BARINGS

PRIVATE CREDIT

The Widening Appeal of Private Placements & Infrastructure Debt

INSIGHTS

Illiquid asset classes such as private placements and infrastructure debt can offer investors incremental risk-adjusted returns, as well as a number of other compelling competitive advantages.

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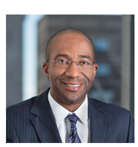

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Institutional investors are increasingly considering investments in illiquid private markets, including private placements and infrastructure debt. For insurance companies and pension funds, in particular, these markets can offer a number of potential advantages, ranging from an illiquidity premium over public markets to enhanced diversification, risk protection, and positive asset-liability matching attributes.

The Defining Attributes

PRIVATE PLACEMENTS

Private placements are essentially notes and loans sold only to qualified institutional buyers (QIBS); they do not have to be registered with the Securities and Exchange Commission. Historically an investment grade market, private placements span a range of categories beyond traditional corporates, from REITs, sports-related transactions and financials to more esoteric products such as structured finance, credit-tenant lease transactions and aviation deals. A decade ago, the private placements market consisted primarily of small and medium sized companies seeking to raise capital to supplement bank financing. That is no longer the case, with many large companies globally choosing to access the private placement market as a means of gaining another source of capital to achieve their financing objectives.

Figure 1: Key Characteristics of Private Placements and Private Infrastructure Debt vs. Public Bonds

	Private Placements	Private Infrastructure Debt	Public Investment Grade Debt
Credit Quality	A/BBB	A/BBB and BB/B	BBB and above
Target Spreads*	IG: T + 100–250 bps ~20–40+ bps over public corporates	IG: T + 150–300 bps 75+ bps over public corporates Non-IG: T + 250–500	T + 50–350 bps
Tenor	Flexible, 5–30-year	5–30-year	2-year to perpetual
Income	Primarily fixed	Fixed or floating	Fixed or floating
Structure	Bullet maturities or scheduled amortization	Bullet maturities or scheduled amortization	Bullet maturities or scheduled amortization
Prepayment	Make whole provisions for prepayment	Make whole provisions for prepayment	Make whole provisions or call structures
Security	Primarily senior unsecured	Senior secured	Senior unsecured through junior subordinated
Key Features	Engaged relationship with borrowers, strong covenants, historically low net losses, stable cash flows	Engaged relationship with borrowers, strong covenants, essential infrastructure assets, defensive in times of stress, stable cash flows, typically secured by assets	Engaged relationship with borrowers, flexibility of tenor and unsecured

Source: Barings. As of April 30, 2022.

INFRASTRUCTURE DEBT

The definition of infrastructure debt is broad and can vary significantly among asset managers, banks and investors. At Barings, our definition centers on the type of asset generating the cash flow, rather than the specific financing structure. We primarily focus on essential assets that meet key social and economic needs and that have the potential to generate stable, long-term cash flows for investors, including:

SOCIAL INFRASTRUCTURE

Projects built through public-private partnerships to meet a social need like hospitals or public housing

*Typically A or BBB credit quality**

DIGITAL INFRASTRUCTURE

Towers, fiber-optic cable networks and data centers

Typically BB credit quality

POWER GENERATION

Solar, wind, hydro or conventional power generation

Typically BBB or BB credit quality

MIDSTREAM & STORAGE

Oil and refined product storage (including non-energy)

Typically BB credit quality

ECONOMIC INFRASTRUCTURE

Toll roads, ports or airports

Typically BBB or BB credit quality

UTILITIES & PIPELINES

Distribution and transmission assets

Typically BBB credit quality

The infrastructure debt market was once almost exclusively the domain of banks. In the past, institutional investors who did gain access to infrastructure assets generally did so through allocations to private equity funds. The key events that set change in motion were the Global Financial Crisis and the European debt crisis. As banks looked to reduce their liquidity and pulled back sharply as a funding source, institutional asset managers were able to step in and fill the gap—particularly in the U.S., where banks still act as arrangers but are typically not involved in lending to the same extent as in Europe.

*NRSRO rating or equivalent.

