INSIGHT DEBT

IFM Investors

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# Opportunities, trends and what the future holds

## Interview with

**Rich Randall**
Executive Director, Global Head of Debt Investments,
**IFM Investors**

**David Nadelman**
Managing Director, Loan Capital Markets,
**RBC Capital Markets**

**By Isabel O'Brien – Infrastructure Investor, PEI**

### Intro

The infrastructure debt market has experienced significant changes and growth over the past decade. The US market alone has consistently seen a deal flow of around $150-$200 billion per year. Recent years have witnessed growth in three key areas: digital infrastructure, energy transition assets, and natural gas.

Growth in the digital arena, particularly data warehouses, has been driven by advancements in technology and recent legislation. This has created new assets and technologies that require infrastructure investment. Additionally, the Inflation Reduction Act and the increasing need for energy security have led to a resurgence in natural gas infrastructure projects.

Traditionally, banks have been the primary source of capital for infrastructure projects due to their ability to provide committed capital over time. However, the rise in interest rates witnessed over the past two years, coupled with with increased sustainability concerns, have caused many banks to pull back from infrastructure lending. This has resulted in a smaller pool of capital available for infrastructure projects.

In response to the changing landscape, infrastructure debt investors have become an important source of dedicated capital to a market in need of backers to fill the space left by traditional bank lenders. These non-bank lenders are also more willing to participate in both fixed and floating rate debt, providing flexibility for borrowers.

QUESTION

## How would you characterise the landscape of infrastructure debt and its transformative journey?

ANSWER

**Rich Randall** - Tightening of liquidity from traditional providers has led to an influx of deal flow into the non-bank lending market, creating opportunities for institutional investors.

Commercial banks have also shifted away from financing natural gas and fossil fuel-related investments due to sustainability concerns. This has created a significant flow of business in the refinancing of existing natural gas assets and the development of new projects, particularly in the liquefied natural gas (LNG) sector. Insurance companies, on the other hand, are seeking to rebalance their portfolios by reducing exposure to private assets and increasing investments in public assets, presenting investment opportunities in various sectors, including renewables.

The term loan B market, which traditionally hasn't been heavily involved in single-asset infrastructure debt, is also experiencing changes. Many collateralised loan obligations (CLOs) are reaching the end of their investment lives and facing a closed reinvestment period. This creates a favourable opportunity for investors to step in and invest in infrastructure projects.

Despite the tightening liquidity, there has been a significant influx of deal flows in the infrastructure debt market. This trend is expected to continue for the next 24 months, providing a favourable investment window for institutional investors looking to capitalise on opportunities.

> **Infrastructure debt funds are great because they're specialised, they understand the asset class, and they have capital that is dedicated to infrastructure lending.**
>
> **David Nadelman**

QUESTION

## David, what are your expectations for yields over the next five to ten years?

ANSWER

**David Nadelman** - Over the next five to ten years, we anticipate a number of developments will impact yields in the infrastructure debt market. Firstly, base rates have shown significant fluctuations over the past years, following the establishment of SOFR and LIBOR rates at relatively low levels initially. However, these have now risen to around five and a quarter per cent for three months SOFR. This substantial increase in base rates will undoubtedly influence the overall yield landscape.

Another critical aspect affecting yields is the credit spread, which is influenced by the type of lender involved. Fixed-rate lenders seeking minimum returns are closely tied to the base rate. As base rates are currently high, these lenders can accept smaller credit spreads to meet their target yield, as opposed to a scenario where base rates are lower, and they need to demand larger credit spreads.

In contrast, floating rate lenders are more sensitive to credit risk appreciation. Even if the credit quality of an infrastructure asset remains the same, the perception of lenders regarding the overall credit environment can significantly impact credit spreads. In recent times, due to the decline in sources of capital, there has been a supply-demand imbalance, resulting in higher demand for capital compared to available supply. This, in turn, has driven yields up.

Moreover, the credit environment itself has witnessed turbulence, with the bank market experiencing a rocky period, higher default rates, and predictions of further defaults in the future. These factors contribute to a negative credit environment, leading to an upward repricing of credit spreads for individual assets, even if their credit quality remains stable.

Considering these factors, the overall yields for infrastructure debt are significantly higher than they were just a few years ago. However, projecting the specific trajectory of yields for the next five to ten years remains uncertain, given the constantly evolving economic conditions and market dynamics.

QUESTION

## It's clear that the need for financing large-scale infrastructure projects is undeniable. Do you believe the private credit market has the capacity to fill the financing gap left by banks, and what fundraising efforts might be necessary?

ANSWER

**Rich Randall** - Private credit has the potential to step in. While historically quiet, it has gained visibility over the past decade, becoming a significant player in the institutional market. As banks and insurance companies retreated from sub-investment grade debt post-financial crisis, private credit, especially in the mid-market, rose to prominence. As institutions become more familiar with infrastructure debt, it will likely emerge as a competitive and rational asset class within portfolios.

> **Infrastructure debt is a natural diversifier to corporate debt. It is a defensive asset class that performs through all market cycles, given its fixed revenue streams, low loss rate and monopolistic nature.**
>
> **Richard Randall**

QUESTION

## What would be the best approach for investors looking to navigate the infrastructure debt space?

ANSWER

**Rich Randall** - Institutional investors understand the unique characteristics of the asset class and its role within a broader portfolio. Infrastructure debt can be positioned as a defensive asset class, offering diversification from corporate debt and performing well through all economic cycles.

One way to approach the market is to view it as a subset of the broader corporate debt market. Investors can leverage their experience in direct lending and private credit to navigate the infrastructure debt space. Infrastructure debt offers a low-risk investment with low default and loss rates compared to the broader corporate market.

Investors should also consider the illiquidity premium associated with infrastructure debt. The stable and reliable income stream, coupled with this illiquidity premium, can offer attractive yields.

When considering infrastructure debt investments, assessing the credit environment and the specific risks associated with each project is crucial. The credit spread, which reflects the appreciation of credit risk, should be carefully evaluated. Additionally, the overall economic and political environment should be taken into account, as these factors can impact the performance of infrastructure assets.

Approaching the infrastructure debt market requires a thorough understanding of the asset class, its unique characteristics, and the changing landscape of capital providers. By leveraging their experience in direct lending and private credit, institutional investors can capitalise on the opportunities in the infrastructure debt market and contribute to the financing of critical infrastructure projects.

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