2020 versus 2008: What's changed for European infrastructure debt?

Infrastructure debt is not immune to a severe economic downturn, but the global financial crisis has left the asset class stronger. We explain why.

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The Covid-19 pandemic has drawn comparison to the 2008/2009 Global Financial Crisis (GFC) as a test of the world's financial system. From the perspective of infrastructure debt investors though, we have reason to be cautiously optimistic.

The 2008 effect – a new and broader investor base

The infra sector was not immune to 2008's market paralysis and liquidity crisis, but suffered less than other sectors. Some transactions were postponed, some transactions were repriced, some bankers lost their jobs. But in reality, life carried on (almost) as usual. The sector even benefitted from some "Keynesian" support, via big public spending on big infrastructure projects.

However, perhaps the most important outcome of the 2008 stress was the diversification of lenders.

In 2008, banks had a 100% market share in European infrastructure (infra) lending. But repricing and banks withdrawing from long-term lending induced new players to enter the market.

First, insurance companies set up infra debt shops to fill in the gap. Some redundant bankers (speaking from personal experience) were lucky enough to re-invent themselves at one of those shops.

Second, asset managers (re)discovered the virtues of private assets, and offered infra debt products to their clients.

These new players are now known as institutional infrastructure debt investors. It remains to be seen how these new players will weather the current storm. However, some factors are encouraging:

A portrait of an institutional investor

- The institutional market has a high number of former bankers, whose experiences in the GFC leave them well equipped for difficult times.
- The institutional market is driven by "real money". While banks rely on short term liabilities - namely the interbank market and client deposits - institutional investors should be a more stable, less volatile source of finance than banks.
- The US institutional market is much more developed than in Europe. However, using it as model, US public-private (PP) markets have proved to be much more resilient than volatile banking markets. It has been said that the US PP market, as opposed to the bank market, never closed. Based on the "dry powder" currently available in the European infra debt fund market, there is no reason to believe the institutional market will not remain open (the big question being over price discovery and repricing).

Today European infrastructure borrowers do not rely only on banks but on more diverse and more reliable sources of financing: banks, European insurance companies, US and Asian direct investors and debt funds. Supply of finance is therefore in a much better shape than in 2008.

Infrastructure not immune to economic contraction

So all is well that ends well? In the financing world maybe. In real life, probably less so. With countries around the world still restricting movement, GDP will take a severe hit.

The jury is still out as to how long the lockdowns will last and how the recovery will look; a "V" or a "U" shaped recovery? As such, while we do not expect supply of financing to cause the issues it did in 2008, underperformance by business is a concern.

V recovery key factors: liquidity enhancers and postponement of interest

This is a drastic but short-term fall followed by strong, quick bounce back. Infrastructure companies will face liquidity issues, but are unlikely to be hit by solvency issues in this scenario. Infrastructure debt structures typically provide for some liquidity enhancers. Some debt structures will have the benefit of a reserves account.

The typical reserve account is the DSRA (Debt Service Reserve Account). The DSRA provides for some cash (enough to meet the next debt service payment) to be set aside and secured in favour of lenders. Borrowers may also benefit from liquidity lines (generally revolving credit facilities provided by banks) to either meet operating costs or debt service.

In very extreme scenarios where liquidity support is not enough, there could be a postponement of interest payments. But in such a scenario, borrowers would remain solvent. We would encourage investors to review liquidity available to borrowers and engage with how "liquid" they are. This should be enough for our European debt investments to weather a V recovery.

U recovery key factors: restructuring an option (but requires experience)

A U recovery is the same as a V recovery, but recovery will take much longer. How long is of course the million dollar question. There is a limit to liquidity buffers a company can live on, when or if all activity grinds to a halt. It could be 3 months, 6 months, 9 months maybe more.

These are still early days to consider and we lack a crystal ball. Having said that, in such a scenario, debt restructurings are not to be ruled out. Debt restructuring is all about maximising recoveries. To maximise recoveries, experience is essential.

We have experience of the US savings banks crisis in the 80s, the Asian crisis in the 90s, the dot com bubble in the noughties and last, but not least, the Global Financial Crisis and European sovereign debt crises. Experience of business turnarounds, restructuring and negotiation is vital, as is technical expertise in debt restructurings.

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