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Changing of the guard

*Flexible dealmaking in a downturn and deep sector knowledge mean private lenders are capturing market share, a group of infrastructure debt professionals tell
Amy Carroll and Zak Bentley*

Infrastructure debt appears to be a resounding winner in the current macroeconomic maelstrom. A combination of potent megatrends, improved competitive dynamics, and strong yield is proving compelling for investors.

“There is huge demand for new infrastructure driven by decarbonisation and digitisation, as well as infrastructure’s defensive characteristics,” says Daniel Fuchs, head of high-yield infrastructure debt at BlackRock. “At the same time, the macroeconomic environment means we are seeing strong yields. It also helps, from a private credit perspective, that banks’ willingness to underwrite has waned and so sponsors are turning to us for execution certainty. All of this means that infrastructure debt is viewed as highly attractive right now.”

Pieter Welman, head of global infrastructure at Barings, agrees. “The tailwinds we see in terms of decarbonisation and digitisation, combined with the yields available, make this a great time for infrastructure debt – and so

far, credit performance has been generally strong across the sector.”

“Infrastructure as an asset class has demonstrated its resilience through market cycles once again,” adds Spencer Ivey, partner and head of infrastructure debt, Americas at Ares Management. “We are seeing huge demand for capital to support the digital buildout, the energy transition, and improvements to transportation infrastructure. This comes at a time when there has been volatility and uncertainty in the public markets as a source of financing. As a result, there is increasing demand for private debt as sponsors recognise the reliability and flexibility of private lenders that can provide execution certainty and bespoke solutions.”

Another reason why infrastructure credit is attractive right now is that debt prices adjusted quickly. “Base rate movements were passed onto the borrower straight away whilst equity prices have been much slower to adjust,” explains Greg Falzon, partner at AIP Management. “On a relative value basis, therefore, credit investment has

been and remains a compelling investment proposition.”

“Credit funds are certainly seeing a lot of opportunities driven by borrowers looking to stretch the capital stack and to stretch equity dollars particularly around development and renewables,” adds David Rosenblum, fund partner at I Squared Capital. “Investors are interested in credit because of the yields that can be generated in contrast to the uncertainty of what can be achieved in the equity. As infrastructure continues to grow and evolve, I think that will drive more capital into the infrastructure credit space.”

Dealmaking in a downturn

Furthermore, dealflow remains strong, according to Fuchs. “It is easier to find deals than it used to be because alternative sources of capital have stepped back and so there is less competition. There are also more sponsors looking for a non-dilutive form of capital that sits somewhere between traditional senior debt and equity, which means high yield in particular is in demand. We deployed

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AIP Management

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SPENCER IVEY
Ares Management

a record amount of money in 2022, and 2023 is on a similar track.”

Matthew Norman, global head of infrastructure at Crédit Agricole CIB, says that the nature of dealflow is changing, however. “We are seeing a lot of refinancing activity and we continue to see a lot of greenfield opportunities driven by the energy transition and digitisation, but M&A-related lending is meaningfully down,” he explains.

“M&A opportunities still arise but they are typically equity related. If you have a flexible mandate that enables you to deploy further upstairs in the capital structure, as an equity replacement for example, then that can lead to interesting transactions, because equity is tighter than it used to be. That is not typically where banks are playing, however, and net-net we expect deal volumes will be down this year on 2022, albeit the long-term tailwinds for the sector are positive and driven by key industry trends.”

Norman adds that the majority of M&A deals getting done today have pre-existing capital structures that can be brought over, or else are minority deals. “The need for debt is therefore more limited than it has been historically. We are not seeing large-scale take privates, for example. They are just very difficult to transact, not least because of the cost of finance. The cost of private credit is one reason that everyone is keen to invest in the asset class right now, of course, but I would sound a note of caution. If that cost of capital is restricting dealflow, then that is a problem. I do think the situation will adjust as sellers and buyers realign on value, but it will take time.”

Alexandra Dimsdale Gill, partner at Clifford Chance, meanwhile, says the tighter debt market is incentivising sponsors to explore refinancings featuring portable debt in anticipation of a potential sales process, which can be helpful for prospective purchasers



Greg Falzon

Partner, AIP Management

Greg Falzon has responsibility for originating and executing investments. Prior to joining AIP in 2021, he worked in infrastructure and renewables for over 20 years, including as head of Royal Bank of Canada's infrastructure debt structuring team in London and as co-head of European power, utilities and infrastructure at Bank of Montreal.

Spencer Ivey

Partner and head of infrastructure debt, Americas, Ares Management

Spencer Ivey is a partner and the head of Ares Infrastructure Debt Americas. Additionally, he serves on the Ares Infrastructure Debt Investment Committee. Prior to joining Ares in 2022, Ivey was a partner and founding member on the infrastructure debt team at AMP Capital, where he was responsible for sourcing, arranging and managing infrastructure debt investments in the Americas.



