Same, but different.

The evolution and growth of infrastructure debt | White paper

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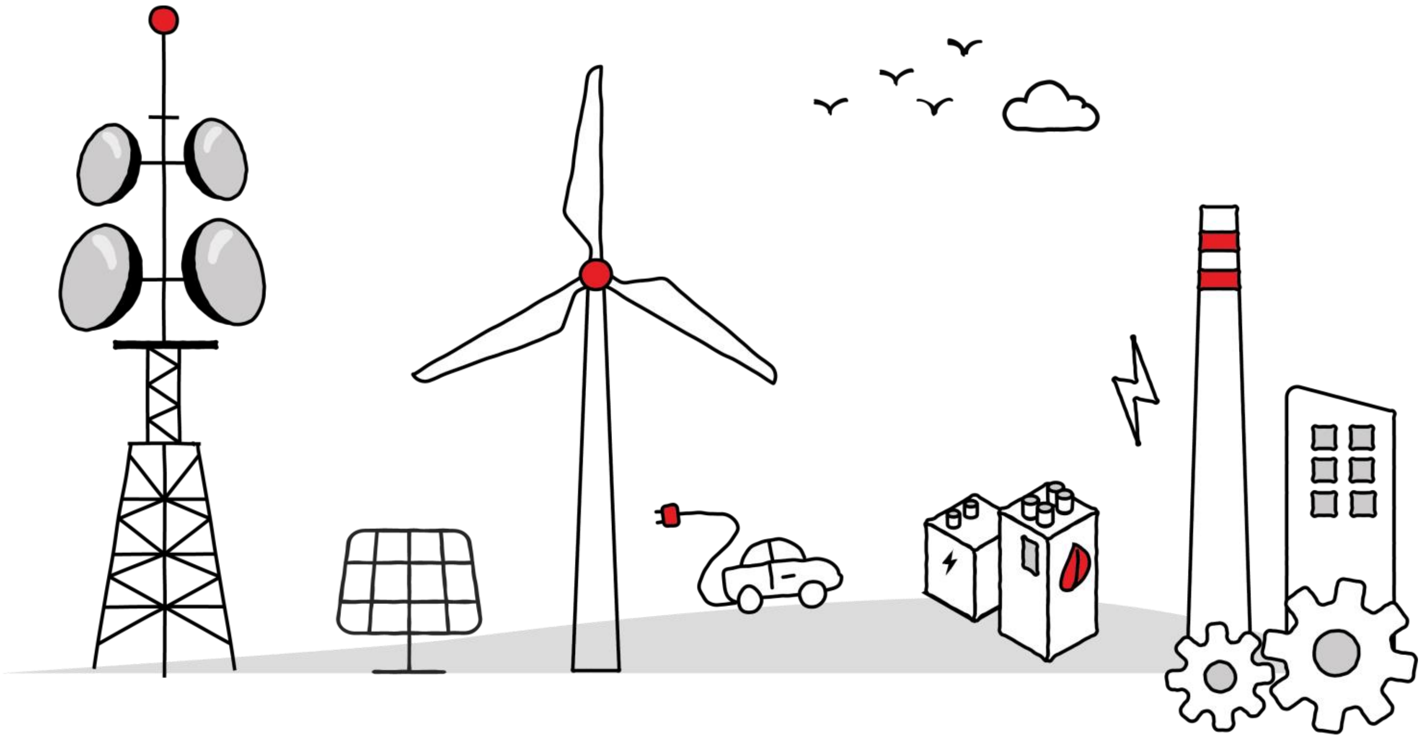


The universe of infrastructure debt investments is diverse and offers investors access to traditional sectors as well as exposure to secular trends around clean energy and digitalization. Importantly, infrastructure debt's defensive features underpin the continued investor interest in the asset class.

Infrastructure debt's resilience is in its DNA

The infrastructure debt market has continued to evolve and grow since its inception as an institutional asset class a decade ago. Its attractive features remain the same while continuing to show resilience throughout times of economic stress, including during the COVID-19 crisis. Infrastructure debt has shown time and time again that it can deliver a sustained yield-pick up at a time of record-low returns in public fixed income. These features provide further tailwinds for growing institutional allocations to the asset class.

