INFRASTRUCTURE Property is not the only 'real asset' sector suffering from a lack of financing. **Georg Inderst** looks at the opportunity to invest in infrastructure debt

A familiar story

The institutional attention surrounding infrastructure has so far been focused on private equity. But infrastructure debt is an interesting emerging theme. There is a growing belief that institutional investors should and will play a bigger role in infrastructure debt financing.

The reasons can be found in the repeated storms on the financial markets that are reshaping the infrastructure landscape:

- Infrastructure companies now find it more difficult to source project loans from banks, while monoline insurers have become restricted in their ability to 'credit-enhance' infrastructure bonds;
- In the general deleveraging process, banks have plenty of old infrastructure debt that could be offloaded to other investors with more capacity to take on the risk;
- Politicians of all colours announce new 'infrastructure plans' as they look for new channels to direct private capital, in particular from pension funds, into the financing of infrastructure;
- Supranational institutions are being asked to step up their contribution. For example, the EU announced the massive '2020 Project Bond Initiative', while the European Investment Bank (EIB) is increasing its engagement in infrastructure investments.

There is an abundant potential supply of infrastructure debt in the form of institutional investors, but will they oblige? The investment case for infrastructure bonds is quite intuitive, as it combines the most popular investment theme 'infrastructure' with the most widely used investment instrument 'bonds'.

Bonds remain the backbone of pension fund investment against the backdrop of ever-tightening pension regulation. In a world of low interest rates, investors seek new sources of income, ideally real income. Can infrastructure assets be of help?

The first thing to do is to clarify terminology, in particular of what is included in the definition of 'infrastructure' and what types of debt (bonds, loans or others) are meant.

It is often overlooked that investors have been buying infrastructure debt for a long time – for example, in the form of bonds of listed utilities (energy, water) and other infrastructure companies (such as transport). In fact, railway bonds and debentures were already an established principal private investment vehicle in the 19th century. Utility bonds are one of the sectors with the lowest default rates, according to S&P's 2010 annual global corporate default study, and their defensive characteristics have made utility bonds popular with investors over the years.

Furthermore, public bonds linked to infrastructure are also established in several countries in Asia, Africa and Latin America. In the US, municipal bonds, often tax-exempt, are the most important infrastructure investment vehicle with an enormous volume of over $2trn (€1.57trn). private finance initiative/public private partnership (PPP/PFI) bonds have been issued over the years in the UK, Canada and other countries. Bonds of supranational and national development banks such as the World Bank, European Bank for Reconstruction and Development (EBRD) and the German KfW have also been popular with investors.

So what is really new? The new wave of infrastructure debt investing tends to refer to something different: that is, dedicated funds that primarily invest in infrastructure loans. With a share of roughly 90%, loans play a much more important role than bonds, especially in smaller projects.

Fund managers, from both bond houses and infrastructure boutiques, are now trying to expand their offerings into this area. Preqin reports about 40 infrastructure debt and mezzanine funds, half of them closed with a volume of $8bn, and the other half seeking $12bn. They are mostly closed-ended, private equity-style funds set up over the last one to three years.

Assets range from renewable energy to hospitals, each with distinct risks

These figures are still relatively low, both absolute and relative to infrastructure equity, but they seem to be growing fast. Some experts in the industry see this as a good investment opportunity for the longer term. However, there are a number of issues investors need to tackle before they invest in such funds, or even build their own portfolios of infrastructure loans.

Experience: The first and foremost issue is the lack of knowledge and experience. Pension funds are not banks, and they would rarely have any direct experience with a portfolio of loans. The more common route is, of course, to invest indirectly, but consultants often find the choice and experience of infrastructure debt managers still pretty limited.

Fund investments: Infrastructure funds are often 'impure' and hybrid, as they allow investments in mezzanine and equity instruments. Similarly, the term 'infrastructure-related' is quite common and investors may be surprised by the type of assets they end up owning. Transparency is paramount.

Heterogeneity: Infrastructure is a wide field and assets are very heterogeneous, with projects ranging from high-risk renewable energy projects in emerging markets to low-risk senior loans for PPP hospitals. Assets in different countries or sectors (for example, economic or social) or development stages (greenfield and brownfield), all have totally distinct exposures to operational, cyclical, inflationary, regulatory, political risks, among others.

Debt characteristics: How should an infrastructure debt portfolio look in terms of key parameters such as maturity, cash flow and seniority? Infrastructure debt comes in different forms and shapes of investment grade and high yield bonds, senior and sub-subordinated loans. Infrastructure loans tend to be shorter-dated and floating-rate, but pension funds have more appetite for longer-dated, fixed or inflation-linked securities. Such a gap cannot be easily or cheaply bridged.

Credit risk: The common expectation from infrastructure investments is one of long-term stable cash flows at relatively low risk. An analysis of project finance bank loans in a 2010 report by Moody's showed comparatively low default rates in infrastructure: 2.2% versus 8% in general. However, a large part of infrastructure loans would be below investment grade and covenants are not easy to assess for investors.

Cash flow and inflation-linkage: How are cash flows structured and how are they 'protected' (by regulation, contracts or monopoly)? What does a link to inflation or money market rates exactly look like? How much has been 'swapped away'?

Liquidity and concentration risk: Illiquidity is a concern for some investors and they find it difficult to invest where there is no secondary market. Furthermore, infrastructure funds tend to be highly concentrated in a small number of assets.

Benchmark: Another question is the benchmarking of infrastructure debt funds. What can be considered a success or a failure on the side of outsourced managers? There are no established infrastructure bond and loan indices on the market (although corporate bond sub-indices for utilities or US municipal bonds are available).

Portfolio positioning: It is not clear how infrastructure debt should be integrated into the overall portfolio of a pension plan or insurance company. Some people look at it as a sector within the fixed interest portfolio, others as a segment of the infrastructure, private, real or alternative investment portfolio.

Fund structure and terms: Finally, is the private equity model adequate for infrastructure debt? What are appropriate fund terms and conditions? Should fees be comparable to corporate bonds funds or private equity funds?

The infrastructure debt market will certainly change in coming years. In what form institutional investors will participate in big numbers is still an open question.

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