KEYNOTE INTERVIEW

Debt's bull case 'remains intact'

Barings' Pieter Welman sees a favourable political backdrop and the urgency of the energy transition trumping the risks of 'crowding' as debt opportunities abound

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Ten years ago, Barings made the decision to set up an infrastructure debt team, initially to handle in-house funds. "We were one of the early investors in this space to set up teams," says Pieter Welman, head of global infrastructure.

As the business grew, the team launched a third-party offering and raised a commingled high-yield debt infrastructure fund. Its focus is primarily on North America and Europe, and with a book worth close to $15 billion now, Welman believes "size does give you an advantage, but it is also important to demonstrate that you have 'flexible capital' and are willing to work with different partners and come up with innovative structures". He surveys the current infrastructure debt scene and finds there is a lot to be positive about.

Q How do you see the current opportunities for credit?

While credit conditions could worsen in coming years, the yields that are currently on offer make the risk/reward equation more attractive to debt investors than has been the case for a while. We have been involved in the asset class long enough to know that it also tends to perform particularly well in challenging conditions – infrastructure debt is a defensive sector with monopolistic characteristics and a very low default and high recovery history.

We believe the sector will continue to perform well during a potentially more challenging economic environment. Higher returns and somewhat tighter structures have been a feature over the last few months, which provide potentially attractive opportunities.

Q How is the current political backdrop?

In Europe, the Russian invasion of Ukraine had an impact on several fronts. Energy security is clearly something which countries will invest in. Several countries have ambitious plans for renewables, nuclear and LNG terminals, for example, as the cost of energy soared last year.

Inflation and rising rates in Europe are also now part of the changing political and economic backdrop, with consumers being squeezed. This could bring about a recession in Europe this year and could have a detrimental effect on investment in infrastructure generally.

The situation is certainly more complicated than it was even a couple of years ago, but in the context of this conversation we believe that the asset class tends to perform well as a result of its inherent defensive qualities.

In the US, the Inflation Reduction Act is a very positive development, in our view, as it gives some much-needed structure around encouraging investment. While there have been some questions as to whether the IRA will draw in vast amounts of capital at the expense of other geographical regions, we don't think the impact will be dramatic. There probably will be more investment allocated to the US in coming years, but there are still vast amounts of capital available for good projects in Europe or Asia, for example.

There is more than enough capital to go around given the current enthusiasm for energy transition.

Q Do you prefer developed markets over emerging ones?

We do have some investment in emerging markets, mainly Latin America, although it is fair to say that we tend to focus more on developed markets. There are fantastic projects in emerging markets and I do think there will be some growth in coming years.

However, we prefer to invest where we have a local presence for smaller projects. This means we tend to focus on larger projects in those regions, where the execution is done out of New York or London, for example. In order to have team members based locally, which would increase our investment volume, there probably needs to be a more consistent dealflow and pipeline, particularly for hard currency investments, which our clients typically want to invest with.

Q Which sectors offer the best opportunities?

There is still a significant opportunity in traditional infrastructure, particularly in the US where there has been a lack of investment for decades, despite the chronic need, but also in Europe and the rest of the world. There are many opportunities, for example, in social infrastructure, utilities, pipelines and digital infrastructure.

However, renewables generally along with transportation sectors look set for strong dealflow in the coming years. With the increasing push from governments, clients and managers for environmentally sustainable investing, we think that this will be an area where there will be increased investment. This includes power generation, of course, but also adjacent sectors like storage and charging.

Transportation also looks set to benefit from these trends as we expect changes in the way people travel and goods trade. For example, the idea of

Q Is ESG an important part of your thinking?

ESG is a big consideration for us across the firm and certainly for us in the infrastructure debt area. We are very fortunate that what we do tends to be ESG positive, whether that is investing in renewables or improving social inclusion.

Because of the strong role that our ESG teams play, we look at environmental, governance and social aspects on all investments and do extensive due diligence. We have a scoring system in place and it is taken into account on every investment decision and then tracked for the life of the investment.

I think sometimes the value of these analyses are overlooked, as one of the key risks of infrastructure generally would be to have a stranded asset. I suspect that one the most likely ways that scenario could unfold going forward would be to have assets that over time do not comply with regulations or social norms. As a result, we do take it very seriously.

having greener trains transporting people and goods instead of cars or trucks is an exciting prospect.

Q Are there any dangers in the rapid expansion of debt providers?

There are always dangers in any rapid expansion, and it is certainly the case that a lot of institutions have in recent times made a push into the sector. This might pose a risk, as there were so few high-profile defaults over the last decade, and it is not clear how the market will react in times of distress. That would be true for any market, though, but institutional infrastructure debt is admittedly a more nascent market than some others.

Complacency is a danger, potentially, but we will see what the future holds. We have not seen a dramatic weakening of terms and structures in the last few years, so although we accept that this is a risk, we believe that the infrastructure debt market will perform well.

Q Clearly renewables are a key part of this rapid expansion, but is crowding a danger there?

Clearly there has been a lot of demand for renewables from institutions, funds and banks. As a result of that, the risk/reward equation for both debt and equity investors probably did deteriorate over the last 10 years.

A cautious approach is critical when there are too many people going into anything at the same time. Overall, though, we think renewables have large tailwinds behind them and we see lots of opportunities across the globe where we can find investments at attractive yields.

Q Is the same true of digital infrastructure?

To some extent. Digital is an attractive and fast-growing sector in infrastructure and we have invested in some fibre deals and data centres. The sector also benefits from tailwinds, so it is the same in that regard. I also think there is an argument for the social benefit that expanding internet coverage provides.

However, it is a sector where the risks vary greatly from one asset to the next, or from one market to the next. That is obviously true for other sectors too, including renewables, but in our opinion the assets and markets vary more from one to the next in digital infrastructure.

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Q What keeps you up at night as a debt investor?

Overall, I am sleeping relatively well! In the short term there may be some uncertainty, and there are elevated risks compared to even 12 months ago, but we believe infrastructure remains well-positioned to perform well over a longer time horizon, particularly given the strong transition theme that is under way.

I guess my biggest concern is that, overall, there is a lot of leverage in the system. Not necessarily only at the individual project level, but throughout the financial system. I do worry about what a rapid rise in interest rates may do and what impact that could have on the assets themselves.

Other things that concern me are whether our expectations of a shallow recession prove to be too optimistic or economic risks increase even further. If the recession – that seems difficult to avoid at this point – is actually more prolonged, or rates rise even further as inflation stays stubbornly high, that certainly could be an issue for some assets.

Finally, I think that distress can manifest itself through, for instance, a contractor or operator or off-taker of an asset that might get in trouble instead of the project or asset itself. That risk and its impact is sometimes harder to predict than the risk of the asset itself.

I am hopeful, though, that the asset class in general will perform well in coming years. ■