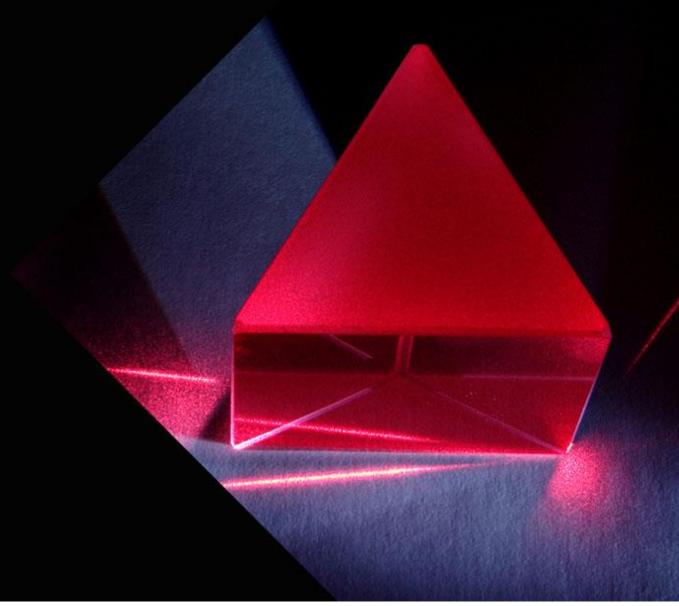
HSBC Asset Management

Unlocking value for investors through infrastructure debt



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Infrastructure assets provide the essential services that underpin the global economy, moving people, goods, commodities and data to where they are most needed. Infrastructure assets encompass a diverse range of assets from a waste disposal facility to an offshore renewable energy development. They can range from data centres to schools and hospitals, roads and airports to water utilities and most things in between.

From an investor perspective, the infrastructure asset class has evolved significantly over several years. Assets under management (AUM) of $161bn in 2010 increased to $1.1tn at the end of 2022 – equal to a compound annual growth rate (CAGR) of 17.3%. AUM across the industry is set to increase further, rising to $1.7tn at the end of 2028, or 7.4% per year.[1] While there has generally been a focus within private markets on investments in infrastructure equity, the infrastructure debt part of the asset class has been growing too. In 2016, infrastructure debt AUM were $38bn and have since risen to $141bn at the end of 2022, slightly outpacing the growth seen in the infrastructure asset class overall. It must be noted that these figures include closed-ended funds, and do not include other parts of the market, such as mandates and separately managed accounts.[1]

Appetite for the broader asset class has grown, with record fundraising in both 2021 and 2022. The increased demand from institutional investors is likely explained by the asset class' delivery of compelling risk-adjusted returns, as well as its general characteristics, which include:

- The potential for inflation-linked revenues, and the ability to provide investors with protection against higher inflation
- Relative defensiveness and consistent through-the-cycle performance
- A potentially attractive income and yield profile
- Broad diversification benefits, when added to a multi-asset portfolio
- Backing by real (tangible) assets, which provide an essential service to society
- Relatively high barriers to entry and large capital expenditure (capex) requirements can afford infrastructure assets a natural monopoly position, often backed by regulation
- Lower default rates of infrastructure debt compared to equally-rated corporate debt[2]
- Higher recovery rates of infrastructure debt compared to equally rated corporate debt in the event of a default.[2]

Any forecast, projection or target when provided is indicative only and is not guaranteed in any way.

1. Preqin Insights as of December 2023.
2. Moody's Investor Services, "Infrastructure Default and Recovery Rates 1983-2021", 31st October 2022

Infrastructure investors can benefit from secular growth in many formats

A number of themes are driving growth in private infrastructure debt markets. Themes that are long-term and thus not linked to the business cycle. We believe that the themes highlighted below are not the only growth drivers for infrastructure but demonstrate the breadth of secular trends, which investors can access through an investment in infrastructure debt.

1. Digitisation

The volume of data created globally is growing incredibly fast. In the era of big data, the Internet of Things (IoT), artificial intelligence (AI) and more, the demand for fast and reliable data processing in real time has never been greater and it is indeed expected to continue growing. The surge in data volume is fuelled by the proliferation of autonomous cars, IoT devices, sensors, and connected devices. All of this data will need to be transmitted, processed and / or stored, requiring significant investment in new digital infrastructure. The resulting investment opportunities are wide-ranging. These include the need to upgrade networks from copper to fibre, to support faster speeds, more bandwidth and lower latency. There is also a need for additional infrastructure to support the rollout of 5G and new wireless solutions. Increased investment in data centres will be needed to support the ongoing migration to the cloud and the unfolding AI revolution.

