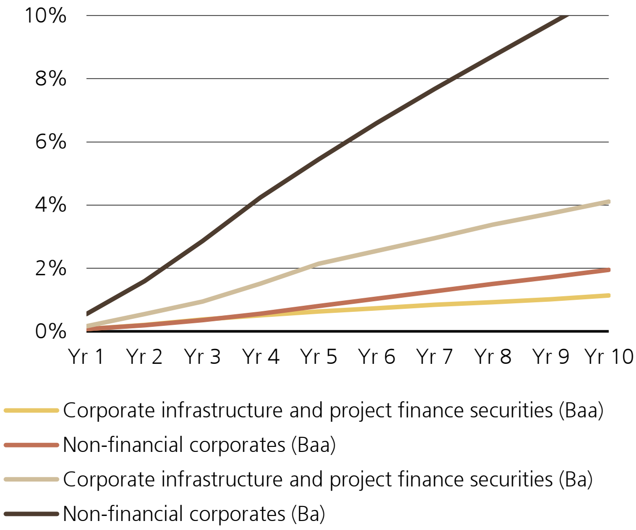
The infrastructure sector is a collection of distinct sub-sectors and Figure 1 shows that range of impact across the key sub-sectors. Renewables, utilities, telecommunications and certain parts of social infrastructure have performed well whereas transportation assets, especially airports have seen a material impact to earnings.

Figure 1: Revisions to 2020 earnings estimates
(Five-month % change)



Source: Bloomberg, May 2020; Categories are from GLIO, equally weighted

Figure 2: Moody's average cumulative loss rates
(1983-2018)



Source: Infrastructure default and recovery rates, 1983-2018, published by Moody's in August 2019

In terms of expected revenue impact, the infrastructure sector looks well positioned versus broader corporates. This is consistent with the results from a recent study by Moody's[1] that shows fewer coronavirus-driven infrastructure downgrades and defaults versus non-financial corporates.

From March to May, only two infrastructure issuers defaulted (0.1% of universe) vs. 66 non-financial corporates (1.3% of universe). Moody's opine that the better result reflects the combination of structural considerations and higher revenue stability that characterize many infrastructure issuers.

While Moody's forecast defaults to rise in 2020, they expect infrastructure to perform better as an asset class than non-financial corporates in this downturn. The expected rise in default rates had resulted in an increase in credit spreads (Figure 3) with BBB and BB non-financial corporates widening by 60bps and 160bps respectively since the start of the year.

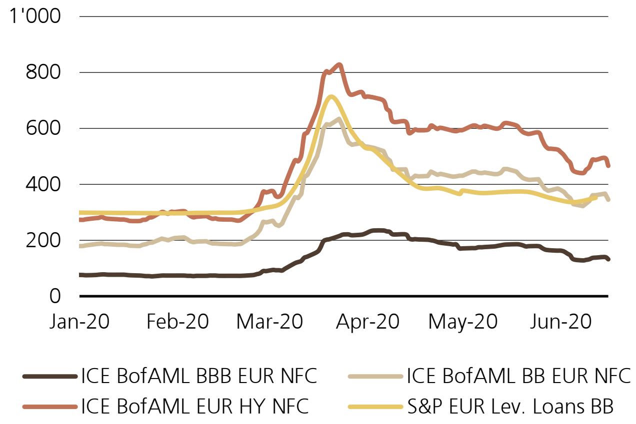
[1] Moody's, Defaults & Recoveries: Fewer coronavirus driven downgrades than non-financial corporates (June 2020)

This is down from the peak stress point at the end of March of 150bps and 450bps, respectively, and reflects the unprecedented level of quantitative easing and fiscal stimulus programs. We've seen in the past that the ECB's asset purchases are effective in compressing spreads, and so, all else being equal, we would expect public spreads to continue to decline as the EUR 1.4tn program starts to flow through the system.

In the following sections, we provide an overview of the winners and losers across the key sub-sectors below and assess the key challenges and opportunities in each phase of the crisis.

Figure 3: Credit spreads

(Bps p.a.)



