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A sector for all cycles

Investor appetite for infrastructure debt will outlive this current period of high interest rates, investment professionals tell Amy Carroll and Kalliope Gourntis

Amid a torrid time for private markets fundraising, infrastructure debt continued to prove a hit with investors in 2023. Brookfield closed the world's largest ever infrastructure debt fund with capital commitments exceeding $6 billion at the tail end of last year.

"Appetite for infrastructure debt is growing," says Orhan Sarayli, head of North America, global infrastructure, at Barings. "The industry has benefited from the recent macro environment and continues to benchmark well on a relative value and comparative credit basis. Furthermore, deals like BlackRock's acquisition of GIP has served to raise awareness, which benefits us all. We are certainly seeing a lot of inbound enquiries regarding both investment-grade and sub-investment-grade strategies."

A rise in rates, in particular, has impacted appetite. "Some LPs are starting to compare infrastructure debt returns favourably with core equity, but with the added benefit of downside protection," says David Rosenblum, fund partner at I Squared Capital.

Sub-investment-grade strategies have benefited the most. "We have seen a high level of interest for sub-investment-grade strategies, in particular, given the quasi-equity returns on offer," says Damien Gardes, co-head of infrastructure debt at Schroders.

"We continue to see strong appetite for sub-investment grade, which has benefited from strong relative value compared to equity, which has taken longer to reprice," agrees Sacha Kamp, investment managing director and head of debt investments at Infranity. "Infrastructure as a whole, meanwhile, has demonstrated its resilience time and time again, withstanding the storms of high inflation, high interest rates, political instability, an energy crisis and covid. I think that helps draw the distinction between infrastructure credit and private credit, where loss expectations are significantly higher."

Of course, allocation to infrastructure debt also helps investors reach their sustainability goals, something that is proving increasingly important. "In addition to providing good relative value compared to other asset classes, investors also welcome the opportunity to invest sustainably and with impact," says Bérénice Arbona, head of infrastructure debt at LBP AM. "As infrastructure debt managers we are able to offer measurable extra value on top of financial returns."

Investment vs sub-investment grade

While sub-investment-grade debt may be flavour of the month, given the macro backdrop, investment grade remains by far the bigger market, according to Sarayli. "We think investment grade outpaces sub-investment grade in terms of the ratio of allocations. That is the part of the market that keeps us busiest in terms of both fundraising and deals," he says.

"Banks and insurance companies tend to focus on investment grade, while it is the sovereign investors that are deploying in sub-investment grade at scale," Sarayli explains. "Some of these investors typically have very ambitious expectations in terms of equity-like returns. Yes, yields are currently comparing favourably to core equity, but we can't take equity-like risk within debt strategies. The eternal challenge

Bérénice Arbona

Head of infrastructure debt,
LBP AM

Bérénice Arbona has 21 years' international experience in the origination, structuring and arranging of structured finance and projects. She joined LBP AM in 2014 and has led the team since 2020.

Damien Gardes

Co-head of infrastructure debt,
Schroders

Damien Gardes started his career in 2009 with the AXA Group. He then moved to Schroders in 2015 and has led the execution of a multitude of senior and junior debt transactions before gaining experience in infrastructure equity.

David Rosenblum

Fund partner,
I Squared Capital

David Rosenblum joined I Squared Capital in 2022 as a fund partner focusing on credit. During his 20 year-career he has held various roles at Deutsche Bank, Goldman Sachs and Frank Fried.

Orhan Sarayli

Head of North America,
global infrastructure, Barings

Orhan Sarayli is responsible for originating, structuring and underwriting a wide variety of infrastructure debt transactions. He has over 24 years' experience in project finance. Prior to re-joining Barings in 2021, he worked at Global Infrastructure Partners. He has also worked at UBS and RBS.

Sacha Kamp

Managing director and head
of debt investments, Infranity

Sacha Kamp joined Infranity in 2018 following 14 years in corporate and investment banking focused on infrastructure. He previously worked at Sumitomo Mitsui Banking Corporation, BNP Paribas CIB and Bayerische Landesbank.

is that borrowers want to put more and more equity risk into their infrastructure debt issuance."