Pieter Welman

Managing director, global infrastructure debt, Barings

Pieter Welman is responsible for the overall management of Barings' global infrastructure business with investment teams based in London and New York. Prior to joining the firm in 2015, Welman worked in the Energy & Infrastructure team at Crédit Agricole CIB and before that at Barclays.



Daniel Fuchs

Head of high-yield infrastructure debt, BlackRock

Daniel Fuchs is the head of high-yield infrastructure debt at BlackRock and the lead portfolio manager for private debt's global high-yield infrastructure debt business. Prior to joining BlackRock, Fuchs was a senior director for Deutsche Bank's structured finance platform in Frankfurt, London and New York.



Alexandra Dimsdale Gill

Partner, Clifford Chance

Alexandra Dimsdale Gill is a partner in the global financial markets team at Clifford Chance, specialising in infrastructure finance, acquisition finance, syndicated loans and debt restructurings.



Matthew Norman

Global head of infrastructure, Crédit Agricole CIB

Matthew Norman has over 20 years of infrastructure and energy industry experience. He previously worked in the investment banking and wealth management divisions at Indosuez. He was appointed global head of infrastructure at Crédit Agricole CIB in 2016.



David Rosenblum

Fund partner, I Squared Capital

David Rosenblum is a fund partner at I Squared Capital focusing on credit. I Squared Capital is an independent global infrastructure manager with over \$37 billion in assets under management focused on investing in North America, Europe, Asia and Latin America.

given the potential difficulties in terms of sourcing acquisition debt.

“If I look back 24 or 36 months, a major theme for us involved helping equity sponsors fund their investment, perhaps buying a minority stake in an asset that already had financing in place,” says Falzon. “What they wanted was holdco leverage to part finance the equity check, which would help them both in terms of the money they required and also in terms of their return. For core, operational brownfield infrastructure, that opportunity just doesn’t exist anymore. The cost of debt is too close to the cost of equity.”

Financing the energy transition

Of course, there are particular investment themes that continue to demand significant capital, most notably

perhaps, the energy transition. “The decarbonisation mega-trend is huge and we have a strong pipeline of renewable energy generation assets covering everything from onshore and offshore wind, to solar. But we also see investment opportunities in newer energy transition sectors such as industrial decarbonisation,” says Falzon.

“Some of those sectors can be challenging for traditional project finance banks or investment-grade institutional investors. Merchant power price exposure is increasing in the renewables sector and some of these newer sectors often fall outside current core infrastructure definitions.

“There is a clear need for flexible capital that can understand the underlying project, therefore. For example, we understand that period-on-period

cashflow variability is not necessarily a cause for concern with a renewable generation asset. We take a more loan-to-value approach even if that means accepting some flexibility on repayment timing. That is a valuable proposition for borrowers.”

Dimsdale Gill adds: “We have generally seen private debt providers being drawn to more mature technologies and assets, in particular where they can gain exposure to portfolios with a mixed risk/return profile, and we have seen some bespoke documentation terms evolving around that where you have some assets benefitting from feed-in tariffs and PPAs and others bearing merchant risk.”

Meanwhile, digital infrastructure is, of course, another powerful driver of dealflow. “There is significant growth and demand for capital across all digital subsectors – data centres, fibre, as well as telecom towers – these are all areas where we have been very active,” says Ivey. “The question then becomes, how are these assets or portfolios financed as they grow in scale. At Ares, we have the size and scale to execute on large transactions, which puts us in a very competitive position as a private lender.”

The fact that banks are sitting on the sidelines is also bolstering private credit activity in the sector.

“There are massive capex requirements associated with digital infrastructure,” says Dimsdale Gill. “A few years ago, those capex lines would have been the preserve of the banks but something that has struck me is the willingness of institutional non-bank lenders to step in and show real flexibility to meet this capital need, including longer availability periods and staggered drawdown profiles.”

But Welman cautions that not all digital assets are infrastructure. “Data consumption continues to grow exponentially, which is creating massive tailwinds for the sector, but I don’t think

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PIETER WELMAN
Barings

that everything in this space has true infrastructure characteristics,” he says.

“There are areas in this market that look a lot more like classic TMT or could have real estate characteristics. These might be great businesses, to be clear, but might not have the characteristics we look for within infrastructure. It depends on what the asset is, who the customers are, how reliable the revenues and costs are likely to be, or what barriers to entry you have among any number of other risk factors. You have to consider the infrastructure credentials of digital assets on a deal-by-deal basis, unlike toll roads, for example, where I think it is generally pretty clear.”

Underwriting risk

Meanwhile, despite the obvious advantages of investing behind these transformative mega-trends, infrastructure debt players do still have to contend with a turbulent macro environment, as well as the persistent threat represented by climate change.

