Infrastructure debt in a sweet spot for 2024

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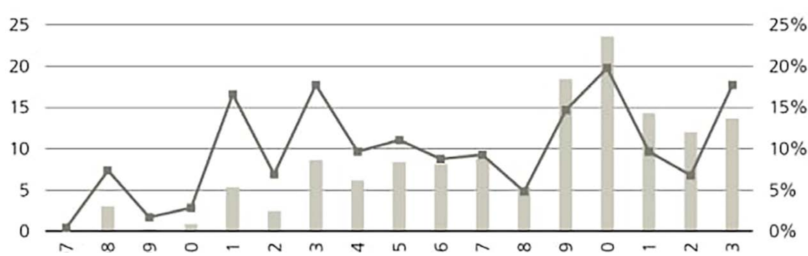
Infrastructure debt fundraising relatively resilient

Private infrastructure had a challenging 2023. After a record fundraising year in 2022, we reported in our Infrastructure Outlook 2024[5] overall funds raised in 2023 fell by over 50%.

However, across all infrastructure strategies, the environment for infrastructure debt has been relatively positive. Rising rates increased the relative attractiveness of infrastructure debt (especially high yield) compared to core infrastructure equity investments, which has not seen significant changes in returns.

Infrastructure debt fundraising grew slightly in 2023, accounting for almost 20% of all infrastructure funds raised (see Figure 1). This is not surprising, given an Infrastructure Investor survey from the beginning of 2023 already highlighted infrastructure debt as the most in-demand infrastructure strategy. Although there is more demand for riskier infrastructure equity strategies in 2024, infrastructure debt still remains a popular choice for institutional investors.

Figure 1: Infrastructure debt fundraising



Source: Inframation, January 2024.

Inflation and the higher cost of debt continue to impact transaction volumes as borrowers reduce their financing needs.[1] Sponsors can no longer rely on cheap debt to fuel aggressive growth plans and are adjusting their capex to adapt to this new reality, while focusing on optimizing their capital structures across both senior and junior debt. Infrastructure debt transaction volumes were only down 9% in 2023, compared to 25% for infrastructure equity.

A positive macro backdrop

Looking at the macroeconomic environment, as inflationary pressures continue to subside, central banks will have more room to start cutting interest rates. The US Federal Reserve signaled at the end of 2023 that they are looking to cut rates 3 times in 2024. Although hotter than expected, inflation so far this year may have tampered those expectations, the general direction of travel is clear, even if rates stay higher for longer.

In Europe, inflation has actually been coming in lower than expected compared to 6 months ago. Switzerland surprised the markets by being the first major economy to cut rates in 2024, followed by Europe recently. Consensus estimates expect 10-year bond yields across Europe to begin declining in 2024[2], which should bring some relief to those concerned about potential financial distress.

Infrastructure investors tend to have long-term investment horizons, and their investments also have long asset lives, which means it is more important to focus on long-term macro trends, rather than fixating on short-term volatility.

Despite the economic volatility in the past 2 years, infrastructure fundamentals actually remain strong, due to a robust post-pandemic recovery, strong inflation passthrough, policy support, and the fact that most infrastructure investments are unique assets that provide essential services and have pricing power.

With the consensus estimates of over 100 listed infrastructure companies as proxy, 2023-2025 revenue estimates have been revised upward by an average of ~15% in the last two years.[3] The risk of further financial distress and defaults in a stabilizing macroeconomic environment is unlikely since fundamentals have held up.

Looking into 2024, as inflation and interest rates have peaked, we could potentially see a recovery in lending activity, especially for borrowers who have delayed their financing plans, as well as increased financing needs as M&A activity picks up again.

In our view, infrastructure debt now sits in a sweet spot. The stabilization and gradual decrease in interest rates will incentivize investors to move away from cash and into private markets, while locking in the still relatively high base rates.

The slowdown of redemptions from insurance companies and the subsiding denominator effect due to recovery in equity markets mean there will be more appetite for infrastructure debt from investors in 2024.

Infrastructure debt investors will be able to find more opportunities with attractive risk-adjusted returns in 2024, taking advantage of the still elevated base rates and improving credit fundamentals.

Secular themes for infrastructure debt (4Ds)

The infrastructure sector continues to benefit from secular tailwinds such as the 4 Ds – decarbonization, digitalization, deglobalization, and demographic change. Infrastructure debt is in a unique position to take advantage of these long-term investment themes.

For example, despite weaker infrastructure debt transactions in 2023, activity remained strong in the energy transition (e.g., renewables) and telecommunication sectors, as investments exposed to secular trends such as decarbonization and digitalization still remain popular.[1]

Pathways to success in 2024

Infrastructure debt has historically been a lower risk way to gain exposure to the infrastructure, as it offers a premium over corporate bonds while providing good downside protection and lower capital charges (for insurance companies under Solvency II).

Default rates have also historically been lower for infrastructure debt than for equivalent credit corporate bonds. For example, S&P reported that the default rate in 2022 for speculative grade corporate credit was 2%, versus 1% for speculative grade infrastructure. Despite the lower risk profile, credit spreads for European infrastructure debt remains much closer to those of corporate high yield than to corporate investment grade in 2023.[4]

Although the macro environment in 2024 is positive for infrastructure debt, there are still many factors to consider differentiating and create the most value, especially when looking to deliver extra premium versus fixed income or other alternatives. For example:

- Proprietary origination is an important lever to uncover value, as it is difficult to find attractive risk-adjusted returns in private placements or syndicated deals.
- Mid-market segment continues to be less crowded with ability to secure off-market deals and realize "structuring premium".
- Although recent commitments have mainly been concentrated towards a few large managers (flight to quantity), smaller managers can often offer a better value proposition to a larger number of transactions in the midmarket space, allowing them to be more selective, as well as placing a greater focus on bilateral transactions and bespoke structuring.
- Having a robust but pragmatic ESG framework with measurable KPIs would be an important differentiator in an industry that is increasingly focused on sustainability.

Sources: [1] Inframation, January 2024; [2] Bloomberg, April 2024; [3] Data based on current and historical consensus estimates of over 100 publicly traded infrastructure companies Sources: GLIO, Bloomberg, UBS Asset Management, September 2023; [4] Bloomberg; EDHEC Debt Indices (Europe); Real Estate & Private Markets (REPM), UBS Asset Management, November 2023 [5]https://www.ubs.com/global/en/assetmanagement/insights/asset-class-perspectives/infrastructure/articles/infrastructure-outlook-top-questions.html)