The case for infrastructure debt

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In today's quickly evolving global economy, many institutional investors have turned to infrastructure debt for potential benefits ranging from an illiquidity premium over public markets to asset-liability matching characteristics. Amid often varying definitions of infrastructure debt, at Barings the definition centers on the type of asset generating the cash flow, with an emphasis on essential assets that meet key social or economic needs and that have the potential to offer stable, long-term cash flows. In our view, today's infrastructure universe encompasses six broad categories:

- Economic infrastructure such as transportation-related strategic assets including toll roads and airports;
- Utilities and pipelines that typically carry water, sewage, electricity, natural gas and other fuels;
- Power generation infrastructure such as renewable energy generation assets;
- Social infrastructure such as government-sponsored public-private partnerships, social housing, and development of hospitals and schools;
- Midstream and storage facilities for commodities and energy and non-energy assets;
- Digital infrastructure including towers, fiber cabling and data centers.

Why invest in infrastructure debt?

Investing in the companies and entities involved in infrastructure can be accomplished through a variety of equity and fixed income vehicles, both public and private. In fixed income, both the established investment grade segment and the fast-growing high yield segment offer several potential benefits for long-term investors:

- **Defensiveness.** Infrastructure assets are typically highly cash generative with high barriers to entry or monopolistic characteristics. Being essential, they generally perform well during recessionary periods. Debt is typically secured, in a senior position in the capital structure, and has protective covenants tied to leverage or interest cover.
- **Low losses/High recoveries.** The high quality of infrastructure debt and the essential nature of the services provided has resulted in a historical record of low losses, high rates of recovery and low ratings volatility. A recent Moody's study found that over the last 39 years, cumulative defaults in BBB-rated infrastructure issues were below those of A-rated investment grade debt.[1]
- **Potential illiquidity premium.** Since private debt tends to be less liquid than its public market counterparts, infrastructure debt traditionally has offered enhanced yields to compensate for their illiquidity. Historically, long-term investors have captured an illiquidity premium substantially greater than 50 basis points (bps) for investment grade credit and potentially even more for credit below investment grade.[2]
- **Inflation protection.** Cash flows of infrastructure assets usually are linked to inflation, with issuers typically able to pass rising costs onto customers. Issuing companies may also be able to reset prices at a higher level in subsequent contracts due to the inelastic nature of the demand for their product or service.
- **Diversification.** Infrastructure debt can be an effective diversifier in a portfolio that includes traditional long-term fixed income assets such as sovereign and public investment grade corporate bonds, as well as direct lending. Infrastructure projects span rated and unrated public and private debt, as well as geographies and a wide range of sectors—all of which exhibit unique return profiles.
- **Asset-liability matching.** Due to the long-term nature of many private infrastructure debt investments (generally five to 30 years) and the highly predictable cash flows generated by the assets being financed, insurance companies find infrastructure debt particularly attractive—especially for purposes of matching their long-term liabilities and complementing or substituting for allocations to real estate.

New drivers of opportunities

Investment opportunities in infrastructure debt are likely to persist well into the future given the global need to replace aging infrastructure and to add new types to serve evolving needs. In particular, to meet global infrastructure demand through 2040, Oxford Economics has estimated that $94 trillion in investments will be needed, or an average of $3.7 trillion a year, which is 19% above prevailing trend investment spending.[3] Since government entities alone cannot meet that level of demand, private investment—often in conjunction with government—will be increasingly necessary.

Four major and interrelated trends are driving demand: A transition to cleaner, renewable energy sources including solar, wind, biomass, hydrogen, and hydro; greater electrification as decarbonisation efforts coincide with the movement to an all-electric economy creating demand for charging stations, storage facilities, and upgrades to distribution grids; U.S. and E.U. government policy that supports infrastructure spending; and the accelerated pace of digitisation that is driving demand for data centers, cell towers, fiber optic cabling, and other building blocks of digital infrastructure.

Already, an increasing number of infrastructure deals are being directly originated and privately negotiated, making manager selection critical. Key manager characteristics to look for include having a strong origination platform and long-term relationships with large well-respected equity sponsors; teams for whom infrastructure financings are not merely an add-on but a core business staffed with experienced professionals who can structure better deals; and a full-time global presence to source the most attractive opportunities.

Well-positioned to outperform in today's more challenging economic environment—particularly in the event of an economic downturn—we believe infrastructure debt currently merits the attention of investors.

FOOTNOTES

1 Source: Moody's "Default and recovery rates for project finance bank loans, 1983-2021". As of April 4, 2023.
2 Source: Barings. As of September 29, 2023.
3 Source: Oxford Economics. As of 2016.

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