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INSIGHT

Finding attractive relative value in sub-investment grade infrastructure debt

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DEBT INVESTMENTS

Infrastructure assets are used by billions of people globally, providing essential services to everyday life. This pattern of consistent and well-understood use tends to support cyclically resilient revenues and strong credit profiles when compared to other industries.

Many investors seek to mitigate the business and financial risks associated with infrastructure debt by primarily targeting the investment grade[2] segment of the market. Such instruments are deemed to have a low risk of credit default by rating agency methodologies. This includes debt rated BBB- or higher by Standard & Poor's and Fitch, or Baa3 or higher by Moody's. Returns in this part of the market are resilient, but they are also constrained by the relatively low level of risk that investors are assuming.

We believe it is possible to generate higher returns by investing in sub-investment grade infrastructure debt where credit spreads on offer in the current market environment typically range between 400-600bps. We believe this represents good risk-adjusted value if the higher credit risk is well understood and appropriately balanced when both business risks and financing structures are taken into consideration.

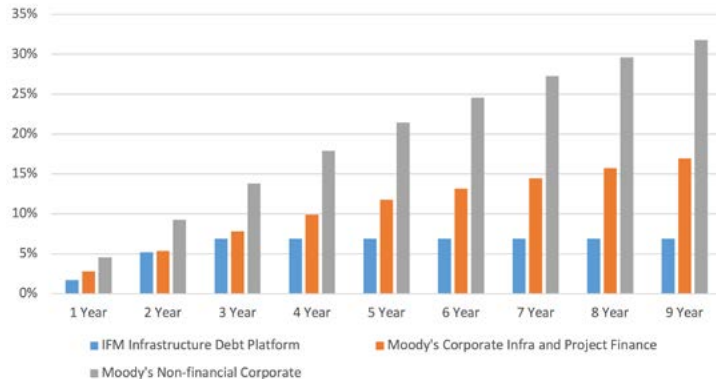
Default rates and credit risk

One of the interesting features of the infrastructure debt market is that when moving just below investment grade, infrastructure assets tend to have much lower credit default rates than similarly rated non-financial corporates over time[1]. We believe this is a feature that can provide strong diversification and help underpin risk-adjusted returns during a cyclical slowdown.

Our analysis using IFM's proprietary sub-

[1] Moody's Infrastructure Default and Recovery Rates (1983-2020), 7 September 2021. IFM cumulative default rates have been calculated using the sub-investment grade deployment history of IFM's Infrastructure Debt Team globally since 2013, using the same definition of default as Moody's.
[2] BBB- or above as rated by Standard & Poor's

FIGURE 01 SUB-INVESTMENT GRADE CUMULATIVE DEFAULT RATES



Source: Moody's and IFM Investors

investment grade transaction data since the globalisation of the platform in 2013 shows an improved default rate compared to both the infrastructure lending and non-financial corporate results as compiled by Moody's as shown in Figure 1[3]. We believe this reflects the strength of our due diligence process and our ability to assess and trade-off the multiple risk factors associated with each transaction.

Navigating the trade-off between financial risk and business risk

To protect against default risk when considering sub-investment grade investments, we think it is important to determine if the risks associated with moving down the credit spectrum to generate higher returns are worth taking. In our experience, it depends on a detailed assessment of two factors: business risks and financial risks.

We may agree to accept incrementally higher financial risk (such as structural subordination via HoldCo financing) if the business risks of the investment are relatively low and consistent with those found in investment grade assets. Similarly, we may accept incrementally higher business risk if we feel well protected in the financial structure of the transaction (i.e. a senior debt position or low levels of leverage).

The two case studies below provide examples of how we consider the trade-offs between these factors prior to investing in sub-investment grade opportunities to assess whether we are being compensated for the incrementally higher overall risk being taken relative to investment grade debt.

CASE STUDY

Accepting incrementally higher business risk if the financing terms are sound

Battery storage asset

Energy storage investments (e.g. batteries) are required to help stabilise energy grids globally. They are critical infrastructure to help enable an increasing supply of renewable energy to be used beyond the time it is generated. This investment was a US greenfield 'front-of-the-meter' battery energy storage system. Once operational, the project is expected to be the second largest US battery storage system and will provide important flexibility and reliability to California's electricity grid.

There were several mitigating factors that helped us get comfortable with the risks associated with the project, including a 20-year fixed price resource adequacy contract with one of the largest utility companies in the area, a fixed price construction contract and a 20-year operation and management services agreement with a top-tier battery supplier and operator. The project plays an integral role in allowing the Californian Independent State Operator (CAISO) to meet its renewable energy target by 2045.

From a financial risk perspective, we invested in the senior-secured debt issued by this project, which made the opportunity more attractive. Senior debt usually has the first claim on the company's cash flows in the event of an adverse situation. It is more secure than subordinated/junior debt as it is usually collateralised by the project's assets/rights.

[3] Moody's Infrastructure Default and Recovery Rates (1983-2020), 7 September 2021. IFM cumulative default rates have been calculated using the sub-investment grade deployment history of IFM's Infrastructure Debt Team globally since 2013, using the same definition of default as Moody's. Past performance does not guarantee future results.

CASE STUDY

Accepting incrementally higher financing risks if the business risks are sound

Ferry Service

This investment was debt financing to facilitate the purchase of a majority share in a short-distance, high-frequency ferry between Germany and Denmark. The two ferry routes had been operating for 20 years as an alternative to slower and longer road routes between the two countries. There was Operating Company (OpCo) debt that was given an investment grade rating (BBB/Stable) by Fitch.

We were willing to accept incremental structural financing risk by investing in the Holding Company (HoldCo) debt which is junior to any OpCo lending. We accepted this subordinated position because of our strong assessment of the business risks associated with the investment, including:

- the high barriers to entry associated with the ferry business, enhanced by the company's ownership of the ferry terminals as well as the ferries
- the captive regional market
- the strong historical track record of performance over 20 years, including economic downturns.

In addition, we felt the key risk of decreased traffic (volume risk) on the ferries was mitigated by the ability of the operator to implement a flexible fare framework. This allows it to optimise revenue, even during economic downturns when ferry use had historically decreased. Historically the ferries had robust demand from both personal and commercial vehicle traffic, which provided beneficial diversification during the COVID-19 pandemic when personal vehicle traffic was light and commercial vehicle traffic remained robust.

We also believed that the development of a tunnel along a similar route would not begin to disrupt ferry demand until at least 2029, far beyond the scheduled repayment of principal and interest from the loan. The amortising nature of the loans would also help reduce risk over time by paying back principal sooner than a non-amortising bullet structure.

This investment was rated BB based on our own internal ratings methodology[3].

[3] Indicative Ratings provided are IFM Internal Credit Ratings. Full methodology available upon request.

Conclusion

We believe the resilient nature of infrastructure debt investing extends to the sub-investment grade segment of the market, where reliable income can be generated by investing in critical infrastructure assets. It is important to understand and mitigate the incremental business and financial structuring risks when making sub-investment grade investments to help deliver attractive risk-adjusted returns to investors.

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