Multiple Benefits for Investors & Issuers

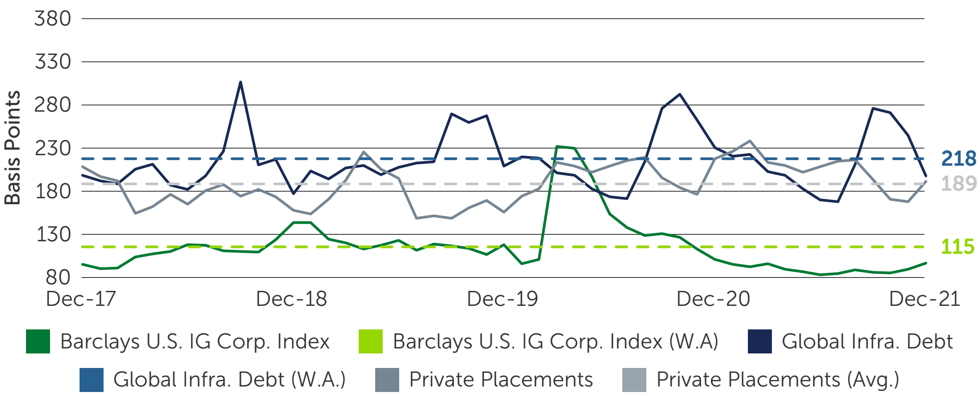
As these markets have evolved, institutional interest in private placements and infrastructure debt has grown. Insurance companies have traditionally been the most active, attracted to the liability matching characteristics, such as longer tenors and prepayment protection, in particular. Investors seeking to enhance yield and portfolio return, such as pension funds, have also turned their attention to the asset class more recently, especially the higher-yielding debt segments of the market. The investor base for these asset classes has also become more global, with investors in both Europe and Asia taking greater interest as they continue their respective searches for higher yields and greater diversification.

FOR INVESTORS...

Specifically, private placements and infrastructure debt can offer a number of key benefits for investors:

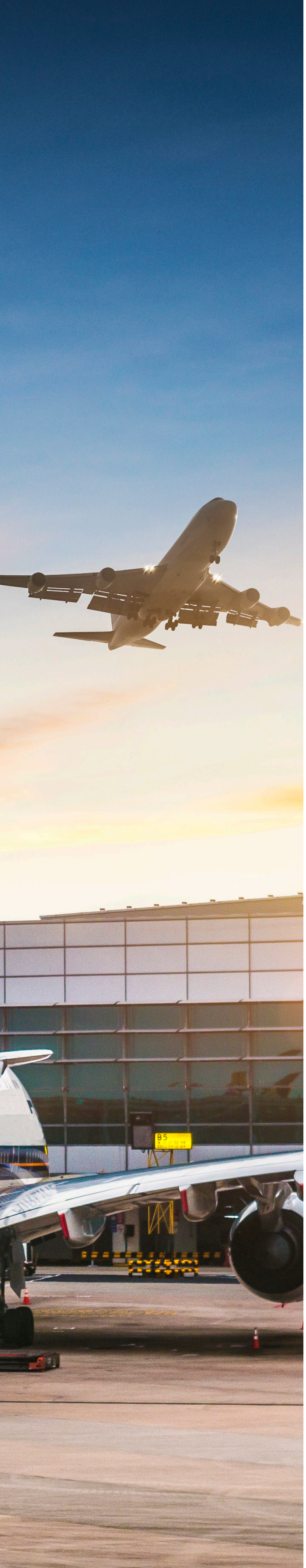
Premium to Public Markets: Private placements and infrastructure debt are less liquid than public bonds, and have historically offered enhanced yields vs. IG credit to compensate for illiquidity, as well as the complexity inherent in underwriting the credits. The opportunity to earn a premium in exchange for giving up public liquidity can be particularly attractive to investors with long-term liabilities that do not need 100% of their portfolio in liquid assets. Over the past five years, Barings' private placement and infrastructure debt strategies have offered a weighted average spread premium of 55–70 basis points (bps) and 85–100 bps, respectively, over the Barclays IG Corporate Index.[1]

Figure 2: Private Placements and Infrastructure Debt Spreads vs. A/BBB Public Corporate Bonds



