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INSIGHT

How pension funds can help lend to the real economy

A decade after the global financial crisis opened up the project finance market to direct institutional capital, we believe there is a growing opportunity for pension funds to support firms with their growth ambitions and invest in the real economy.

By David Cooper

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DEBT INVESTMENTS

Today, firms seeking to finance an infrastructure project by raising debt have a broad range of financing sources including banks, but also direct investors such as insurance firms and, increasingly, pension funds. This growth in the type of lenders for infrastructure project finance following the 2008 financial crisis has facilitated increasing levels of direct investment in the real economy, and provided a new source of yield for these direct investors. Infrastructure debt may also appeal to existing and prospective investors due to its relative security of capital and potentially improved risk/reward characteristics compared to other

forms of corporate debt¹. However, investing in project finance has its own unique set of challenges and risks which should be thoroughly understood and addressed in order to benefit from these potential advantages. IFM Investors has been allocating to infrastructure debt for two decades and, as an experienced project finance practitioner, can share many insights in this area. It is important to define what we at IFM Investors mean by Infrastructure Debt. Establishing a common understanding is important, as the definition may vary from manager to manager. IFM Investors defines Infrastructure Debt primarily by a set of

¹ Moody's Infrastructure Default and Recovery Rates, 1983-2017 (published September 27, 2018); Moody's Default and Recovery Rates for Project Finance Bank Loans, 1983-2015 (published March 6, 2017); Moody's Special Comment: Annual Default Study: Corporate Default and Recovery Rates, 1920-2013.

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characteristics that differentiate it from the wider corporate credit market. As a result, we only classify an investment as Infrastructure Debt if it demonstrates a relatively low probability of default; stable credit ratings throughout the cycle, and high recovery upon an eventual default. Typically our investments fall within what most managers and investors would view as mainstream, core, infrastructure – i.e. social infrastructure, transport, energy and utilities.

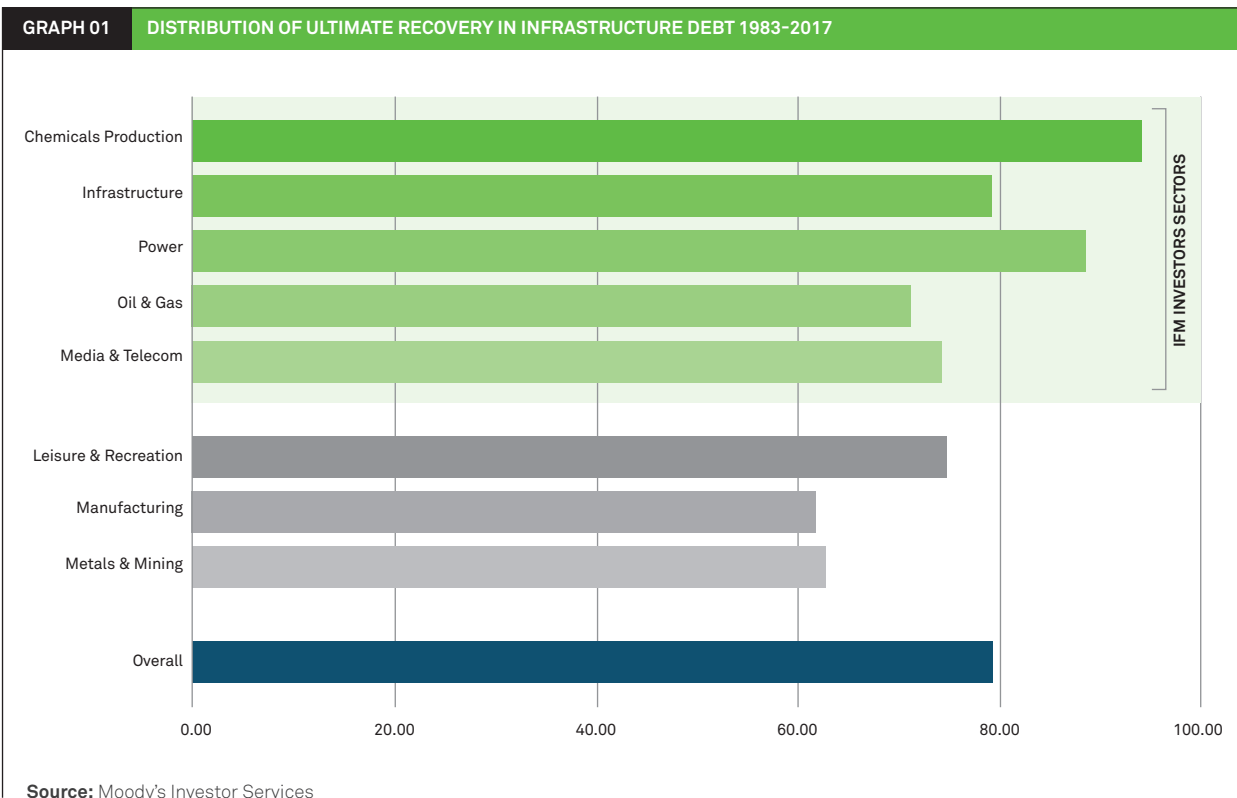
Whatever the definition, we believe the main aim of managers should be to identify opportunities to provide debt to infrastructure that is relevant and important to the society and economy economy in which it operates. It is important that this test is passed not only at the point of investment but also through the life of the asset. This caveat is crucial. Whilst it is relatively easy to spot the white elephants of today, it is more difficult to spot those of tomorrow, especially in our world of intense, rapid technological change. Generally lending to essential community assets underpinned by proven technology can alleviate this risk.

