KEYNOTE INTERVIEW

Infra debt has a bright future


As competition increases, infra debt has the potential to shake off its 'niche' label, say Alter Domus's global head of real assets Anita Lyse and director of debt capital markets Laurent Fudvoye

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Q Why are investors increasingly drawn to infrastructure debt?

Anita Lyse: It is important to first take a step back because infrastructure debt is attractive for many of the same reasons that make infrastructure appealing more broadly. The asset class is attractive from a portfolio diversification perspective and by its very nature is a long-term investment. There is also often less volatility, and it is less subject to short-term market sentiment. Infrastructure is an asset class that typically provides secure, stable and long-term cashflows.

Infrastructure also provides essential services on long-term contracts and consumer demand is strong through economic downturns, similar to what we are experiencing now. The asset class is viewed as a safe investment with decent returns, offers a natural hedge against inflation and has moderate risk.

The picture is much the same for infrastructure debt, except since you are investing in debt as opposed to equity it is a little lower on the risk curve. There might be some variance to that, depending on whether the debt strategy favours senior debt or mezzanine debt, but you still see a lot of the same benefits from infrastructure debt as you would from equity.

Laurent Fudvoye: Resiliency is the word I would use to describe private debt in general and infrastructure debt in particular. Back in 2014, private debt was seen as a new emerging asset class. Since then we have experienced a few challenges such as the pandemic, and now this inflationary environment. Through this entire period, private debt has proved to be very resilient and there has been a growing allocation from LPs to the asset class. By nature, with floating rate interest components and a strong security package, debt instruments are seen as very low risk and we continue to see more and more players entering the market.

Q How competitive is the space becoming?

LF: We are definitely seeing greater competition, especially given the macroeconomic backdrop and the need to find the best deals on the market. There is also appetite among investors for a more diversified portfolio. Infra debt may still be quite a niche for the time being, but there are lots of new entrants emerging and good opportunities for GPs.

AL: Infrastructure has become the darling of many different types of investors and managers in recent years, due to many of the reasons already discussed. Research suggests that infrastructure will see the largest growth of any alternative asset class in the years ahead.

We may be reaching an inflection point, in Europe particularly, where infrastructure assets under management are expected to outgrow both real estate and private debt, leaving the asset class behind only private equity in the alternatives market. That is something that we have been seeing this year across our own portfolio. It has been an extremely strong year in terms of opportunities, and we have recorded a 50 percent year-on-year increase in new business.

The same thing is happening with infrastructure debt. It is a sub-asset class primed for very strong growth in the next few years. We have had infra debt funds in our own book of business for quite some time, but it is safe to say the number of them has doubled in 2022.

There is a lot of interest and a lot of attractiveness around infra debt, and with that comes increased competition and more players in the market – they will all need to find deals to deploy capital raised.

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>
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Q How much do managers' back- and middle-office operations need to adapt when dealing with infra debt funds?

LF: There are some challenges from a purely operational point of view. The setup is slightly different when dealing with an equity versus debt strategy. We can see some players that have strong knowledge on infrastructure as a specific underlying strategy, but maybe less as a debt-related instrument.

Typically, when you are investing through loans, it means additional cashflow management, specific income fees attached to those loans, etc. As a result, it's key to follow the portfolio of loans and the portfolio of assets in a slightly different way compared to what is done for pure infrastructure funds.

This means that from a loan administration and portfolio overview perspective, back- and middle-office functions need to adapt. The right teams and systems need to be in place either internally or externally.

The relationships with different borrowers are also key. There is a need to gather the underlying borrower data and make it readable. Building specific valuation loan models also requires specific expertise.

AL: It is not particularly complicated, but it is not to be underestimated.

Q What are the foremost challenges lying ahead for the infra debt market?

LF: Risk is quite similar across the traditional asset classes: inflation, energy, salary costs and what is happening in the East are the elements that are creating uncertainty in the market, and currently there is a degree of 'wait and see' adopted by certain LPs.

AL: There are operational challenges that are naturally important to us as fund administrators. There is also the competition element previously mentioned. It is not just around infrastructure; we are seeing this across the board. There are fewer assets, a lot of dry powder and plenty of fundraising. The question is where are we going to deploy all that money? Infra debt is still quite nascent and from several angles it has a long way to fully mature. It will certainly be very interesting to see how this market develops over the next five to 10 years.

Managers that are maybe new to a debt investment strategy will need to adapt how they operate and make sure that their back and middle office is set up for that. We are always highlighting the importance of having solid technology in place and skilled teams and resources, either in-house or externally.

As the market matures, managers and all sorts of external parties will mature in a way that makes much of this more mainstream. Entrants will become more and more familiar with the differences and become experts in how they manage things.

Q Net-zero pledges may have shone a spotlight on ESG and greater sustainability. But how do you see that dynamic shaping the infra debt

market?

AL: People are still getting to terms with what ESG means. Managers are adjusting to the new regulations and there are probably going to be additional regulations emerging in the future. Regulatory reporting around ESG is one thing, and then you have to consider what investors want to see and how managers approach ESG from their own corporate perspective.

ESG is a work in progress today and the industry is still defining what it should mean tomorrow. Some people are very focused on the 'E'. Infrastructure is naturally very focused on the E, but there are also the 'S' and the 'G'. What do we do with those? Some firms are more advanced on that than others. But the push for net-zero strategies suits infrastructure and that is also what helps build up the momentum we see around infrastructure today.

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>
> **Anita Lyse**

LF: Almost all new funds are Article 8 or 9 compliant. ESG is now integrated at the level of most, if not all, managers in terms of investment criteria. Where there is still room for improvement, it is about how proper tracking can be put in place to assess and measure progress. This is especially the case in private debt, in case borrowers are boutique or small yet need to provide data or track broad sustainability on their side. It is a challenge to get together what needs to be collected.

Q How do you see LP appetite for ESG and sustainability evolving?

AL: We have all seen ESG come to the forefront over the last couple of years, probably accelerated by the pandemic. It used to be something nice to have not that long ago, but it has clearly become a must have today. There are certain asset classes that are a natural fit. Infrastructure is undoubtedly one of them, and especially when you look at the energy transition. The drive towards a net-zero future is here to stay.

Standardisation is very important, too, because investors want something that they can benchmark against. I think in the future we will see the same things happen in infrastructure as we have seen across asset classes, real estate included, where there has been a constant drive towards standardisation. The ultimate goal is being able to compare apples with apples.

How should we measure ESG? There is no single standard answer to that today and perhaps there never will be, but there needs to be some kind of common understanding so that investors can look at a teaser, or a term sheet, that includes certain ESG criteria and be able to compare like for like. Investors will want to know this information and the industry is heading in that direction, but it is going to take time. ■