KEYNOTE INTERVIEW

Flight to quality over quantity

Diversification is key as global and macroeconomic trends continue to boost returns across the infrastructure debt market, says Viktor Kozel at UBS Asset Management

In the world of infrastructure debt, investors need to employ a diversified but highly selective approach, according to Viktor Kozel, head of infrastructure debt at UBS Asset Management.

While UBS has a substantial infrastructure platform valued at circa $15 billion around the globe, the investor targets assets that "provide essential services, possess strong cashflow and retain inflation protection attributes across key sectors", says Kozel, who joined the company in 2018. Today, his team runs a portfolio of 40 direct investments valued at $2 billion and has launched three funds since entering the infrastructure debt space back in 2015.

SPONSOR
UBS ASSET MANAGEMENT

"The funds we run are very much diversified funds, not specialist. We're across all of the infrastructure space: energy, transport, telecommunications and social. But we are very selective in where we see opportunities," says Kozel, who has a clear focus on mid-market opportunities valued between $50 million and $200 million and on direct lending to sponsors with little involvement in syndication.

Q How would you characterise the current fundraising environment for infrastructure debt?

The current environment is a challenging one. Interest rates have risen, as have redemptions from insurance funds – a major source of capital for the sector. And infrastructure overall has been handicapped by the denominator effect as valuations largely remained in place while other sectors retreated.

However, in infrastructure debt, we have seen nothing like the reduction in volumes that has been experienced elsewhere in the sector as a whole. But the debt deals that have been done have

been dominated by the large mega funds and, in my opinion, they represent a flight to quantity not quality.

Fortunately, we are beginning to see the tentative signs of an improvement as market conditions stabilise. I think this is driven by interest rate expectations moderating and by a slowdown in insurance company redemptions.

The fundamental characteristics of infrastructure underpin our subsector as they do the entire asset class, namely proven resilience, portfolio diversification, solvency efficiency and very strong underlying demand growth.

Q What strategies do you and your team employ in the infrastructure debt space?

As part of a much larger organisation, our team has excellent access to proprietary dealflow. Being part of UBS also means that we are very conservative in our risk profile. But we are not vanilla fund managers.

It is important for us not to lose sight of what we do best. We want a strategy that is targeted. Although, we were one of the first houses to be involved in the infrastructure debt space, we have not chased the large scale-up deals that some of our competitors have. We have a focus on risk protection, and while we may have a relatively small market share, this is because we stick to our roots and have not over expanded. We remain active both in senior debt and high yield.

Q Which of the subsectors within infrastructure are you most involved in?

I am aware of the emergence of specialist fund managers, for example teams that specialise solely in renewables. By contrast, we believe in a diversified approach, one which we feel offers better protection for our investors.

That also allows us to be lot pickier about the opportunities which we wish to invest in. In my opinion, specialist funds have less room to manoeuvre. In consequence, we are pretty evenly distributed across the subsectors and have an equal weight in digital infrastructure, transportation, energy and social infrastructure.

Q What do you make of the competition between debt and equity as a source of funding for the infrastructure sector?

Debt continues to have the upper hand in my opinion, and for very good reasons. The capital stack of any business is always dominated by debt rather than equity. Across the sector there are huge capital needs as we see businesses drive forwards in their decarbonisation and digitalisation missions. These significant needs will overwhelmingly be met by debt.

Infrastructure debt benefits from having a large equity buffer in front of us. And we are certainly seeing high-yield credit becoming more attractive compared to equity, in consequence of the rise in interest rates.

Q Where are you seeing the best opportunities at the moment?

We continue to see opportunity in the mid-market space. If you look at the overall European infrastructure debt market, it is now valued at around $130 billion. Something like 75 percent of the opportunities are in that mid-market space.

Investors have a particular window now to take share in that space from

the banks that are withdrawing. This is where the biggest opportunities are. Previously, the artificial support of quantitative easing made them awash with capital, and it was harder for managers like us to compete. Now, many banks have been burned in the leverage finance market and so are much more cautious. It has reduced their risk appetite and changed their general approach to deploying risk capital.

We have more pricing power and much more structuring power. We are in a position to achieve a much better risk-return profile than before.

If you look at the general market indices, there is something like a 50 to a 100 basis points pick up between the corporate investment grade index and the comparable infrastructure debt index. Some managers, like us, are able to increase that pick up by another like 50 to 200 basis points.

Investors are going through a learning curve. They are making greater allocations to infrastructure and have a greater appetite for alternatives. That trickles down into the sub-class of infrastructure debt, as there is more awareness of the solvency efficiencies and the lower risk profile that we can offer. We are giving investors a better risk-return equation.

The infrastructure debt sector has a long history of lower losses. Moody's research demonstrates that the recovery rate is something like 72 percent in infrastructure debt, compared to just 55 percent for corporate debt. The default rate of corporates is one and a half times that for infrastructure debt, namely 3 percent versus just 2 percent. And when you look at rating downgrades, the comparison is also very favourable, coming in at 15 percent for infrastructure debt versus 35 percent for corporates.

Q Are you seeing social infrastructure grow, and what do you generally look for there?

Social infrastructure as an investment is absolutely on a growth trajectory. We were one of the first investors to take positions in that sector, as we realised it often overlaps with real estate. We have made a series of different investments in the educational and healthcare arenas.

What is important is finding a social infrastructure investment that has the same characteristics that we would want in more traditional infrastructure. Social is important, but we are looking for strong stable cash flows as well.

"Infrastructure debt benefits from having a large equity buffer"

"Social infrastructure as an investment is absolutely on a growth trajectory"

For example, in education, we have financed childcare facilities in the Nordics because they have long leases and a favourable regulatory environment. Indeed, the government there subsidises around 75 percent of the costs.

In healthcare, we are of course looking to play longer-term trends such as the ageing of the global population. But again, we will continue to remain very selective in the individual deals which we do, and we are still looking for the traditional infrastructure characteristics which we like, such as high barriers to entry in the market.

Q What are you seeing going on in the competitive landscape?

There is a lot of merger and acquisition activity across the infrastructure sector, some of which spills over into infrastructure debt. Take Ares's recent acquisition of AMP, for example. There are also a lot of the smaller funds changing hands.

I see this as all part of the evolution of the market as, more and more, the sector is dominated by very large players and the resulting consolidation occurs.

Q How do you feel about the future of the infrastructure debt subsector?

Frankly, we are highly optimistic. The losses across the board have been so much less in alternatives than they have been in mainstream equities and bonds. And as we move away from a high interest rate environment, we expect to see a pick-up in deal activity. Indeed, some of that is already happening as rates plateau.

But more important is how the sector is placed in the longer term. We are in a very good situation in the infrastructure space. The fundamentals of the sector are being driven by the four Ds: digitalisation, demographics, decarbonisation and deglobalisation. All of these will propel the sector forwards both in the near term and further out.

Deglobalisation is a relative newcomer to this series of secular tail winds, addressed in our *2024 Infrastructure Outlook* whitepaper. But I think it is a factor which is going to grow and grow as we see the global macro environment deteriorate and the increasing need for 'near shoring' and 'friend shoring' in the supply chain. This is going to require significant investment from infrastructure players, and we're here to help with that. ■