Changes to the Status Quo

Looking back to a time prior to the collapse of Lehman Brothers, the lending landscape was quite different. A firm looking to finance a project by raising debt had limited options. For any project still in the construction phase, in most cases, the shareholders would rely on their principal banking relationships, who were generally happy to supply 30-year finance at tight margins with no prepayment protection. Otherwise, such firms could turn to the monoline project finance specialist¹ wrapped bond market, where margins were even thinner, and firms had to pay to ‘borrow’ the monolines’ ‘cast iron’, triple A rating. The only real alternative shareholders had to these two options was the relatively new and exotic world of unwrapped bonds, or the pursuit of a US private placement. Potential direct investors were generally excluded from this market.

This status quo changed with the onset of the Global Financial Crisis. Monolines went out of business as their cherished ratings turned to dust – albeit not as a result of their infrastructure exposure. Meanwhile, banks realised that short-term borrowing to extend long-term loans was only

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¹ Specialising in a single financial services line or discipline.

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sustainable if you can guarantee 30 years of endless, cheap liquidity. The liquidity crunch of 2008 proved this was not the case. The door was being opened to new sources of capital.

Once the dust from the liquidity crisis began to settle, direct institutional investors began to take interest in the sector being vacated by banks. The first movers in this market were large insurance companies. This outcome meant the initial focus of virtually all infrastructure debt strategies was on creating long-dated, fully investment grade assets ideal for regulated liability matching investors. Such a singular focus would present investors with only one facet of the infrastructure debt universe.

It is our contention that this singular focus predominantly on fixed rate, longer-dated infrastructure debt has obscured the view of shorter-dated and higher yielding opportunities. Many UK pension funds are not sufficiently aware of the breadth of opportunities available within infrastructure debt, missing out on a whole panoply of other opportunities in, for example, floating rate or sub-investment grade credit. We believe taking advantage of a pension fund's ability to provide long-term capital to the real economy whilst avoiding competing with Solvency II regulated investors can be the key to unlocking this opportunity.

Crossover Credit

As a global investor, IFM Investors has frequently found that some of the most compelling opportunities, when examined for their relative value, are in the world of crossover credit – the nexus between BB

and BBB credit. This is the boundary where banks and insurance firms are exposed to substantive increases in regulatory costs. As a result, deals falling the wrong side of such a boundary often generate a significant premium over and above what could be considered reasonable for the increased risk compared to its investment grade cousin.

Through our conversations with UK pension funds about this segment of the market, we have found there is a frequent misconception that BB credit automatically means unsecured, subordinated or emerging market debt. This runs counter to our experience. Typical transactions below BBB- which IFM Investors has allocated to have been senior secured debt in high income OECD countries. Obviously there are limits as to how far down the credit spectrum the positive attributes associated with infrastructure debt persist. At some point debt may become equity – but with none of the upside.

Whilst much of the early interest from institutional investors came from insurance firms with a natural demand for fixed rate debt, the majority of infrastructure debt is floating rate. Floating rate infrastructure debt can act as an important diversifier for investors who might be over-exposed to fixed rate debt. As institutional investors, including UK pension funds, face the prospect of a rising rate environment, floating rate infrastructure debt may be able to mitigate some of that risk. Floating rate investments can also provide a level of inflation protection, even if the link between Libor and the Consumer Prices Index in the UK may not be as strong as it once was.

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The Green Premium

The market for infrastructure debt assets with a direct inflation link is far smaller than it was pre-2008. Opportunities are generally found in only a small number of sectors – particularly renewables. Renewable investments are often investors’ principle focus when considering lending to projects with environmental, social and governance (ESG) credentials, noting this focus may result in sector concentration. We also observe that ESG assets are in demand, often resulting in a “green premium” where they deliver lower returns relative to comparable non-renewable projects.

In our view, ESG should be at the heart of all infrastructure investments. However, it is often difficult to determine what constitutes green and sustainable, even in seemingly the simplest cases. Evaluating the ESG credentials of a project demands detailed research and a strong understanding of the underlying asset as it may not be sufficient to assume that something badged as ‘green’ or ‘sustainable’ will be entirely without issues.

In the UK, for example, High Speed 2 appears to have some strong green credentials, given the amount of traffic it should take off various congested motorways. However, its construction will involve millions of tonnes of concrete and hundreds of miles of steel; it will also involve hacking through 19 ancient woodlands and a dozen Sites of Special Scientific Interest. Even seemingly

innocuous wind farms can ruin cherished views and effect migratory paths for wildlife. Therefore, we believe that when considering providing infrastructure debt to renewable and ESG projects, investors and managers should consider the range of risks to which they might be exposed.

The infrastructure debt universe is broader than many UK pension funds have realised. Whilst we would argue that direct investment in project finance should be supported by an experienced investment manager such as IFM Investors, opportunities exist, and not solely in the narrow world of long dated, investment grade, fixed rate, and quasi-government credit. Taking advantage of the regulatory constraints of other institutional investors can allow pension funds to invest in the real economy and generate meaningful potential returns for members. Infrastructure debt has the potential to provide security beyond corporate debt, whilst its floating rate characteristics can provide diversification in times of rising rates. An allocation can provide global opportunities or can be focused on specific sectors and geographies. But it is important to remember that the debt market is deeper – and more interesting – than the layman might assume. ■



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