"We strongly believe that continuing to offer both investment grade and sub-investment grade remains critical. This year there has been an increase in terms of the amount of capital deployed on the sub-investment-grade side, but we continue to raise funds for both markets. It's important commercially to have scale and breadth when negotiating terms, and to have the flexibility to select the optimal positioning in the capital stack on any given transaction," adds Kamp.

Arbona, meanwhile, says that LBP AM has been more cautious on high yield in the past, believing that investor demand has exceeded the pipeline in the market. "However, today, in this new macroeconomic environment, we believe market trends are favourable to new junior and high-yield strategies," she says. "Because it is now more challenging to raise equity, mezzanine and junior debt are proving very useful in allowing borrowers to continue to develop. We are also seeing new trends such as platform development which requires a lot of capital but is not yet investment grade."

"As Europe continues its transition towards green energy, we are also having to take the cannibalisation effect on pricing into account"

BÉRÉNICE ARBONA
LBP AM

Platform financing

The financing of platforms is one of the most complex areas of the infrastructure debt market. "No two situations are the same. Everything is bespoke within the platform financing segment," says Kamp. "These are highly complex transactions, which is why we like them. We have the skill set to tackle that complexity and to structure around it."

Putting carefully considered milestones in place is one of the key structural tools at a lender's disposal. But highly disciplined diligence is equally important. "You are not going to be saved by the financial structure alone," Kamp says.

"There are a lot of sponsors that have development pipelines but very little in terms of ready-to-build, let alone operational assets within the portfolio. It is important to understand the track record, the asset base and the markets that the platform is operating in. That will help dictate where milestones should be set and the valuations that need to be associated with the underlying development portfolio. It's not just about structuring. Having a strong underlying business and strong management team is critical."

According to Rosenblum, the devil is in the detail. "We work closely with our equity business which has built over 40 platforms worldwide, so we can leverage that experience in our credit underwriting. As we sift through opportunities, we look for a strong asset base, strong management team and good market positions.

"Through that lens, we have closed a number of platform transactions in the renewables space and are looking at several in the digital space as well. In each case, we put very specific milestones in place. They are critical to our ability to get in and fix things. But ultimately, the fundamentals of the business are what matters."

For Schroders, meanwhile, the answer has been to focus on platforms weighted more towards operational assets. "The bulk of our platform portfolio is made up of assets that are already generating cash," Gardes says.

"We are less exposed to the growth of those platforms. Any growth there is, is typically fully contracted and permitted. Having said that, we are also increasingly exploring development risk, particularly for renewable assets but also in the data centre industry. We are, of course, highly selective but there is undoubtedly a huge need for financing and huge demand from investors, given that these deals can command very high returns compared to standard infrastructure debt."

"There is no shortage of development platform opportunities out there. Separating the wheat from the chaff is the biggest challenge," adds Sarayli. "We see two technical issues with financing development platforms. One is that our investors like current income.

"When you get multiple risk factors coming together… it can lead to [Thames Water] types of situations in what should otherwise be very safe sectors"

DAMIEN GARDES
Schroders

"Some LPs are starting to compare infrastructure debt returns favourably with core equity, but with the added benefit of downside protection"

DAVID ROSENBLUM
I Squared Capital

They also like duration. Development platforms typically involve either bridge financings to permanent take-outs, which puts pressure on duration, or they don't have the cash right now, which is why they need our money. My view is that, if you need equity, then you should go and get equity. I'm not sure that these are always situations appropriate for infrastructure debt."

Risk revisions

While platform financing may be widely viewed as existing at the riskier end of the infrastructure debt spectrum, recent developments in sectors ranging from fibre to water, have reinforced the danger of over-simplified risk perceptions.

Political risk and by extension regulatory risk, in particular, have raised their heads in recent months. "There are risks that we need to pay attention to now, perhaps more than we have in

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> **ORHAN SARAYLI**
> **Barings**

the past and one of those is political risk," says Kamp. "Digitalisation and decarbonisation are both supported by EU commitments. Those sectors are therefore dependent on political posturing and regulatory targets. We are now starting to see populist parties gaining ground in many European countries and that could potentially have an impact on the momentum behind these industries."

The energy sector, in particular, of course, has faced an onslaught of new risk factors, following the outbreak of war in Ukraine and subsequent actions taken by governments. "Because of all the change that has occurred in energy markets, it has become very important to consider the impact of volatility on electricity prices," says Arbona. "As Europe continues its transition towards green energy, we are also having to take the cannibalisation effect on pricing into account."

