INVESTMENT INSIGHTS

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Should you consider an allocation to infrastructure debt?

As equity and fixed-income markets face growing headwinds, infrastructure remains an asset class that can offer institutional asset owners the potential for attractive risk-adjusted return. What's more, infrastructure debt can help plan sponsors who are looking for assets to match their long-dated liabilities. The opportunities in infrastructure debt have never been better — as long as you have the right partner, explains Emeka Onukwugha, head of Barings' Private Debt Group.

|Pensions & Investments| ***What does the infrastructure investment universe look like today, and how has it changed over the last year?***

|Emeka Onukwugha| The changes have been in how intense the competition for core assets has become, combined with what we see as very high asset prices. And this is now taking place against the backdrop of lower growth in the U.K. and Eurozone, along with higher volatility and uncertainty in the global equity markets.

Infrastructure debt can offer benefits in terms of both diversification and the potential for alpha. A key point is that the full benefits are only possible if you have the ability to originate these transactions.

Generally we are seeing an increased appetite from institutional investors.

|P&I| ***What impact does the macro environment have on infrastructure investing?***

|Onukwugha| When you think about infrastructure investing, the need for developed and developing economies to upgrade, as well as invest in new infrastructure is constant. We view infrastructure as a defensive investment given the inelastic nature of the demand for services from most projects we invest in. An economic slowdown will have some impact on [gross domestic product]-linked assets, such as airports, toll roads and ports; however, in our view, the overall impact will be minimal given the importance of these assets to the communities and economies they service. This is based on our historical experience with our portfolio during prior economic slowdowns.

We tend to spend more of our time worrying about the legal system within the jurisdictions that we operate in, rather than the macro outlook.

|P&I| ***Tell us specifically about the infrastructure-debt market and why it's so interesting to institutional investors right now.***

|Onukwugha| For most investors in the space, it's really an extension of their fixed-income strategies. For liability-driven investors, such as life insurance companies, it provides them with the long-lived assets needed to match their long-dated liabilities.

Infrastructure has very low default rates and high rates of recovery in case of a default. It may also allow you to earn better risk-adjusted returns than you might elsewhere.

|P&I| ***Where are the greatest opportunities by region outside the U.S.?***

|Onukwugha| When you look at Europe, we find more opportunities in the renewable space, mostly in wind and solar. We continue to see interesting opportunities in terms of pricing from some of the peripheral countries such as Spain, Poland and Hungary.

In Australia/New Zealand, the opportunity is our ability to provide long-term financing solutions in a market that's largely dominated by banks and used to refinancing risk given short-term bank loan tenors.

In emerging markets, where the need for infrastructure investing is more pronounced, we tend to pick our spots since not all jurisdictions are the same, and performing proper, intense due diligence in terms of the legal system and creditor rights is of paramount importance. This is where having an experienced manager with global reach and resources becomes critical.

|P&I| ***What about the U.S. — has President Trump's stated interest in infrastructure translated into new projects?***

|Onukwugha| The Trump administration has been keen to attract more private capital into the core infrastructure space to help modernize and invest in new facilities. The short answer is we're not seeing it, not yet anyway.

The real work for a successful infrastructure plan takes time. It has to be embraced at all levels, from municipal and county to state and federal. It will require streamlining the approval process that takes too long at all levels of government. That means that the plan will have to wind its way through Congress, the state and the local communities.

|P&I| ***Greenfield vs. brownfield opportunities?***

|Onukwugha| The reality is that greenfield opportunities have been few in the past year and half. It takes a lot of time to develop, and for the planning and permitting process needed for any new major infrastructure projects to get to the financing and construction phase. You have to have started it five, six years ago for some of those projects to be on the books today. In Europe, the financial crisis and a lack of political will from a number of coalition governments have also hampered the development of new projects. For these reasons, the pipeline has been very weak and disappointing.

More actionable opportunities can be found in the brownfield space, in the form of refinancing of existing transactions and some M&A activity.

|P&I| ***How do institutional investors resolve their need for increased access to deal flow?***

|Onukwugha| Institutional investors can access deal flow in two ways: They can come at it through the syndicated market, in which case they compete with everybody else on the few available transactions, which tend to be oversubscribed; or, they can be more active in sourcing transactions where they add in origination.

We think successful active management today has to involve origination. To do so, you have to have specialized investment capabilities, and expertise in structuring and advisory roles. In our opinion, you have to have local contacts. You can't add alpha given the high asset prices without having that origination capability.

|P&I| ***Why are partnerships between management and clients so important when it comes to infrastructure?***

|Onukwugha| By partnership, we mean the level of trust that has developed between an asset manager and an institutional client. This takes time to build. It requires a true understanding of the investment needs and the risk tolerance of the client. Once established, it opens up a lot of doors for the investment manager in terms of their ability to really put money to work on behalf of that client.

|P&I| ***How can managers and clients achieve a mutually beneficial relationship in terms of outcomes and economics?***

|Onukwugha| Again, it comes down to the depth of that relationship between the asset manager and the institution, and trust. It's almost like a dance between two elephants as the manager and institutional client learn to work together.

We believe infrastructure debt is a great alternative to core fixed income in today's environment, especially for liability-driven investors. It can offer diversification, downside protection and low correlations with other assets.

To access all of those advantages I spoke about, you really need an asset manager that has a global reach as well as the expertise to originate transactions. The ability to look across the globe and find pockets of relative value is critical to finding alpha in today's market.

We think that overall this space is special, and the debt side remains very positive today. ■

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