Secular tailwinds creating infrastructure debt opportunities

Infrastructure debt remains an attractive opportunity despite a challenging economic outlook that could bring with it an increase in credit market defaults, argue David Cooper, Head of EMEA and Australian Infrastructure Debt and Jacob Otto, Director, Debt Product Specialist of IFM Investors

Against a challenging macro backdrop which could produce an uptick in credit market defaults, IFM Investors believes infrastructure debt's typical resilience to cyclical slowdowns will be a key theme over the year.

Infrastructure assets are traditionally resilient to cyclical slowdowns due to inelastic demand for their services. This is because infrastructure assets are essential to the smooth functioning of daily life, providing services like electricity, heating, water supply and transport. They are not completely immune to cyclical slowdowns, but the impacts should be less severe than for corporations that are leveraged to discretionary consumer spending.

From a credit perspective, infrastructure businesses are judged to be resilient to rising inflation as they often have contracted pricing mechanisms that are linked to inflation, and the ability to hedge the cost of business inputs given the long life of their assets and relatively stable demand.

Under most downside economic scenarios, we expect infrastructure debt investments to remain relatively resilient and this is supported by the infrastructure credit defaults historically tending to stay relatively low during periods when corporate credit defaults have moved higher. To avoid credit incidents in the infrastructure sector we believe it is important to be prudent when taking certain risks. For example:

- We are generally more reluctant to lend to greenfield projects if there is a significant risk of recession and when considering such opportunities, we pay particular attention to assessing the equity sponsor and constructors' experience.
- It is important to be prudent when considering technology risk, so we prefer to invest in tested/established technologies that we understand well.
- There is the potential for regional differences in credit performance, so understanding the national economic environment is important.

Secular tailwinds driving attractive opportunities

We see two secular tailwinds driving transaction activity in the market – the strength of government infrastructure investment and the enormity of the investment required to fund the energy transition to decarbonise the global economy.

1. Increasing government investment in infrastructure

Infrastructure investment was a key feature of many COVID-19 pandemic-related government stimulus packages across developed economies, as governments matched the immediate need to stimulate weak growth with the longer-term imperatives of decarbonisation and modernising ageing infrastructure. For example, the UK government announced £100bn in infrastructure-type spending for 2021-22 as part of the 'Build Back Better' plan.

Similarly, in the US, the Biden Administration has been successful in passing legislation investing over US$1 trillion to improve America's infrastructure. The Infrastructure Investment and Jobs Act includes historic support and funding for public-private partnerships at the state and local level.

Increasing government infrastructure spending can help bolster the whole infrastructure investment ecosystem and creates opportunities for long-term debt investors. This is because, in our experience, infrastructure financing is typically more heavily weighted towards debt than equity, so the potential for new infrastructure debt supply is greater than equity.

Government support for infrastructure can also help reduce risks in the form of direct capital investment, guarantees, or paying for infrastructure services.

2. The enormity of the energy transition and energy security

The entire energy system is expected to undergo a profound transition in the next two decades. The International Energy Agency (IEA) estimates that from US$1.3 trillion today, clean energy investment will rise above US$2 trillion by 2030 to meet global government stated commitments. Annual investment will then need to be above US$4 trillion by 2030 in the IEA's 1.5 degree scenario to achieve net zero emissions by 2050. This amounts to around US$2.8 trillion over the decade to 2030.[1]

There is a strong nexus between infrastructure debt investments and transition objectives mainly due to the investment required to achieve this huge energy transition, aiming to increase the supply and use of renewables. For example, the European Commission is backing a new target which seeks to raise the share of renewables in the EU's energy consumption to 45% by 2030, and many individual European governments also have their own pro-renewable policies and plans. We expect more of these policy decisions in Europe and other developed economies in coming years, underpinning the supply of renewable transactions in the market.

Volatile energy prices have also heightened the need for increased energy security at the country-level and this is another potential driver of new investment. For example, gas has until recently been considered as a transition fuel, but the Russian invasion of Ukraine has disrupted supplies and significantly increased gas insecurity, particularly in Europe. This will potentially accelerate renewables investment as a means of reducing the reliance on imported gas.

Energy security concerns are also impacting at the individual company level, stimulating a trend towards corporate power purchase agreements, where companies can lock in longer term contracts at fixed prices direct from energy generators. These agreements can mitigate risk from a lending perspective, although to some extent this involves swapping market price risk for corporate credit risk.

As a result of strong investor demand, investments within widely adopted renewables sectors, such as solar and wind (which tend to be investment grade-rated) have been more resilient to widening spreads. Spreads in other transition focused sectors (across the credit spectrum) have widened with broader fixed income credit markets. We are finding attractive relative-value in opportunities related to the energy transition that go beyond renewable energy such as: electric buses, district heating, battery storage, biomass, and waste management solutions.

We believe this link between infrastructure debt and decarbonisation is so strong that that some investors are starting to view investing in infrastructure debt portfolios as an alternative to pure-play climate-specific strategies.

David Cooper
Head of EMEA and Australian Infrastructure Debt

Jacob Otto
Director, Debt Product Specialist

Sectoral opportunities for investors

At IFM we are focused on originating opportunities in a broad range of sectors:

- Energy transition - the global shift towards renewables, including wind, solar, hydroelectric, storage and renewable natural gases (biogas and landfill gas).
- Electrification of transport - a key theme where we have made several investments and continue to see interesting opportunities in the pipeline. These include electrification of buses, ferry fleets and rail, as well as the necessary infrastructure to support electrical charging of these transportation assets.
- Energy efficiency - opportunities include district heating, power networks, interconnectors and smart meters.
- Environmental management - opportunities include water utilities, waste to energy and recycling facilities which are critical services for society.

FOOTNOTES:
1 IEA World Energy Outlook, 2022