Infrastructure debt: still undervalued by European institutional investors

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Infrastructure investments are illiquid but generally characterised by predictable and stable long-term cash flows, with typically low correlation to other assets and often investment-grade credit risk profiles. Hence, a class of liability-matching assets suitable for long-term oriented, professional investors like pension funds or insurers. In this context, long-term, fixed-rate infrastructure funding will keep shifting from European banks to institutional investors.

Background

As a result of the prolonged low interest-rate environment, investors with long-term liabilities (e.g. insurers, pension funds) are seeking alternatives to low-yielding government or covered bonds to reduce the impact of duration mismatches on their guaranteed payments. Long-term infrastructure debt is a good fit as it usually pays an illiquidity premium but requires a buy-and-hold approach. Other characteristics such as the low correlation to other assets or risk factors, the vital importance to society and the intrinsic value of real infrastructure assets, often with monopolistic structures with high barriers to entry, also match the typical requirements of risk-averse long term investors.

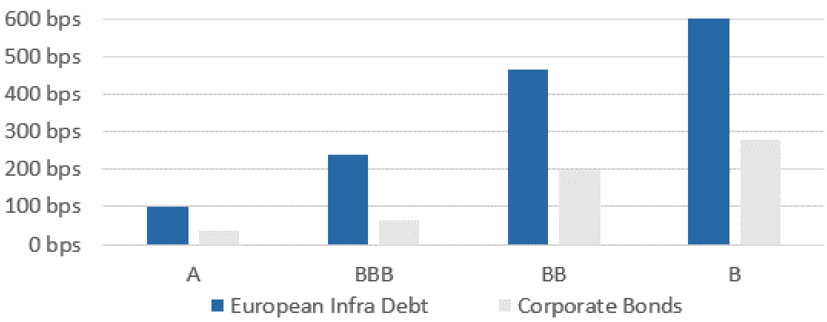
This low-risk profile is confirmed by the investment-grade ratings assigned to various debt transactions and issuers of infrastructure debt. Sector-wide experience also shows that the historic 10-year cumulative default rate for infrastructure debt is below 5%, which is consistent with medium investment-grade credit quality. Furthermore, this debt class has shown above-average historic ultimate recovery rates of around 80%.

Infrastructure Debt - Key credit strengths

- Long-term stable cash flows
- Attractive credit spreads
- Low default rates and high recovery rates
- Low correlation with other asset classes
- Importance of infrastructure assets
- Sustainable Investment (ESG)

An increasing number of investors also comply with guidelines of investing in assets with positive environmental, social and governance (ESG) characteristics. Most infrastructure assets naturally fit into this bucket.

Figure 1: margin over Euribor



Source: BNP Paribas Asset Management, June 2021 : EUROPEAN INFRASTRUCTURE DEBT: RESILIENT AND ESSENTIAL IN THE POST-COVID ENVIRONMENT

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Financial Regulation

Insurance regulation to promote investments in infrastructure assets

Regulation has an impact on the allocation of capital in infrastructure assets. Following the global financial crisis, European banks retrenched from long-term funding markets due not only to the flattening interest-rate curve (ECB monetary policy) but also because of stricter capital adequacy rules under the Basel III framework. In addition, limited fiscal head-room led to lower government spending on infrastructure investments in many countries. In contrast, solvency regimes for insurers, e.g. the EU's Solvency II directive, created separate treatment for "qualifying infrastructure investments", allowing for lower capital charges in order to bridge the long-term funding gap with financing from EU insurance companies.

Actual state

Sector-wide investment activity has upside potential

Where are we today? In recent reports, the European Insurance and Occupational Pensions Authority (EIOPA) has stated that European insurers have been increasing their exposures to more illiquid assets such as infrastructure, real estate and even equity. Our perception is that actual investment activity in infrastructure debt still remains relatively cautious, considering the large pool of available capital among European institutional investors and the attractive lending rates of between 2.5% and 4.0% p.a. for long-term (>10y) infrastructure debt.

We think that a lack of bankable projects and risk aversion are the main reasons. Institutional investors have a natural bias towards low-risk, fully operational (brownfield) projects in advanced economies that either entail renewal of existing infrastructure or have a track record and no construction or delay risk. In the energy sector, however, we see a greater willingness to invest in greenfield projects as the construction period and the ramp-up phase are usually short, even for largescale projects. In order to be rated investment grade, issuers usually have strong contractual protections against construction risk while engaging highly experienced EPC contractors with low counterparty risks.

Outlook

Crossover-rated assets to gain in importance

Scope Hamburg has rated various infrastructure debt issuers, many of which on a preliminary and confidential basis. Often subject to lower ratings in the crossover area (low BBB to mid BB), a number of proposed transactions never reached financial close as they did not fit investors' risk appetite or the desired capital contribution charge associated with high credit quality (BBB or better).

However, we think that in a prolonged low interest-rate environment, opportunities once rejected will regain attraction while competition for bankable projects will keep spreads under control. Regulatory refinement of asset classes and market pressure will direct investors to accept more risk such as greenfield or merchant infrastructure, refinancings or subordinated structures (junior secured, mezzanine, securitisation).

Experience shows that the default risk of infrastructure debt tends to be lower relative to equivalently rated corporate debt over the long term. Once the operational brownfield stage is well established, ratings on infrastructure debt usually migrate higher. Moreover, infrastructure debt proved to be a highly resilient asset class throughout the 2020/21 pandemic crisis, irrespective of economic conditions. In this context, we expect that external credit risk assessments for issuers of crossover-rated infrastructure debt (low BBB to mid BB) will gain in importance.

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