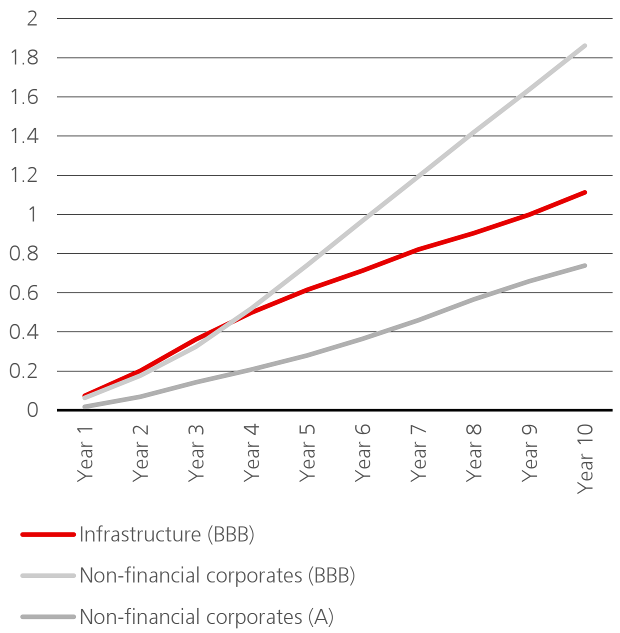
Portfolio considerations

As introduced in our 2017 paper, infrastructure debt can provide a number of attractive features for institutional investors. These continue to be relevant in today's market.

Lower risk than equivalent corporate debt:

- Moody's studies show that at the BBB rating, the 10-year expected loss rate of infrastructure debt is around 40% lower than equivalent corporate debt (see Figure 1)
- The European Commission reflected infrastructure's lower risk by providing capital relief for regulated pensions and insurance companies under Solvency II, resulting in a capital charge for infrastructure debt of 11.4%[1] versus 17% for an BBB-rated corporate bond
- The asset class continues to deliver strong defensive characteristics driven by a combination of the essentiality of the underlying assets and structural protections within infrastructure financings, e.g. distribution blocks and security over physical assets

Figure 1: Moody's average cumulative loss rates (%)



Source: Moody's Infrastructure Default and Recovery Rates, 1983-2019, October 2020

[1] Commission Delegated Regulation (EU) 2017/1542, based on 8-year duration

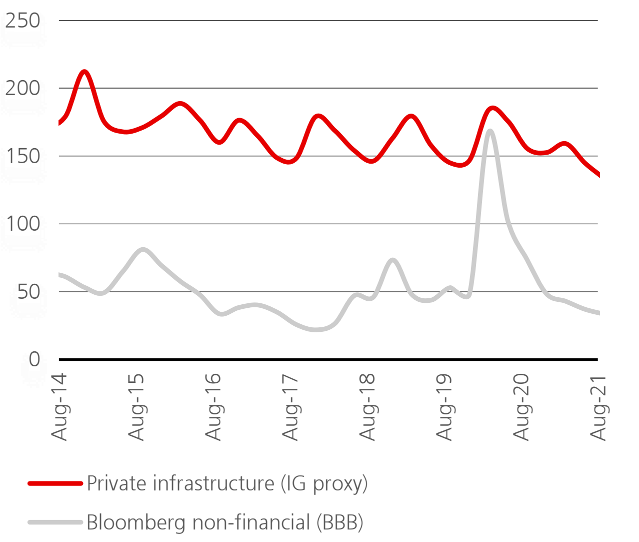
Duration and premium over public corporate bonds

- The capital-intensive nature of infrastructure assets is well-suited to long-dated capital, making the asset class ideal for liability matching
- Infrastructure debt provides a sustained premium over public corporate bonds (see Figure 2), reflecting elements of complexity, illiquidity, origination expertise and speed of execution
- The search for yield has been intensified by the persistent low-rate environment. The returns on public investment-grade bonds are at an all-time low. This premium from infrastructure debt has been a been a big driver of increasing allocations to the sector.

