KEYNOTE INTERVIEW

Strong tailwinds keep infrastructure debt on course

Interest rate hikes may have upset global markets, but infrastructure debt has been remarkably resilient, says Barings' Pieter Welman

Barings has invested $19 billion in infrastructure debt since launching its business in 2013, and its head of global infrastructure, Pieter Welman, believes the market has much further to go, driven by global mega-trends such as the energy transition and an increasingly digital infrastructure.

At the same time, cash-strapped governments need the private sector to fund essential works, and investors are attracted to the sector's essential characteristics. These factors have combined to make infrastructure debt a resilient asset class.

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Q How do you define infrastructure debt and why is that important?

The definition of infrastructure debt can vary widely among managers, banks and investors. At Barings, we focus primarily on economically critical assets which meet social or economic needs and have the potential to offer stable, long-term cashflows.

The definition is important as it brings discipline; a lot of infrastructure assets bridge into other asset classes.

We think of infrastructure debt as encompassing six categories: economic infrastructure, such as toll roads and airports; utilities and pipelines, assets which carry water, electricity, natural gas and other fuels; power generation, such as renewable energy assets and EV charging infrastructure; social infrastructure, which include social housing as well as development of assets like hospitals and schools; midstream and storage facilities; and digital infrastructure, such as cabling and data centres.

Q How is the role of private credit in infrastructure developing?

The private infrastructure debt market really developed after the global financial crisis as banks began to reduce their exposure to real assets, having been burned by over-leveraging real estate. They were also reluctant to lend to very long-term projects, whereas these were an ideal fit for insurance companies. Banks are still active lenders to infrastructure, but they remain conservative. Meanwhile, private credit keeps evolving and offering a broader range of options to sponsors.

I think where we are now is at a place where there is so much flexibility for a sponsor raising money. You can access different types of capital, use different structures for a broad range of assets all over the world. Private credit caters to different risk appetites and different return expectations. There is a lot of optionality that has been created, which at the end, hopefully makes the market more efficient.

We may see more bilateral lending in the future. When banks dominated, they tended to syndicate loans in order to spread their risk. However, a private credit fund or platform will spread the risk of a large loan across various investors and will be prepared to take on larger ticket sizes.

Q What attracts investors to infrastructure debt?

The assets are resilient, and they are real assets. They generally tend to offer a hedge against inflation, which is attractive from a risk perspective, especially recently. They also offer diversification benefits for investors who are exposed to more traditional, fixed-income assets such as government and investment-grade corporate bonds. There is also considerable market diversification available as it is a global asset class.

Infrastructure debt also offers the potential for attractive yields, averaging 5-7 percent for investment grade and 7-10 percent for higher yielding transactions, although these can vary depending on the market and asset. For insurance companies, the long-term predictable income from investment-grade assets is an important tool in liability matching.

Q Have investor attitudes changed in this different economic environment?

Infrastructure debt has performed well despite rising interest rates and investors being hit by the denominator effect. In particular, the asset class has continued to offer an attractive spread relative to similar quality corporate debt. And performance, particularly in private markets, has been strong.

I think that is for two reasons. One is that, as it turns out, investors have become quite comfortable with the asset class. The other is that the tailwinds, such as the energy transition and the digital economy, are incredibly strong. You might contrast an office asset in real estate, where values have fallen partially because of concerns about how we will use offices in the longer term. Investors know infrastructure is the essential kit for our future, so many remain keen to back it.

Q How is the investor base for infrastructure debt developing?

Demand from insurance companies is strong and growing because of the role of infrastructure debt in asset-liability matching. They are the dominant investor type in investment-grade debt.

We are also seeing more pension funds and sovereign wealth funds investing in a range of infrastructure debt. Sovereign and pension funds have, of course, been equity investors in infrastructure for a long time, but we are seeing more look at high-yield infrastructure because of the need for diversification and because it looks more attractive in an environment where interest rates may remain elevated for some time.

We have not seen too much from high-net-worth individuals or family office investors, although they are active on the equity side, especially in smaller projects.

In the longer term, I can see their interest growing, for all the reasons that make the sector attractive, and

also because many wealthy individuals now like to put their money into things which are good for the environment and good for society.

Q What are the key themes driving infrastructure debt opportunities?

There are a number of fundamental drivers for the growth of infrastructure in the long term. Firstly, the transition to renewable energy sources and the electrification of economies. As well as renewables, there is demand for natural gas, often in liquefied form, as a transition fuel until renewable energy sources can fill the gap. Nuclear-powered electrical generation is also attracting renewed attention, with a lot of research underway into smaller reactors, for example. The energy transition doesn't just require renewable energy production and storage, but upgraded transmission networks and the infrastructure for an electrified world, such as EV charging stations.

We are also engaged in a rapid digitisation of economies all over the world. The amount of data created seems to be growing exponentially and is driving demand for data centres, cell towers, fibre optic cabling and the other necessary building blocks of digital infrastructure. A recent survey of institutional investors showed data-related infrastructure was the highest-ranking subsector in terms of increasing deployment over the next three to five years.

Q How important is government policy in supporting the market?

Both the US and the EU have made significant commitments to spending on infrastructure. The US Bipartisan Infrastructure Law and the complementary Inflation Reduction Act include massive spending on infrastructure over the next five years – including $110 billion on road and bridge repairs, $65 billion to upgrade the nation's power grid, $65 billion on broadband infrastructure deployment and $55 billion on clean water infrastructure. And the European Fund for Sustainable Development will make up to €135 billion available for infrastructure projects between 2021 and 2027.

> *"Infrastructure debt has performed well, despite rising interest rates and investors being hit by the denominator effect"*

However, with higher interest rates and already high debt, governments cannot afford to fund the entire cost of infrastructure projects with either taxed or borrowed money. There is a big role for the private sector, including private credit, to play going forward.

Q Which markets or regions offer the best opportunities?

Due to the size of developed markets in Europe and the US, their substantial infrastructure needs and government commitments, the majority of the opportunities are in these markets. They are also reassuring for investors as the political risks are well understood and there is little currency risk.

Developing markets have political and currency risk as a barrier, but the opportunity is huge. Asia, in particular, offers a combination of substantial demand, large populations and rising wealth. And there is also a great need for infrastructure in Africa and South America too, although the risks there may be harder to price.

Q What do you expect to see from the asset class in the year ahead?

Last year was obviously rather subdued as everyone had to readjust to the new interest rate environment, but I think we will see a lot more activity this year and more transactions in the infrastructure sector. People have a clearer view on the outlook for interest rates – which seems to be that they will remain at current levels for a while – and have worked out what their discount rate should be and are ready to make decisions. We also have funds maturing and other things which will spark more deals in the market. There should be a lot more to look forward to this year. ■