# European infrastructure debt – navigating new challenges

**Particularly during the height of the Covid-19 pandemic and ensuing lockdowns, infrastructure debt proved to be resilient as an asset class. Despite lockdowns shutting down businesses and many aspects of society, specific sectors such as renewables, telecommunications and utilities continued to perform through the provision of essential services.**

However, while infrastructure debt demonstrated to be a safe haven through its ability to weather the storm during the pandemic, new challenges have since arisen as we move into the new post-pandemic normal. A key concern for investors is now rising inflation, as well as rising interest rates. Further fuelling uncertainties for investors, are concerns about an impending economic recession across Europe and globally. Hence the question for investors, is European infrastructure debt an investment solution fit for the current environment?

## A broad and diverse investment universe

The simple answer to the question above is yes, although investors need to consider that the infrastructure debt market offers a range of solutions with differing sector exposures and risk return profiles. The market is broad, diverse and remains buoyant, with approximately €310 billion in deal value in 2021, of which 70% is financed with debt.[1]

Overall, the infrastructure debt market remains resilient and well positioned to navigate through a potential recession. For the same reasons that helped navigate through the pandemic, many infrastructure projects provide essential services that are mostly recession-proof. Examples include projects in the renewables and power sectors, where people require energy irrespective of market conditions. Similarly, the telecommunications sector provides essential services including data and vital communication networks. Utilities is another sector where infrastructure projects provide essential services, an example being water and sewerage facilities.

Another resilient sector that is well placed to perform irrespective of a recession is transportation, with projects such as rail and roads essential for the movement of people and goods. While this sector was adversely impacted by the 2020 lockdowns, we have seen a recovery of deal flow.

For investors seeking long-term stable income, infrastructure debt remains a resilient investment solution. However, what about investors seeking greater yields or premiums?

## Case for junior infrastructure debt

2022 has been a year of soaring inflation, with inflation rates for the UK and the Euro Zone at 9.1% and 8.9% respectively.[2] It has been a challenging environment for credit markets, with corporate bond yields also rising significantly – Euro BB corporate bond yields rose from 2.36% in February to above 5.50% in July 2022.[3] This situation has created a potential dilemma for some infrastructure debt investors, particularly ones seeking a relative yield premium (to equivalently rated corporate bonds), which has largely diminished.

Junior infrastructure debt is a potential solution for these investors seeking higher yields, offering higher equity-like returns while maintaining debt-like protections. It is an investment solution befitting the current market environment and outlook, given it offers higher returns without overly extending on risk. For example, in Europe we have been witnessing junior infrastructure debt transactions offering over 6.5% return, which is relatively attractive when factoring in the additional covenants and collateral when compared to an equivalently rated European High Yield Bond, which is unsecured and with little (or no) covenant protection.

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Within the broader infrastructure debt market, the junior debt segment is becoming more prominent. An increasingly competitive infrastructure equity market has pushed project sponsors to become more sophisticated in their financing structures to reduce debt servicing costs. This in turn has led to more tranching to target investors with different risk return objectives.

Linked to this, infrastructure equity reserves have been growing significantly, pushing up the underlying equity prices. Equity holders are utilising junior infrastructure debt as a mechanism to increase leverage and increase their internal rate of return. This segment of the market is now well established in Europe and growing at a steady rate.

Notably, the junior debt segment of the market is still relatively uncrowded, as regulations (i.e. Solvency II Capital Charges) have so far enticed investors to focus on the senior (or investment-grade) segment of the market. From a pricing perspective, these regulatory constraints mean that junior infrastructure debt is not suffering the same competitive pricing tension as observed in the investment-grade space where banks and insurance companies compete heavily.

Due to the increase in supply of junior debt and less investor demand, the junior debt segment of the market offers a highly attractive risk return profile, including for many insurers after adjusting for Solvency II capital charges as well as other investors seeking attractive yields.

## Challenges that lie ahead

Whether it is an investor seeking higher risk adjusted returns, or one seeking a safe haven ahead of potentially challenging market conditions, European infrastructure debt can offer an attractive solution. As already proven during the height of the Covid-19 pandemic, the asset class is steady and resilient, and backed by projects providing essential services. More recently, we have seen an expanding segment of the market, the junior debt segment, offering higher returns at a subordinated level while retaining debt-like protections. Whatever the investment preference, European infrastructure debt represents a compelling solution to weather oncoming storms.

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**FOOTNOTES:**

1 Infranews, Jan 20222
2 ONS, Bloomberg, August 2022
3 Bloomberg, BaML Euro High Yield BB Index, August 2022

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