Diversification

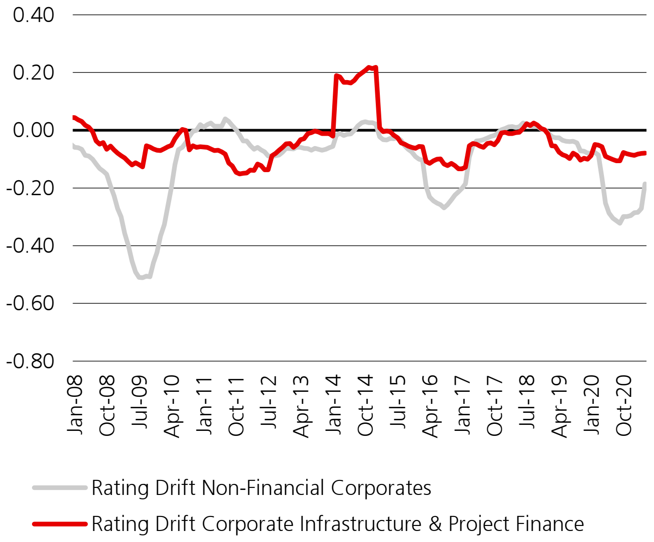
- The asset class is a collection of diverse sub-sectors which are exposed to different regulatory and market drivers. This can be seen by the range of outcomes by sub-sector during the COVID-19 pandemic (see Figure 8)
- According to Moody's, the essential nature of infrastructure assets has historically resulted in more stable cashflows and less downgrades versus corporates
- Data from the Great Financial Crisis and COVID-19 disruption support the thesis of resilient cashflows from infrastructure assets, providing diversification versus wider corporates (see Figure 3).

Figure 2: Spreads on private infrastructure debt (basis point, p.a)

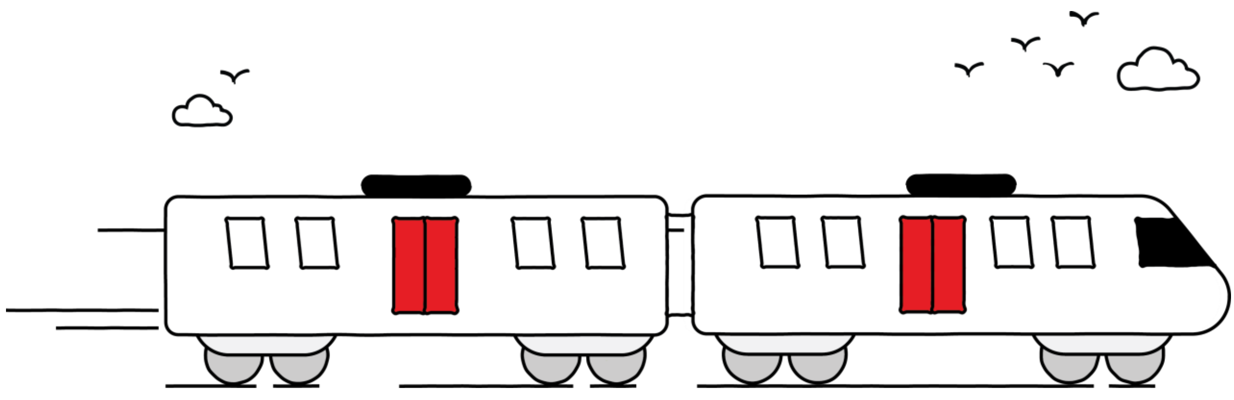


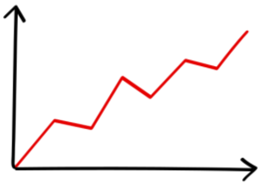
Source: EDHEC Scientific Infrastructure, Debt Indices (Europe), November 2021

Figure 3: Rating drift of infrastructure vs. corporates



Source: Moody's: Default and recoveries: COVID-19 one year on – infrastructure proves its resilience, May 2021

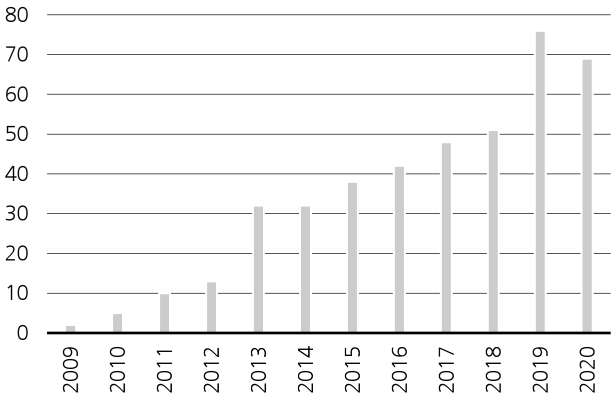




How has the asset class evolved?

Institutional investors grow market share
In our 2017 paper[1], our central assumption was that institutional investors would continue to increase their market share in the European debt market at the expenses of traditional bank lenders. As shown in Figure 4, the number of transactions financed by non-bank lenders continues to grow.

