Cashflow-Driven Investing

UK infrastructure debt: its merits for Cashflow Driven Investors

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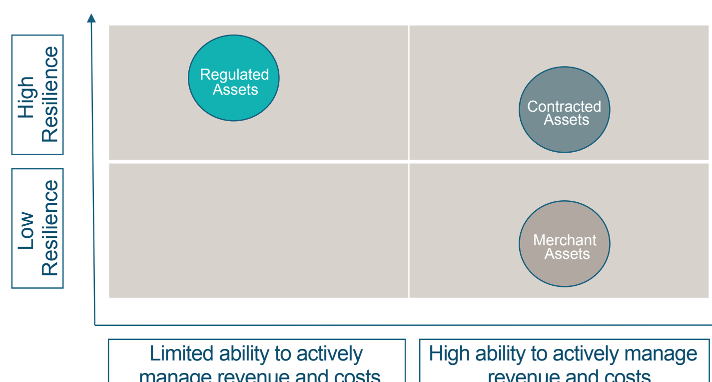
For cashflow driven investors drawn to infrastructure debt for its stable cashflows, a deeper understanding of the asset class, and specifically the key drivers behind the stability and predictability of cashflows, may be helpful. This may assist either in making new investments or explaining the portfolio benefits of existing investments to key stakeholders.



How different are the various infrastructure assets when it comes to offering stable and predictable cashflows?

All infrastructure debt investments carry some credit risk, but the level of risk varies according to the type of asset, as well as depending on asset-specific factors. Assessing the stability and predictability of cashflows that may arise from a specific project requires an evaluation of at least three factors all of which link in to the future profitability of the infrastructure project under consideration. These are:

- Pricing risk – a lower-than-expected price may be achieved for the goods/services being sold.
- Volume risk – sales volumes may be lower than forecast.
- Renewal risk (for contracted sales) – at renewal, prices and/or volumes could be lowered and the contract term shortened.

(Note that stable cashflows for a business/project increase the likelihood that debt holders receive the full and timely repayment of their loans).

To assess the sensitivity of infrastructure assets to these factors, it is useful to group the assets into three categories:

- **Merchant assets** are often viewed as the riskiest, with less certain and more variable income (often reflected in sub-investment grade credit ratings). An example is a power plant selling electricity at the spot market price rather than through a medium- or long-term contract which provides certainty of pricing and/or volumes.
- **Contracted assets** are less risky than merchant assets. They may have medium-term contracts (e.g., 3-5 years) which typically provide pricing certainty and often specify volumes. Renewal risks can be mitigated if multiple buyers have contracts with different maturities.
- **Regulated assets** probably lend themselves most to income investing. These are typically natural monopolies delivering essential services, such as water networks, and they tend to have the most stable demand and price inelasticity of demand. However, it's important to note that this is also where returns are on average lower.

One way to evaluate all of these type of infrastructure assets' ability to generate stable and predictable cashflows is to consider ***both*** their resilience to economic cycles and the ability to manage revenues and costs. Our 2x2 matrix on the right shows that contracted assets demonstrate both high resilience to the economic cycle and a high ability to actively manage revenues and costs. This makes them ideally suited to form the mainstay of an infrastructure debt portfolio aimed at cashflow driven investors.

Combining contracted assets with merchant assets (high yielding, possibly less stable) and contracted assets (lower yielding, more stable) would allow a portfolio manager to construct an optimal portfolio across risk (of not receiving cashflows as and when due) and return.

What are the main cashflow characteristics of private infrastructure debt?

Most private infrastructure debt is fixed or floating rate; only a small proportion is inflation-linked. It is also generally amortising, meaning that both capital and interest are repaid through the life of the debt. Amortising cashflow profiles are suited to portfolios requiring more cashflow to be paid back in earlier years. Regulated assets, which as we have seen, lend themselves to stable cashflows, are interestingly more likely to be bullet redemption, meaning 100% of capital is paid at maturity.

How do returns on private infrastructure debt compare with those on corporate bonds and listed infrastructure debt?

As well as considering relative credit risk, investors need to be mindful that private infrastructure debt is unlisted, so will be less liquid, and uses customised lending agreements, which can be perceived as increasing complexity. Investors may expect to be compensated for both factors. Conversely, private lending agreements may give lenders greater protection than standardised corporate bond agreements.

We explore relative yields in more detail in our longer paper[1]. In summary, we believe there is strong evidence that:

- Private infrastructure debt offers attractive risk-adjusted returns relative to listed (non-financial) corporate bonds and listed infrastructure debt.
- Some of the additional yield is compensation for greater illiquidity and complexity. A further premium arises from the challenge of constructing a sufficiently diversified portfolio of infrastructure debt.
- A significant component of the yield uplift is due to private infrastructure debt exhibiting lower expected losses (lower probability of defaults and higher recovery rates when defaults do occur).
- The premium on private infrastructure debt has been broadly persistent through time.

Harvesting the credit risk premium from private infrastructure debt is probably best done via a buy-and-hold strategy – which can be particularly suitable for cashflow-driven investors.

Are there benefits to investing internationally?

For a UK investor with Sterling liabilities, there are opportunities to earn higher yields in the US and Europe, but the advantage may be offset by currency risk. Increasing the universe of assets also offers opportunities for diversification and hence for improved risk-adjusted returns. That said, hedging the currency risk of a US dollar-denominated or euro-denominated asset back to Sterling would currently offer a yield pick-up (based on current pricing in the relevant currency market, i.e. the market in cross-currency basis swaps of an appropriate maturity).

One way for investors with Sterling liabilities to take advantage of offshore opportunities may be to set a Sterling benchmark for a manager to beat, but allow the manager some flexibility, perhaps up to 25% of a mandate, to access non-Sterling debt, possibly on a currency-hedged basis, as opportunities arise.

Is too much capital chasing too few infrastructure assets? Could global uncertainty disrupt the pipeline of new issues?

The UK deal pipeline is deep and robust, and we don't foresee a supply/demand imbalance any time soon. Even if new issuance is curtailed, refinancing of existing debt from existing projects has historically accounted for c. 45% of the debt pipeline.

Many investors favour inflation-linked debt. Is that a viable option?

There is much less inflation-linked infrastructure debt than fixed-rate debt. To illustrate the former's relative scarcity, we estimate that fully deploying £1bn of capital into inflation-linked debt instruments may take 2-3 years. We believe that an approach that includes fixed-rate debt would offer access to the asset class sooner and is also good for a portion of defined benefit pension fund liabilities.

How does size impact an asset manager's ability to provide competitive services?

As with other asset classes infrastructure investing requires a team with broad capabilities, including:

- Deal origination.
- Credit and equity research and analysis.
- Portfolio management and monitoring.
- Work-out skills.

This creates a fixed cost base that needs to be spread over a sufficiently large asset base. However, we do not believe there is a specific minimum size needed to be competitive, as there are different ways to build and maintain these capabilities. We suggest that investors should aim to understand:

- A manager's competitive edge in each of the above areas.
- Given that origination is key, whether a manager's size (or lack thereof) may impact its ability to access deal flow.

FOOTNOTE:
1 Cashflow Driven Investing: The merits of infrastructure debt for Cashflow Driven Investors.

For a more detailed exploration of private infrastructure debt from the perspective of cashflow-driven investing, please contact Shalin Bhagwan.

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