Source: Bloomberg, May 2020

Table 1: Impact of COVID-19 on infrastructure sub-sectors in Phase 1

	Sector	COVID Impact	Commentary
Transportation	Airports	●	– Traffic drop of 95+% in affected regions – Airline counterparty risk and reduction of routes
	Toll roads	◕	– Traffic levels significantly down although those routes with higher % of freight have been less affected
	Ports	◑	– Global container volumes fell by around 40%, but surprised to the upside as trade continued to flow
Energy and utilities	Utilities	◔	– Regulated utilities are well insulated; however, potential for rising bad-debts; – Unregulated utilities exposed to falling power prices of 10-40% across Europe
	Renewables	◔	– Benefit from priority of dispatch and being cheapest form of generation; assets with power price risk negatively impacted
	Oil and gas	◕	– Risk of underutilization of assets as oil price drops by 50-60% making some assets uneconomic; storage assets have benefited from a supply glut
Telecommunications	Fiber	○	– Fiber one of the few beneficiaries of the crisis. Increasing working from home creating the requirement for a more distributed system
	Data centers	○	– Increased use of cloud applications and future proofing disaster recovery will be a positive for sector
Social infrastructure	Public-private partnerships (PPPs)	○	– PPPs benefit from availability-based revenues and therefore were well insulated. Healthcare assets are facing more operational challenges and may have to bear some increased costs
	Non-PPP	◔	– Non-PPP assets are more of a mixed bag: assets serving the healthcare sector have seen an increase in demand but are dealing with higher operational costs of keeping their staff and patients safe

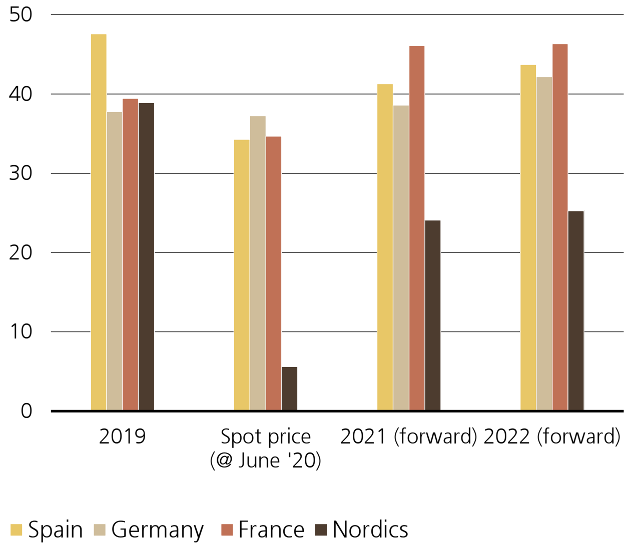
Source: UBS Asset Management, Real Estate & Private Markets (REPM), June 2020

Challenges and opportunities
The revenue drop experienced in certain sectors is more severe than any downside financing case envisaged. Sponsors and lenders have been focused on ensuring that companies have sufficient liquidity to service their obligations. Generally, the sector seems to be well capitalized with liquidity facilities and cash reserves.

Waiver requests will increase the longer the pandemic lasts. Generally, lenders have been amenable to waiving temporary covenant breaches based on the robust long-term fundamentals of the assets.

So far we have not seen many forced sellers or an uptick in defaults in Europe. Primary activity from Jan-April 2020 has been around 20% lower than last year as some M&A processes are put on hold. We have seen an increase in opportunities for secondary purchases (at a discount) as banks looked to offload exposure for non-key markets and relationships. This is largely a function of increased funding costs (as measured by credit default swaps) and uncertainty around their ability to syndicate in a stressed environment.

Figure 4: Significant drop in power prices across Europe
(EUR/MWh)



Source: Bloomberg, June 2020

Phase 2: Re-opening

Oxford economics expects eurozone GDP to decline by around 5% in 2020. This will not be an even correction, but rather a sharp downward drop in the first half of the year followed by a recovery towards the end of the year (but not sufficient to make up the losses in 1H). The recovery is based on moving smoothly from Phase 1 to Phase 2 with the return of industry and most commercial and leisure sectors.

The infrastructure sector should also receive a boost. Many assets will revert to close to pre-COVID levels but some assets will still be operating significantly below capacity, especially airports. The features of the specific assets will be increasingly in focus. Whether the investment is exposed to commuter or leisure traffic, passengers or freight, regulation or commodity price risk will have a significant bearing on its attractiveness.