Figure 4: Number of European infrastructure transactions financed by non-bank lenders



Source: Inframation, August 2021

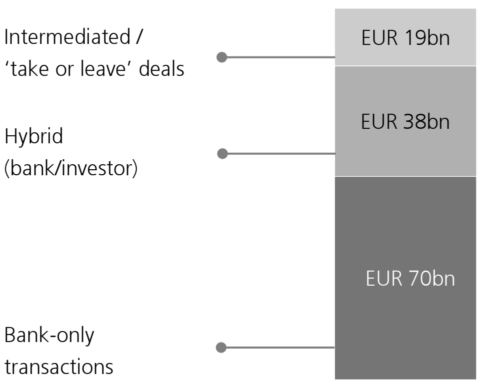
The European infrastructure debt market is around EUR 130bn annually (see Figure 5). A decade ago, the financing market was dominated by bank financing. We now estimate that *bank-only* transactions have reduced to around 55% of the market. Institutional investors are involved in the remainder of the transactions, either as part of a club or as the sole lender.

We distinguish between transactions that are highly intermediated by investment banks and/or issue public bonds or private placements and *hybrid* transactions where a debt investor/fund is involved in a transaction that required structuring.

The hybrid part of the market is most relevant for infrastructure investors looking to generate a premium. Hybrid's share of transaction volumes has increased three-fold versus the period 2016-2018 and now makes up around 35% of total transactions.

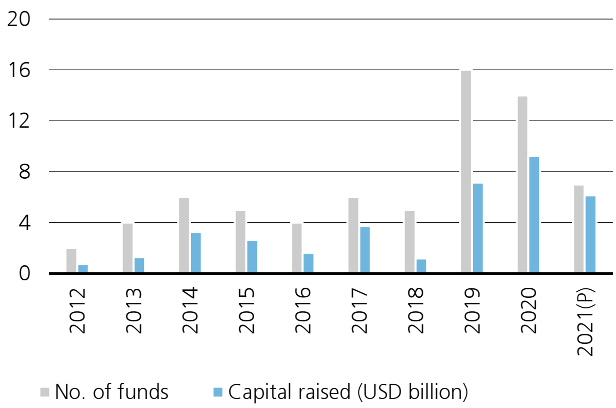
This increase reflects the growing sophistication of debt funds and more collaboration with banks. We expect the hybrid part of the market to continue to grow at the expense of bank-only transactions.

Figure 5: EUR 127bn European private infrastructure debt market*



Source: UBS Asset Management, Real Estate & Private Markets (REPM); Bloomberg; InfraDeals, June 2021. Notes: * Annual average of 2019-2020 private infrastructure financing.

Figure 6: Fundraising for European infrastructure debt market (Bps p.a.)



Source: Preqin, January 2022

Fundraising in the infrastructure debt market in Europe picked up in 2017. The combined effects of changes to Solvency II treatment and ever falling yields increased the attractiveness of the asset class (see Figure 6). However, the infrastructure debt fund market is still relatively immature with 75% of the capital raised by the top 10 managers in Europe. This means that the year-by-year trends can be skewed, for example, by the largest managers fundraising in the same year. A better representation is the growth in fund size: the median increase in capital raised by these managers was 30% between the last two vintages.

Fundraising in the European market has historically been in the senior space. More recently, we've seen the larger managers also adding high yield/ junior offerings to their shelves. We estimate that around 20% of infrastructure debt transactions can fit such mandates, providing a large addressable market for deal flow.

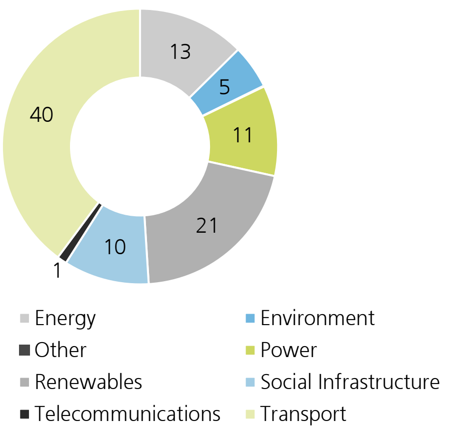
The higher-returns are also attractive to yield-seeking investors, especially as non-investment grade credit is less impacted by the European Central Bank's QE programs.