Interestingly, Dimsdale Gill, says she is yet to see anything related to climate risk going into loan or note documentation. “It is certainly brought up in Q&A during due diligence, but I have seen nothing so far in terms of it being embedded in contractual protections or covenants, although perhaps it is a matter of time.”

Increased scrutiny is undoubtedly being placed on the impact of the economic backdrop, however. “We are certainly more cautious around the thresholds that need to be met before we make an investment,” says Rosenblum. “In this higher interest rate environment, it’s important to make sure that borrowers have the capacity to make interest payments and that can mean a cap or hedge is required.”

“We haven’t changed the way we underwrite risk but higher inflation, higher interest rates and greater volatility mean there are areas that require

enhanced focus,” adds Fuchs. “We are looking more closely at everything associated with refinancing and everything associated with capex. Cost overruns are always an issue but in an environment of higher inflation and continued supply chain disruption, it is something that requires even greater attention.”

Dimsdale Gill, meanwhile, says that the more challenging macro environment is being reflected in documentation. “One unsurprising by-product of constrained liquidity has been a deceleration of the trend towards ever greater flexibilities in loan documentation, and we have seen greater lender focus on distribution and incremental debt capacity, while EBITDA adjustments linked to capex spend are subject to heavy scrutiny,” she explains. “I think it’s fair to say there has been a slight rebalancing when it comes to leveraged

loan terms creeping into infra-style documentation.”

Inflation

Significant uncertainty remains regarding the future trajectory of the economy, of course. Fuchs’ personal view is that we are destined for a higher-for-longer scenario, albeit with regional variations. “Deglobalisation and decarbonisation, with all the upfront capital that’s required, both have inflationary tendencies. Demographics are driving inflation as well,” he says.

Falzon agrees that there are long-term trends paving the way for inflation including the move away from globalisation. “Nearshoring and more localised supply chains simply cost more.”

Norman, meanwhile, says that capex overruns are already resulting in credit events in some sectors. “Some projects that have closed over the past

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BlackRock

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Crédit Agricole CIB

12-36 months are experiencing significant delays and cost overruns and we have to manage that in our portfolios,” he explains. “The good news is that inflation does appear to be coming down. However, that last piece to get down to central bank targets will be challenging given wage inflation, which can be difficult to weed out without causing significant economic adjustment. Until we reach a lower and more predictable level of inflation, we may continue to see further credit events and there may be further project delays, and possibly further impact on the deal pipeline as bidders struggle to deliver on bids.”

“Whether you are talking about greenfield or brownfield, it comes down to confidence,” adds Welman. “If you have confidence on where inflation could settle then obviously you can use that to be more sure about what

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DAVID ROSENBLUM
I Squared Capital

something will likely cost and its value, whether you build, buy or sell. Whether inflation reaches a new normal or returns to historical levels, it is that confidence as much as the level itself that will allow investors to more confidently predict the cost of building or buying, which will ultimately stimulate more dealflow.”

Rosenblum, meanwhile, emphasises the positive inflation linkage that much

of the infrastructure asset class enjoys. “Every era has a different shock that causes inflation to spike. In this case, of course, it was covid. Bringing inflation down from 8 or 9 percent to 5 percent generally happens pretty quickly, but getting down to 2 or 3 percent can take several years,” he says. “Consequently, I do think we are going to see higher for longer inflation and as a result risk-free rates will remain elevated for a

period of time. Given that many assets in the credit space have cashflow that is pegged to inflation, that can be very attractive for investors.”

Staying power

Of course, infrastructure debt players must also consider what lower inflation – and therefore lower interest rates – would mean for the appeal of the asset class. But Welman is unconcerned. “Even though interest rates have been incredibly low for the past 10 years, there has still been plenty of appetite in the market. It all depends on what you are comparing infrastructure debt with. If you are comparing it to equity, for example, then clearly debt has become relatively more attractive on a risk-weighted basis as rates have increased recently. But if you are comparing it with fixed income, there has always been value in infrastructure debt.”

Ivey adds: “If you look at the fundamentals, there is huge demand for capital and – while inflation or interest rates may ease – that will spur other sources of dealflow. For example, we would expect M&A to pick up and projects currently on hold will return to the market, all of which means dealflow for private debt managers will likely remain strong. At the same time, this period of dislocation has seen private credit gain share from banks and the public market, and sponsors have learnt that it is valuable to work with sophisticated lenders that really understand infrastructure and can act as a true capital partner for the long term.”

Rosenblum agrees that private capital has really made its mark on infrastructure over the past few years, given its proven ability to execute quickly and provide customised solutions that require a nuanced understanding of the assets beyond simple standardised, high-yield bonds on leveraged loans. “That has secured private credit’s place in the asset class regardless of the interest rate environment,” he says. ■