2. Decarbonisation

According to BloombergNEF, if the world is to hit net zero targets, then a total of $194tn of investment is required by 2050.[3] Put differently, every one dollar invested in fossil fuel energy supply will need to be matched with five dollars invested into low-carbon supply out to 2050.[2] The sheer scale of investment needed is clearly staggering. With such a vast sum required, there will need to be significant input from the private sector – and private capital markets will have a major role to play.

Furthermore, the drive towards net zero encompasses a wide array of sectors that support the development of technologies such as e-mobility and green power generation. This includes battery production and the large scale processing of key materials for the production of batteries such as graphite and cobalt under long-term contracts.

3. Deglobalisation

Geopolitics can play a major role in the way in which the global economic climate evolves. More recently, geopolitical shifts have led to a watering down of globalisation and a potential reversal of the decades-long globalisation of economies and supply chains. Deglobalisation can take many forms, and has been referred to as re-shoring or near-shoring. It involves the onshoring of industries and value chains that are considered critical or strategic. Should this trend accelerate, large investments will be needed to build supply chains,[4] industrial facilities and the infrastructure that binds these together. One notable example of deglobalisation in action is the semiconductor industry, where the US and Europe have announced programs totalling more than $100bn to expand onshore manufacturing. These are highly capital intensive facilities, as the recent $30bn partnership between Intel and Brookfield shows[5] – further highlighting the potential for private capital deployment.

Waste recycling and urban mining (reclaiming essential minerals, including rare earths from recycled electronic devices) constitute another area of opportunity. While linked to targets for the delivery of net zero, these sectors are also contributing to the shift towards shorter supply chains that are active at the regional and local level, and can contribute towards policy goals for the onshoring of critical industries and production of key refined commodities.

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3. BloombergNEF, New Energy Outlook 2022
4. World Economic Forum, DeglobalisationL here’s what you need to know as of January 2023.
5. Intel, Introduces First-of-its-Kind Semiconductor Co-Investment Program, as of August 2023.

The role of infrastructure debt

Infrastructure debt has become increasingly popular among investors and is by now a well-defined asset class in its own right. Infrastructure debt can offer insurers and pension funds the potential to invest in well-structured investments with long-term, stable cash-flows. These are key advantages, that help a range of investors that wish to match long-term liabilities but also any investors that seek a better balance between risk and return than what corporate debt investments would typically offer.

Infrastructure debt funds still represent a relatively small portion of the private market infrastructure asset class. With debt AUM of $141bn (as of end 2022) in an asset class which is almost $1.1tn in size, infrastructure debt funds account 13% of AUM.[1] This is partially because dedicated infrastructure debt funds have not traditionally been the main source of financing or funding for projects. Similarly, they have not been the main source of leverage for infrastructure transactions. This is changing, and should continue to do so in future. One of the reasons for this potential growth is the retrenchment of banks from many lending markets. This has benefited private credit markets and it has also been a driver of growth in the infrastructure debt market.

Another driver of investor interest in infrastructure debt is the relative risk / reward trade off. When things do go wrong in infrastructure debt, recovery rates are relatively high: 76.9% according to Moody's.[6] In most cases (62%) the ultimate recovery rate is 100% — in other words, no economic loss.

Within the infrastructure debt asset class, defaults are far less common than for corporate debt. Moody's data suggests that cumulative default rates by year 10 are just 1.2% across the asset class. This compares to default rates of 14.1% across non-financial corporates. This risk / reward trade-off has proven instrumental to the industry's growth.

Market moves create an opportunity for infrastructure debt investors

Traditionally, private equity capital has been the main source of investing in infrastructure for institutional investors. The advantages of investing in infrastructure debt versus equity are clear: the seniority of payments and lower risk of loss in a default, the clearly defined return (at the cost of limited to no upside in return) and higher clarity on the timing of exit from an investment. Investing in infrastructure equity on the other hand comes with the expectation of being appropriately remunerated for the additional risk, i.e. a higher return profile than investments in infrastructure debt.

This relationship between debt / equity and their respective risk / return profiles is currently being challenged by a market that has seen interest rates rise drastically from the historically low levels experienced in 2020-21. Higher interest rates lead to erosion of equity returns, and more expensive debt leads to fewer transactions being able to produce sufficient IRR to meet the cost of equity capital. On the other hand we see debt, particularly floating rate debt, which directly benefits from the increase in benchmark rates such as SOFR, EURIBOR and SONIA (though newly issued fixed rate debt still benefits from interest rate hikes), delivering higher returns to infrastructure debt investors than was considered possible only a couple of years ago.