More diversified

The infrastructure sector has become more diversified over the past decade (see Figure 7). The biggest growth sector has been in telecommunications (+15%) and renewables (+7%), while transport (-12%) and social (-5%) saw the biggest fall in share. The decline in transport may be overestimated by the severity of the COVID-19-impact on the sector in 2020. However, the trends reflect infrastructure's positive exposure to important secular trends in the economy, especially around decarbonization and digitalization.

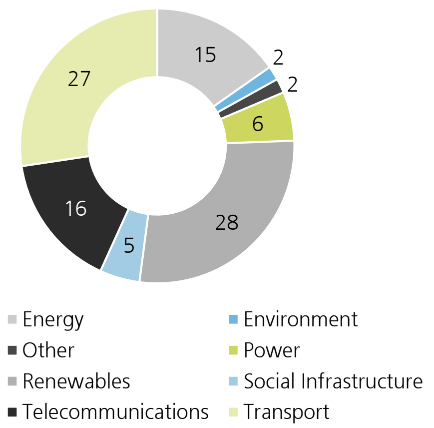
Figure 7: Infrastructure sector is now more diversified

Sub-sector split, 2010-2012
(% of European market by transaction size)

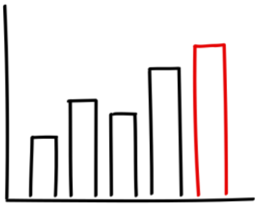


Sub-sector (%)	
Power	-5
Renewables	+7
Social Infrastructure	-5
Telecommunications	+15
Transport	-12

Sub-sector split, 2018-2020
(% of European market by transaction size)



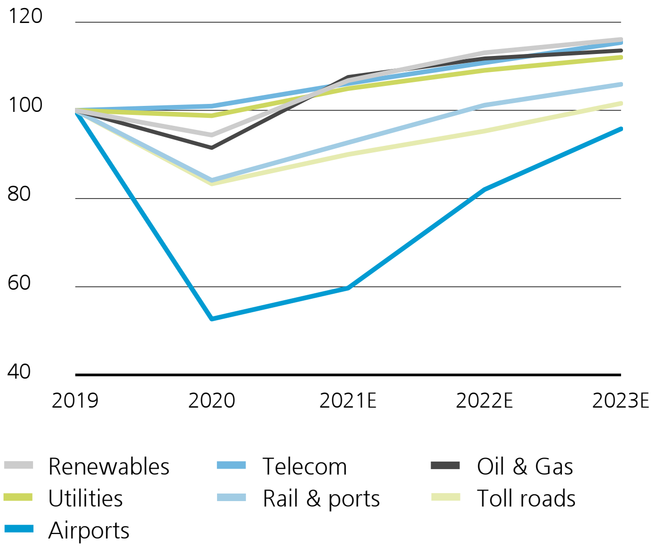
Source: Inframation; UBS Asset Management, Real Estate & Private Markets (REPM), October 2021



Experience during COVID-19

The infrastructure sector comprises many distinct sub-sectors which provide diversification. This is illustrated in Figure 8, which shows the performance of various sub-sector since the COVID-19 crisis and revenue forecasts to 2023.

Figure 8: COVID-19 recovery by sector shows diversification (2019 = 100%)



Source: Bloomberg, July 2021

Infrastructure has been resilient during the COVID-19 crisis, with Moody's reporting[2] that only 11% of its universe was downgraded versus 26% for corporates. Defaults were also low and concentrated on coal-fired and Argentinian assets. There were no infrastructure defaults in Europe in the year to March 2021.

The pandemic was a good test case for the diversification benefits of infrastructure. As shown earlier in Figure 3, infrastructure was more resilient than non-financial corporate debt, reporting fewer negative rating actions. This follows the experience during the Great Financial Crisis.

Growing sustainability focus

The asset class is well placed to enable the decarbonization of energy and transport sectors. It can also provide important social and economic benefits to an economy such as providing fiber to the rural economy or healthcare services. However, despite these benefits, many assets, particularly in the transport and conventional energy sectors, have high recurring carbon footprints.

As infrastructure debt providers have less control over the assets, there are fewer levers to improve the ESG profile of an investment versus equity providers. The two concrete options that debt providers have are through pushing for better ESG disclosure, and engagement strategies to move borrowers towards a more sustainable profile.

The first step towards improving the ESG profile of an asset is for the borrower to disclose its positioning in terms of carbon footprint and key ESG metrics. Increasing transparency and disclosure are central aims of the European Sustainable Finance Disclosure Regulation (SFDR), which went into force in March 2021.