Transportation

Airports
We expect some restrictions on international travel to remain in place during Phase 2. The extent of restrictions and quarantine requirements will vary by country so some assets will be affected more than others. The extent of the recovery in international traffic will depend on the success of governments in negotiating air bridges/bubbles and the ability of airports and airlines to balance the need to meet safety protocols without over-burdening passengers.

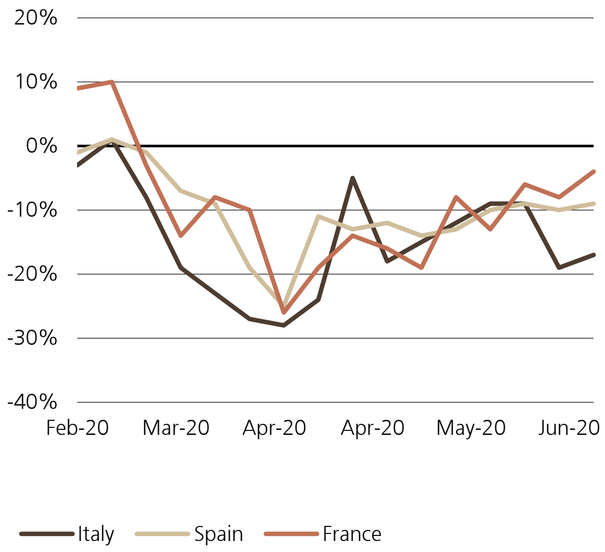
In the short-to-medium term, airports with a higher contribution from domestic and short-haul flights may be more attractive than those more exposed to long-haul traffic. Retail revenues are likely to fall, penalizing airports with a heavy reliance on commercial revenue and dual-till regulation. Investors will also need to pay close attention to the financial health of airlines, especially for airports with exposure concentrated around a small number of airlines.

Toll-roads
Toll roads saw less severe declines than airports in Phase 1, especially those with a high percentage of freight. As Europe exits Phase 1, we see a positive outlook for toll roads as industry re-mobilizes. Toll roads may also see substitution traffic from airports as people choose *staycations* over international vacations, and from a rise in private car usage as passengers avoid mass transport.

Energy and utilities

Utilities
Regulated utilities should continue to perform well in Phase 2. For unregulated utilities, electricity demand will recover as industry re-mobilizes although at lower levels than pre-COVID. Figure 5 shows increasing demand across Europe as restrictions have been eased. This will have a knock on effect on power prices which are significantly below 2019 levels (see Figure 4). We expect prices to remain below pre-crisis levels in the short-term, largely driven by significantly lower commodity prices. The futures market indicates that most markets will substantially recover by 2022.

Figure 5: European electricity demand starting to recover (YoY % change in weekly load)



Source: Bloomberg, June 2020

Clean energy
Renewables will continue to generate a bit of a halo effect. The public demand for cleaner, more sustainable energy will not be dampened by this crisis. In Europe, the new EU green deal aims to mobilize EUR 1tn over the next decade with an aim of reaching net zero by 2050. This will create significant opportunities for infrastructure investors. The investment will not just be in renewables, it will need to be in the next generation of carbon reduction technologies, storage technology and infrastructure for electric and hydrogen vehicles. Some of these opportunities may be in less mature sectors and will need debt capital to mobilize.

Telecommunications

Fiber
Before the outbreak, rolling out fiber to the home (FTTH) was already central to governments' agendas across Europe. This will only strengthen post-COVID. Government funding is still required for many rural fiber projects, a key focus area for infrastructure investors. This crisis will have further strained the urban-rural divide so we expect increased activity in this area, especially as more people need to continue to work remotely. Business-to-business (B2B) services should pick back up although some SMEs will not have survived Phase 1.

Data centers
While data usage will level off as more people return to work, there will still be significantly higher demands on the system. People will continue to use cloud software, video conferencing and online entertainment and gaming. All of these applications require low latency and therefore result in increased demand for datacenters. We also expect businesses to invest in additional disaster recovery resources and to ensure they are futureproofed for a second wave through cloud-based software solutions.