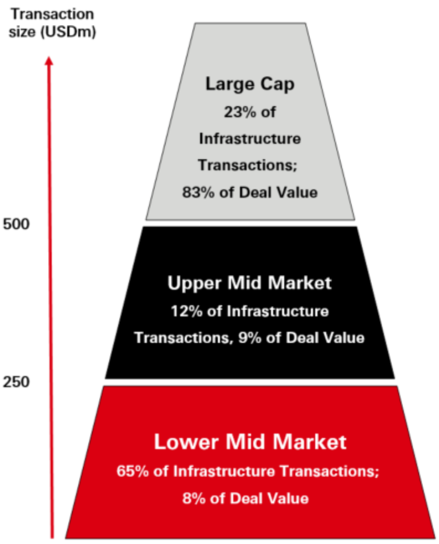
6. Moody's, credit ratings, research, and data for global capital markets, as of December 2023. Moody's Investor Services, "Infrastructure Default and Recovery Rates 1983-2021", 31st October 2022

This has led to a convergence in the returns provided by infrastructure equity and infrastructure debt investments. Pitchbook data reported in Q1 2024 suggests that one-year horizon IRRs across infrastructure equity have fallen from 15.2% in Q3 2022 to 10.7% in Q3 2023. In contract, one-year horizon IRRs in infrastructure (and real estate) debt combined have increased from 3.5% to 10.0% over the same period. This challenges traditional thinking around the risk-return profiles of debt and equity and may well lead to a change in expectations around the cost of equity capital in due course. In any case, the current environment highlights the potential attractiveness of investing in infrastructure debt. In this market, investors can enjoy all the well-established advantages that infrastructure debt investing enjoys: priority of payments, cash flow visibility, strong recoverability, and a degree of certainty on the timing of exit from the investment.

Identifying the Lower-mid market opportunity

The market for infrastructure debt transactions is vast and indeed global, ranging from large-cap deals that measure in the USD billions, to smaller deals that are valued in the tens of millions. According to IJ Global, a total of 16,587 transactions were recorded between 2021 and 2023 (up to and including Q3 2023), with a total value of $12.45tn (this dwarfs the overall industry AUM, as banks are still the leading providers of infrastructure financing on a global scale). Within this spectrum, there are significant differences in terms of transaction dynamics. This is particularly true as one moves from large cap transactions that are dominated by the bulge-bracket investment bank-led syndications and mega funds, towards the mid-cap space. The market is vastly different at the lower-mid market, where typical transactions are in the form of bilateral deals, involving individual mid-cap lenders or small clubs of lenders investing alongside each other.

$12.45tn across Infrastructure Debt transactions between FY 2021 and 9m 2023.



Overview	Advantages	Challenges
Large deals typically syndicated across a large number of lenders. Each lender owns a small part of the loan. Usually structured and distributed by banks.	Execution risk lies mostly with the structuring / distributing bank. Structured execution process leads to speed of execution for investors. Higher investment liquidity.	Lender competition leads to yield compression. Lenders are "price and structure takers". Higher incidence of covenant-light loans. The structuring bank owns the borrower relationship.
Small club and bilateral transactions dominate this segment of the market. Lenders own all or a significant part of the loan. The loan is often structured directly by the lender.	Lower lender competition supports better pricing. Stronger negotiating position leads to more lender-friendly covenant and security structures. Direct relationship with the borrower can drive deal flow.	Execution risk usually lies with the lender. Time to completion may exceed 3 months. Lower investment liquidity.

Source: IJ Global 2021-2023. As of 31st October 2023.

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With about 65% of all infrastructure transactions recorded by IJ Global between FY 2021 and 9m 2023,[7] the lower-mid market is a deep, global, yet highly fragmented market that offers an attractive opportunity for investors. This market is less conducive to the needs of bulge bracket investment banks to structure and distribute large syndicated deals to a wide investor audience. Nor does it cater to the need of mega funds, which require larger tickets in order to meet their deployment targets. This removes a substantial pool of liquidity, which sets the scene for a market where risk is typically priced at more attractive rates. The lower-mid market, being dominated by bilateral or small club transactions is a place where lenders enjoy a direct relationship with the borrower. In such a setting, lenders are able to negotiate superior terms, characterised by both more attractive pricing and more lender-friendly structuring. In our view, this can include tighter financial covenants, cash sweeps and distribution locks that enhance lender control and improve credit performance. Covenant-lite structures are a less frequent occurrence in this part of the market.

Compared to investment managers that focus on public market bonds and large syndicated loans, structured by bulge bracket investment banks or corporate banks, those which target privately negotiated infra debt deals in the lower-mid market, will for the most part face higher execution risk (i.e. the risk of spending time and effort on deals that ultimately do not reach financial close). In addition, experience shows that it can take longer to execute deals, with some stretching from three to nine-months in some cases. In the process, however, they often end up crafting portfolios that deliver the unique combination of private debt investments in infrastructure assets with the attractive features of a portfolio of lower-mid market loans.