For Rosenblum, however, the trick to managing shifting risk factors is to take a long-term view. "You will always see an ebb and flow with regards to the short-term risk factors. The solution is to only back businesses that have long-term tailwinds behind them."

"The advantage of being in debt rather than equity, is that we are able to observe these trends emerging from a safe distance," adds Sarayli. "Equity feels the pain first."

One obvious example of a sector that has been experiencing challenges is fibre. "Several players in the market have been disappointed by uptake and have underperformed against the original base case," explains Kamp. "That said, geographic markets, business plans and market players vary significantly in this sector. So, it depends on where you are operating and with what strategy. I would add that the fundamentals of many of these businesses remain strong. It's really a question of liquidity."

According to Gardes, meanwhile, EV charging is another sector that is giving some pause for thought. "EV penetration in many European countries has slowed when compared with the recent past. That may impact businesses rolling out EV charging networks, creating some uncertainty in what is still a nascent sector."

It is Thames Water, however, that is currently dominating the headlines for all the wrong reasons. "Thames Water is a complicated story. There have been many contributing factors," says Sarayli. "Something that is of particular concern for me, however, is that the ROEs on that business were never particularly high but the multiple paid on those ROEs was eye-popping. How many other situations are out there where very high multiples have been paid for low-yielding assets, which have then been levered up as much as possible? Thames Water may always have faced issues, but I don't think it would be where it is today, if the price had been right."

Gardes agrees that Thames Water also serves as a cautionary tale in terms of the amount of debt that can be put on an asset. "The hike in interest rates proved that in some cases, far too much leverage has been applied. When you get multiple risk factors coming together, such as political risk

and structuring risk, it can lead to these types of situations in what should otherwise be very safe sectors."

Rate risk

Regardless of the shifting risk profiles playing out in individual sectors, one external influence that the infrastructure debt industry is watching with interest is rates. Infrastructure debt and sub-investment-grade debt, in particular, has benefited from a macro environment that has proved punishing for many other asset classes. The question is, will its popularity remain intact, as rates begin to fall?

Arbona is optimistic. "The rise in interest rates gave us an opportunity to start a conversation with investors that may have historically focused more on equity. But I think that appetite will remain, even as interest rates fall. First, because of the resilience and relative value that infrastructure debt is offering investors and second because of challenges that can exist around exit in the equity market. Infrastructure debt, by contrast, is providing investors with regular cashflow."

Sarayli, meanwhile, believes that a drop in rates will lead to more capital availability, not less. "I definitely think we will see an uplift on the investment grade and even non-investment grade side."

Rosenblum agrees. "This asset class is still nascent and growing and the capital needs are significant, driven by the decarbonisation and digitalisation mega-trends that are in the early stages of an infrastructure supercycle. We expect to see continued demand for our capital and continued demand from investors."

Infrastructure managers appear sanguine about both normal economic cycles and the macro shocks that infrastructure has proved itself well able to handle, instead focusing on those factors that do lie within their control – namely deployment discipline.

"It is important to have the right covenant packages and the right project finance style waterfalls in place," says Rosenblum. "We have seen structures weaken in the corporate direct lending market because those lenders are competing with syndicated deals. But within infrastructure, we have been able to maintain a lot of the structural protections that are a hallmark of infrastructure investing."

"Our portfolio has held up well through a global financial crisis and a global pandemic. Our investors view infrastructure as a safe haven, a place where they can shield themselves from those sorts of seismic events," adds Sarayli. "Cycles don't worry me. What concerns me is whether I am underwriting hope or a real business model. I do think we are seeing more deals based on hope coming across our desk today than we did 10 years ago."

Arbona agrees: "Infrastructure, by definition, is less vulnerable to economic cycles. But it is down to us to analyse risk profiles, carry out our due diligence and structure deals appropriately, without being overly bullish on business plans. It is that discipline that ultimately makes infrastructure resilient."

"We are talking about regulated, monopolistic, contracted businesses that are providing essential social and economic services, and which are supported by trends tied to national and international targets," says Kamp. "As long as you stick to the fundamentals and remain disciplined then I think the asset class will continue to be resilient and will continue to attract investor appetite." ■

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