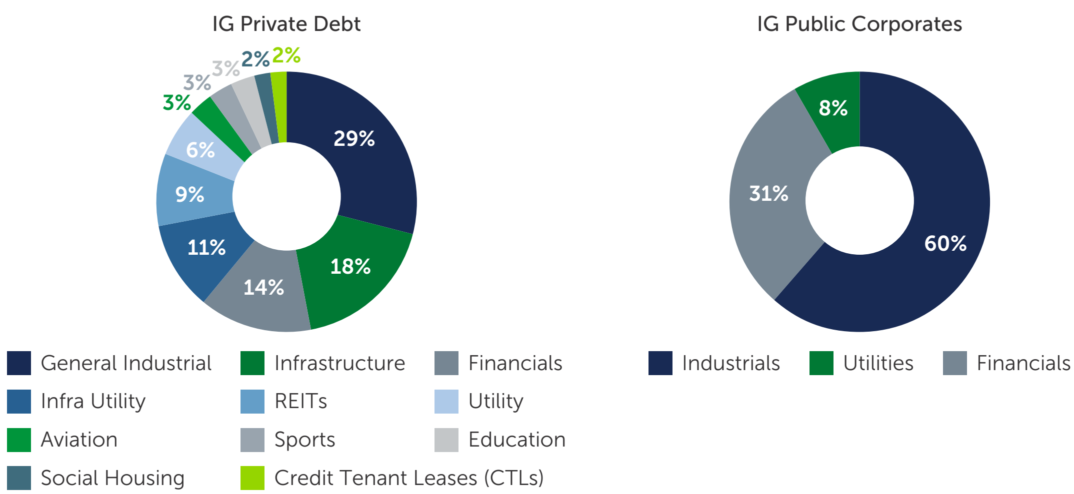
Source: Barings market observations. As of March 31, 2022.

1. Based on Barings' market observations.



Diversification Benefits and Unique Exposures: Private placements and infrastructure debt are global asset classes, and can be effective diversifiers in a portfolio that already includes more traditional, long-term fixed income assets such as sovereign and public investment grade corporate bonds. Whereas public debt is heavily concentrated in the industrial, financial and utility sectors, private placements and infrastructure projects span rated and unrated public and private debt, as well as a wide range of industry sectors and sub-sectors—all of which exhibit unique return profiles. Infrastructure debt, for example, funds critical projects in both developed and emerging markets. Even projects within the same sector can offer diversification, such as exposure to different offtakers, regulatory regimes and payment mechanisms. Private placements, relative to public corporate bonds, can provide additional exposure to consumer sectors, social housing, sports, REITs and a wide range of industries.

Figure 3: Private Placements Offer Diversification From the Public Bond Market



Sources: Barings; Bloomberg. As of March 31, 2022.

Downside Protections: Private debt investments have a potential advantage over public bonds given the strong negotiated covenant structures unique to each deal, which help ensure that investors will be properly compensated and protected for the risks they assume. Often, the agreements also include make-whole provisions that will compensate investors if borrowers decide to prepay their debt. Private placements and infrastructure debt are also typically senior in an issuer's capital structure. In times of stress, the combination of strong covenants and capital structure seniority gives the holders of private investments a seat at the table ahead of public bonds, enabling them to reprice or renegotiate a deal to compensate for higher risk and/or receive partial or full prepayment offers.

Low Losses/High Recoveries: Given the strong downside protections, private debt assets have exhibited resilience over time, including through periods of market volatility and economic downturns. While the costs associated with managing private assets can be higher relative to public bonds, losses for private placements and infrastructure debt have historically been lower relative to public corporates of similar credit quality. Historical recovery rates for private assets also compare favorably to public corporate debt.[2]

Duration/Liability Matching: The long maturities of infrastructure debt and private placements can also potentially benefit institutional investors. Both private placements and infrastructure debt have long tenors, generally five to 30 years, with fixed-rate debt typically offering a longer average maturity (12–15 years) than floating-rate debt (3–7 years). The long-dated debt is supported by steady, and highly predictable, cash flows. The ability to establish different maturities, backstopped by prepayment protections, makes these private markets particularly effective for asset-liability matching relative to public debt—which often requires long-duration investors to use derivatives, which can be both expensive and volatile, to ensure their liabilities will be met.

Opportunity in Action

ENVIRONMENTAL, SOCIAL AND GOVERNANCE

Environmental, social and governance (ESG) considerations are playing an increasingly prominent role when it comes to both infrastructure debt and private placements, with ESG factors more frequently being integrated into underwriting and investment standards across both asset classes. Sustainability has become a top priority, and that is evident with the attention paid to renewable energy and digital infrastructure. In both the infrastructure debt and private placements market, there has been an increase in green bond issuance as more companies look to address environmental concerns. In recent years, we have also seen an increase in investments that address social needs by improving communities through building projects like hospitals and public housing. Even with the need for additional yield, investors have exhibited a strong commitment to these goals—and in some cases impact bonds may contain penalties for issuers that fail to meet ESG key performance indicators.