The second lever available is engagement, i.e. working with the company to establish ESG KPIs and setting out to improve the profile over time, generally through margin ratchet incentives. According to Bloomberg, the market for sustainable debt has increased by more than 3x from 2017 to USD 721bn in 2020. Sustainable debt also has its share of critics, notably around concerns that margin ratches are too low to influence behavior and that there are insufficient checks and balances on sustainability-linked loans.

[2] Moody's: Default and recoveries: COVID-19 one year on infrastructure proves its resilience, May 2021

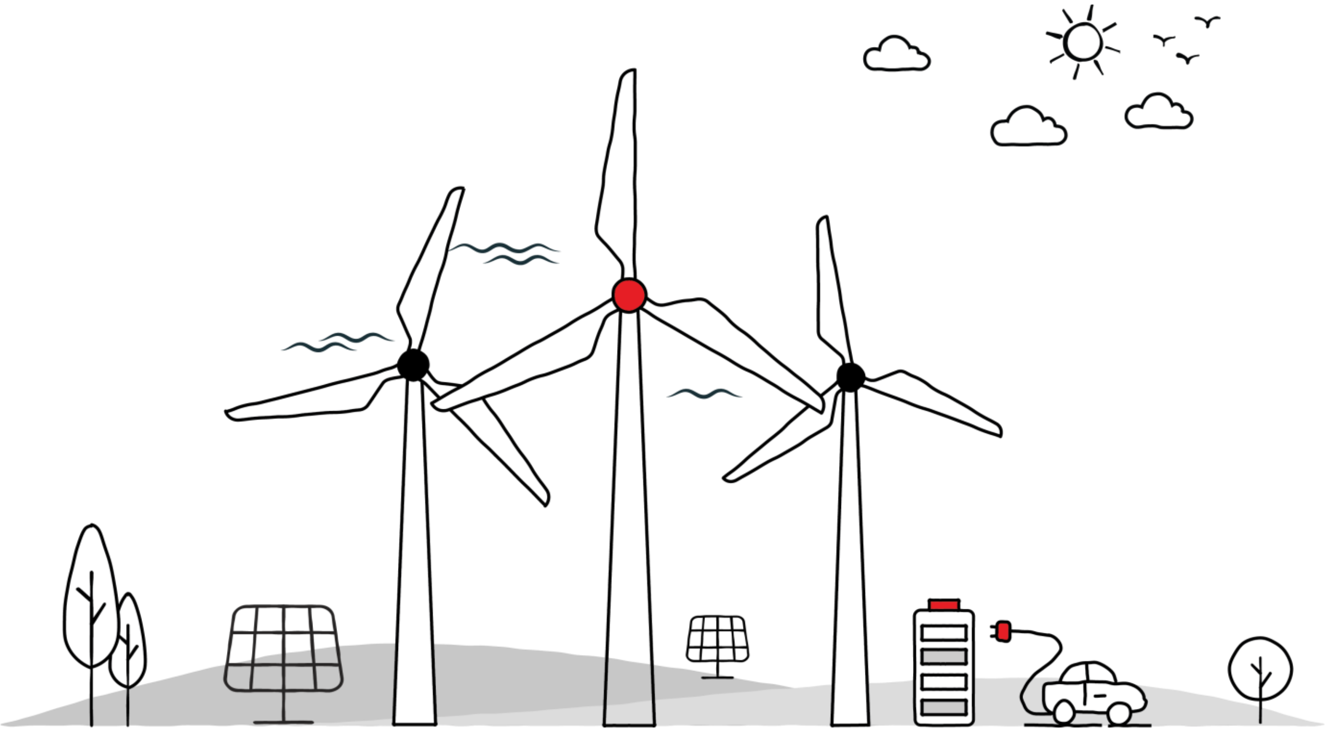
Final thoughts

The infrastructure debt market continues to evolve as it grows. However, importantly, it continues to provide the same defensive features that originally attracted institutional investors to the asset class.

Institutional investors' share of the European infrastructure debt market continues to grow. This is driven by the defensive nature of the asset class and the sustained premium provided over public bonds. The sector was resilient during the COVID-19 crisis, providing further tailwinds to increasing allocations in the future.

We expect to see an increasing focus on sustainability. This will be driven by investor demand and regulatory pressures under the EU SFDR.

Infrastructure debt is positively exposed to important secular trends in the economy and will continue to evolve. Nonetheless, we expect the asset class to continue to demonstrate its importance as a diversifier in investors' portfolios.



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