Social infrastructure
As in phase 1, non-PPP social assets will be a mixed bag. Assets serving the healthcare sector could see an increase in demand but are dealing with higher operational costs of keeping their staff and patients safe. Care homes in regions without regulatory protection are under stress, dealing with falling occupancy and higher costs. This crisis may create opportunities for providers of social infrastructure projects as governments deal with increasing fiscal deficits.

Challenges and opportunities
Asset owners in affected sectors will most likely need to seek waivers with lenders. Defaults may increase, especially for over-levered companies in affected sectors if there is no clear pathway to recovery. More generally, companies will need to take a view as to the appropriate capital structure and liquidity reserves to endure a prolonged transition period to Phase 3.

This could lead to opportunities for debt providers. The lack of clarity around the epidemic could reduce the number of M&A transactions. Sellers may be reluctant to compromise on price while buyers may be unable to lodge competitive bids as this requires making assumptions around the future of the epidemic which infrastructure investors are arguably not best placed to make.

This could make mezzanine financing an attractive option as companies can add some firepower without touching the existing financing. This can be an attractive way to revamp growth. Unlike equity, a debt investment can be made so long as the worst case view of the epidemic and associated recession still results in repayment of interest and principal. We also expect to see recapitalizations with mezzanine debt to allow companies to pay dividends, relaunch capex plans, replenish cash/reserves or to pay down senior debt to adjust the business for any "new normal." Some companies will need to refinance existing facilities to avoid breaching covenants and/or to avoid rating downgrades.

Phase 3: New normal

The biggest uncertainty is how long it will take to get back to normal and how different this new normal will be from the pre-COVID world. If there are no major setbacks and a vaccine is developed within 12-18 months then a strong rebound could be expected but short-to-medium term GDP growth is forecast to be lower than the baseline pre-COVID.

We believe that the long-term themes of digitalization and energy transition have only been strengthened by this crisis and will continue to be attractive sectors to be delivered by infrastructure investors. Despite a lower GDP-growth trajectory and some changes to usage habits, we also see opportunities in transportation. The table below shows that the average EBITDA margin for Moody's European transport sub-sectors is above 50% with low volatility over the period 2014-2019. Despite being unfashionable now, these assets will continue to be essential post-COVID and those investors taking a blanket unfavorable view of these sub-sectors may miss opportunities to secure attractive risk-adjusted return.

Figure 6: High EBITDA margins for transportation assets (2014-2019, %)

	2014	2015	2016	2017	2018	2019
Airports	52	52	52	54	54	53
Toll Roads	55	55	56	58	55	49
Ports	62	67	66	65	66	59
Networks and Utilities	39	38	39	38	38	39

Source: Moody's, May 2020
Note: Past performance is not a guarantee for future results.

Conclusion

Europe is now moving from Phase 1 to Phase 2 with major parts of the economy reopening. This will provide a significant boost to most infrastructure sectors. In Phase 2, it will be essential for infrastructure debt providers to select the right assets within sub-sectors that can withstand another outbreak and subsequent lockdown.

The features of debt can be very useful in this crisis. Debt does not benefit from upside as the investment case is based upon the repayment of principal and interest under a downside. The experience of Phase 1 and Phase 2 will be invaluable in setting reasonable downsides. It is more difficult to say with conviction what an appropriate equity base case should be and this may slow down M&A activity in affected sectors. Sponsors may instead choose to recapitalize by issuing mezzanine to pay dividends, replenish liquidity or pay capex. We also expect a rise in refinancings where businesses are breaching financial covenants and/or to avoid downgrades.

Early evidence from Moody's suggests that the infrastructure sector is seeing a lower proportion of downgrades and defaults relative to non-financial corporates, mirroring the experience during the GFC. Most infrastructure sectors seem to be performing robustly with the exceptions of oil and gas and transportation. The ultimate level of defaults will be a function of how quickly restrictions are lifted and how profitable the businesses are in the new normal.

Infrastructure's robust performance during the GFC helped to increase institutional allocations to the sector. If infrastructure continues to be resilient to the end of this crisis, allocations to the sector will receive a further boost as investor seek stable income from defensive assets that can provide diversification for investors' portfolios.

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