Successful investment managers that focus on investments in the lower-mid market, require a strong pipeline of investment opportunities. These will come from a wide and diverse network of relationships with local advisors and brokers, as well as from direct relationships with private equity fund managers or corporate borrowers and asset developers. They will have a strong track record in negotiating and structuring private debt deals in infrastructure, beyond simply the ability to analyse, stress and understand financial projections or due diligence reports. Many lower-mid market infrastructure debt investment managers can play on a particular geographical or sector niche, where they have an origination advantage through an established relationship network. Ultimately, focused strategies do come with limitations in terms of growth potential and scalability. For this reason, those investment managers that are affiliated with the global infra debt origination operation of an international bank, may ultimately face fewer limitations to their growth.

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7. IJGlobal, Infrastructure Journal and Project Finance Magazine as of December 2023.

Conclusion

The infrastructure debt market has grown significantly in recent years. Despite this growth, it remains relatively small compared to other asset classes. Given the breadth of opportunities, and the convergence of infrastructure debt returns with infrastructure equity returns, this growth should continue. Considering also the lower default and higher recovery rates – a function of its inherent characteristics and the position of debt in the capital stack – there are a number of positive attributes for investors. Furthermore, secular trends, such as those discussed involving Digitisation, Decarbonisation and Deglobalisation, could ensure a steady stream of demand for capital across the scale – from the lower-mid market transactions to billion-dollar large cap deals.

For investors who wish to access the relatively untapped pool of opportunity posed by the lower-mid market, it might be good time to consider their options and to pick those managers they identify as best positioned to deliver. Success in the lower-mid market depends on a manager's ability to originate, structure and execute the right investments and requires experience in crafting deals. In picking the right managers, investors may well be unlocking access to a unique pool of value on a global scale.

Key Risks

Investing involves risk and the value of an investment and the income from it may fall as well as rise. You may not get back the full amount invested.

The risks in relation to infrastructure can generally be grouped into: completion, prepayment, technological, raw materials supply, economic, financial, currency, government contract, political, regulatory, privatisation and industry restructuring, environmental and force majeure risks – this latter category concerns the risk that some discrete event might impair, or prevent altogether, the operation of the project for a prolonged period of time after the project has been completed and placed in operations. More detailed information is contained in the IMA.

Completion risk has a monetary aspect and a technical aspect. The monetary element concerns the risk either that a higher-than-anticipated rate of inflation, shortage of critical supplies, unexpected delays, an underestimation of construction costs or a lower-than expected price for the project's output might cause the project to be no longer be profitable. The technical element is where the project may prove to be technically infeasible; environmentally objectionable or require such large expenditures to become technically feasible, that the project becomes uneconomic to complete.

Prepayment risk is the risk that a loan or investments is repaid earlier than expected with the result that the term of the loan or investment is shortened; the interest paid in respect of that loan or investment is reduced and the yield is adversely affected.

Technological risk exists when the technology, on the scale proposed for the project, will not perform according to specifications or will become prematurely obsolete. The risk of technical obsolescence following completion becomes particularly important when a project involves a state-of-the-art technology in an industry whose technology is rapidly evolving.

Raw Material Supply risk is particularly in connection with natural resource projects, where there is a risk that the natural resources, raw materials, or other factors of production necessary for successful operation may become depleted or unavailable during the life of the project.

Economic risk is where demand will not be sufficient to generate revenues to cover the project's costs and debts and provide a fair rate of return to equity investors.

Financial risk exists as rising interest rates could jeopardise the project's ability to service its debt, if a significant portion consists of floating-rate debt.

Currency risk arises when the project's revenue stream or its cost stream is denominated in more than one currency and a change in the exchange rate occurs.

Government Contract Risk arises where authorities may not be able to or may choose not to honour their obligations, especially over the long term. If a project fails to comply with any regulation or contractual obligation, such project could be subject to monetary penalties, loss of the right to operate affected businesses, or both.

Political risk involves the possibility that political authorities might interfere with the timely development and/or long-term economic viability of the project.

Regulatory risk includes failure to obtain or a delay in obtaining permits/approvals which could result in fines; additional costs; or lost revenues.

Privatisation and Industry Restructuring risk is present as governments or government-controlled entities may, either directly or through regulatory agencies, control many assets in the jurisdiction of a project. This control may also extend to the distribution, sale or use of certain infrastructure commodities.

Environmental risk is present when the environmental effects of a project might cause a delay in the project's development or necessitate a costly redesign.

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