2. Moody's; S&P; Barings market observations.

FOR ISSUERS…

For issuers too, financing through the private market has potential advantages, including:

- **The ability to execute a wide range of transactions:** With private placements, for example, volumes can range from $50 million, to larger deals well in excess of $2 billion.
- **Fixed or floating-rate coupons available:** Deals can be structured with either option, giving borrowers much flexibility.
- **No ratings requirements:** Private placement and infrastructure borrowers are not required to obtain external ratings from a nationally recognized ratings organization.
- **Flexibility around maturities, as well as a choice of bullet or amortizing structures:** The debt can be structured or offered in a variety of maturities. There is also the option to have bullet maturities—with interest paid periodically and principal paid in a single payment at maturity—or an amortizing schedule, whereby both principal and interest are paid through periodic payments.
- **Multiple currencies:** If a borrower needs access to capital in multiple markets, they do not necessarily have to do separate deals for different countries. In one deal, a transaction could encompass Sterling, Euro, and U.S. dollar tranches, for example.
- **Delayed draws:** For borrowers that do not need immediate access to capital, but that might be concerned about rate volatility, delayed draws can offer greater flexibility to 'bridge' to upcoming financing needs. With both infrastructure debt and private placements, pricing can be locked in when a deal is done, but it may not have to be funded until some point in the future.
- **Ease of Execution:** Executing deals in these markets can be easier for issuers given that document and disclosure requirements tend to be less comprehensive relative to public markets. Repeat borrowers may also find that raising capital gets easier with each subsequent deal, as they are often able to access the same groups or clubs of investors.

Opportunity in Action

HIGH YIELD AND EMERGING MARKETS DEBT

With both infrastructure and private placements, more institutions are investing in BB debt. While generally riskier, the below-investment grade realm typically offers higher yields, which may compare quite favorably on a risk-adjusted basis with returns in the more traditional investment grade space today. Emerging markets are another area some investors, particularly in infrastructure debt, have considered—as they tend to yield substantially more than developed markets. However, these markets come with additional risks and are prone to heightened volatility, and investing requires careful analysis and selectivity with respect to jurisdiction and projects.

"The ability to establish different maturities, backstopped by call protections, makes these private markets particularly effective for asset-liability matching relative to public debt."

Accessing the Opportunity

Given the potential benefits on offer, it is no surprise that private placements and infrastructure debt have seen surging demand and heightened competition. In the private placement market, for example, competition for broadly syndicated deals has increased substantially. Combined with limited supply, this can lead to tighter pricing for broadly syndicated transactions. By contrast, non-broadly syndicated private placements are typically originated through relationships that are cultivated throughout the industry. These deals often allow for larger allocations and more control over pricing and terms, and may also offer a more attractive illiquidity premium relative to the corporate investment grade market. It's a similar story in the infrastructure debt market, where the low supply and high demand dynamic also persists.

Strong origination capabilities are therefore critical, not only to accessing a broader opportunity set via smaller club transactions, but also to achieving a more diversified portfolio and delivering enhanced value.

What to Look for in a Manager

For investors interested in gaining exposure to the asset class, there are a number of ways to access the opportunities on offer. Historically, large institutional investors have accessed these markets primarily through separately managed accounts, but more funds have emerged in recent years, allowing smaller investors to participate. That said, given that many deals in these markets are directly originated and privately negotiated, selecting the right manager is critical to accessing the opportunity in both private placements and infrastructure debt.

Key characteristics to look for in a manager include:

- **Strong origination platform:** Access to deal supply is without a doubt the 'secret sauce' to outperforming in the private market. A proven origination strategy to underwrite deals seamlessly from the broadly syndicated market as well as more proprietary deal sources is key to achieving growth, name diversification and spread outperformance. While private markets have grown considerably in recent years, they are still relatively small in comparison to public markets—meaning managers that have strong, established partnerships with market participants are often better positioned to find the best pipeline of opportunities and source the highest-quality deals for investors.
- **The ability to structure and price deals properly:** An experienced team knows how to structure deals with covenants that will provide optimal protections for investors, and an experienced manager will bring a better understanding of where the market may be currently moving in terms of pricing.
- **Global presence:** More opportunities are emerging around the world, and it is important to work with a manager who has a foothold in and experience across different countries and regions. That will enable the manager to identify the best opportunities for each client given their particular investment criteria at any point in time.

Conclusion

Private placements and infrastructure debt can offer access to high-quality assets that may provide incremental, risk-adjusted cash returns, particularly for investors able to allocate to illiquid private debt assets. In order to access the broadest selection of investment opportunities, investors can benefit from partnering with experienced managers who have longstanding relationships with key market participants, access to a large and diverse pipeline of opportunities, and the ability to appropriately structure, price and monitor the investments. This access is critical for investors seeking to deploy long-term capital and positions them to capitalize on both opportunistic and fundamental investment opportunities in the growing asset class.

Barings is a $371+ billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

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