From bridges to broadband: building opportunities in infrastructure debt

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Propelled by governments' bid to support the economic recovery from Covid-19, booming demand for digital services and the push to a greener economy, infrastructure spending is ramping up. That should create opportunities for institutional investors seeking stable, long-term cash flows.

Key takeaways

- As a portfolio diversification option, infrastructure debt has much to offer investors and the long-term prospects look strong: USD 94 trillion of investment is needed by 2040
- While transport infrastructure is gradually shaking off the effects of the pandemic, rising interest rates will present fresh challenges for companies and projects
- Batteries, hydrogen and biofuels are areas to focus on within the green economy as such investments are usually financed by debt
- Digital infrastructure offers significant opportunity as countries like Germany and the UK catch up in the shift to fibre-optic broadband

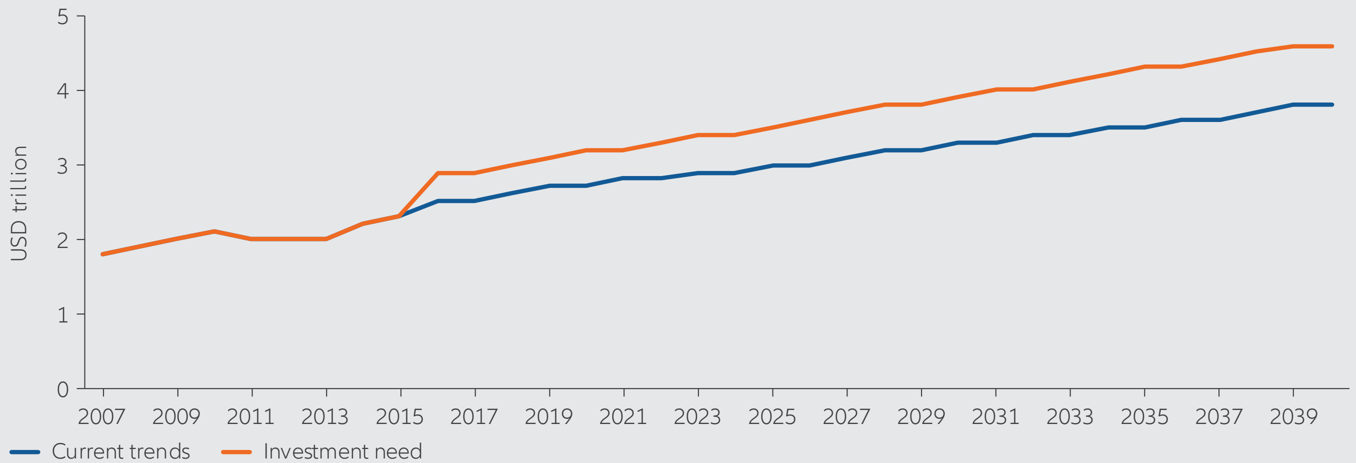
From financing bridges to broadband, infrastructure debt is a growing asset class with much to offer investors. As well as its built-in illiquidity premium – an additional compensation for investors in return for tying up investment in an asset that cannot easily be converted to cash – infrastructure debt also offers portfolio diversification opportunities and a tangible way to boost economies and improve societies. And the long-term prospects are strong. Global infrastructure investment needs to rise to USD 94 trillion by 2040 to keep pace with economic growth and meet the UN Sustainable Development Goals, estimates the G20 Global Infrastructure Hub (see **Exhibit 1**). To seize the opportunities in the infrastructure-debt realm, we suggest that investors focus on five areas – from rising interest rates to regulation.

1 Rising interest rates pressuring borrowers down the road

When financing a company or project, investors need to consider what the terms might be in the future when repayment is due. Issuers have taken advantage of the low interest rate environment of recent years to increase leverage.

Higher interest rates could pose a hurdle for many companies – including those in the infrastructure sector – that need to refinance their debt in an environment of much higher interest rates. Will they then be able to service their debt while maintaining their investment grade status?

Exhibit 1: Global infrastructure spending: current trends vs investment need



Source: Global Infrastructure Outlook outlook.gihub.org

At the same time, even though rates are on the rise, we're still in a low-yield environment. Under these conditions, infrastructure debt can still provide significant benefits to investors with a buy-and-hold mentality. Infrastructure projects are inherently long-term illiquid sustainable assets, and their illiquidity premium may provide superior yields to many sovereign or covered bonds.

How we can help

As one of Europe's first infrastructure debt financiers, Allianz Global Investors has the experience to carry out the necessary due diligence to manage risks and understand how these conditions may impact our investments. With our focus on longer-dated duration assets, we seek to actively navigate the potential for rising interest rates by putting in place structural protections that can provide capital stability to investors.

2 Infrastructure projects hurt by Covid-19 should recover – but gradually

Passenger traffic came to a virtual standstill when the pandemic broke out, hitting transport infrastructure. Many airports, toll roads and other "essential assets" did not have sufficient ongoing cash flow to continue servicing their debt.

In some cases, shareholders have been asked to step in, while other companies have had to negotiate with their banks to extend the liquidity line or draw on existing credit lines to bridge this period. Therefore, the liquidity position of these assets is a key factor. Consider these different sectors:

- **Airports:** passenger numbers are likely to recover to pre-pandemic levels, but airports with a high share of intercontinental traffic will need more time. We expect the impact on airports to continue for three years before possibly returning to 2019 levels.
- **Road traffic:** traffic volumes fell by 90% during the lockdowns. After the restrictions were lifted, however, traffic quickly returned to pre-pandemic levels.
- **Public transport:** this sector has suffered, but has shown great resilience, thanks to the support and financial backing of municipalities. These important services will continue in some shape or form as people return to normal life after the pandemic.

How we can help

The expertise and deal sourcing capabilities of our Infrastructure Debt team allowed us to successfully navigate the market turbulence caused by Covid-19. We added EUR 2.2 billion of investments in 2020. We were able to build on that in 2021 by completing 14 transactions, amounting to EUR 2 billion. In 2022 we are identifying opportunities for our clients from an expected increase in the volume of mergers and acquisitions as businesses recover.

3 Transformation to a sustainable footing

Many investors are interested in green bonds and renewable energy investments as part of the push to a carbon-neutral economy. This also reflects the increasingly widespread pressure to take ESG (environmental, social and governance) considerations into account in investment decisions. The current political situation also underpins the drive to significantly increase the share of renewable energy.

Green bonds, which support specific climate-related projects and renewable energy, are being swamped by demand. As a result, financing terms have softened so that some can no longer be considered investment grade. This may mean that in some transactions where there is strong investor demand, lenders receive less protection. Therefore, investors should be very selective in choosing their transactions.

Over the years, the industry has made significant progress in its understanding of ESG. However, investing in ESG "friendly" assets only leads to net zero up to a point. Sustainability-minded investors should favour investments that support a holistic transformation of the company and should seek to support other issuers on their "green" journey. We see particular opportunities in the area of emerging energy technologies – such as batteries, hydrogen and biofuels – as companies can invest in new areas and thus reduce their CO2 emissions (see **Exhibit 2**). Such investments are usually debt financed to optimise the return on equity.

How we can help
We help the companies we invest in focus on a holistic transformation, while recognising that overnight change can be difficult. For example, when investing in an energy company we may seek to provide covenants within financing documents pledging to increase the company's use of renewable energy – hence, moving the business to a more sustainable footing. We are actively seeking similar opportunities where we are helping to put our economy on a net-zero trajectory.

4 Be prepared for regulatory changes

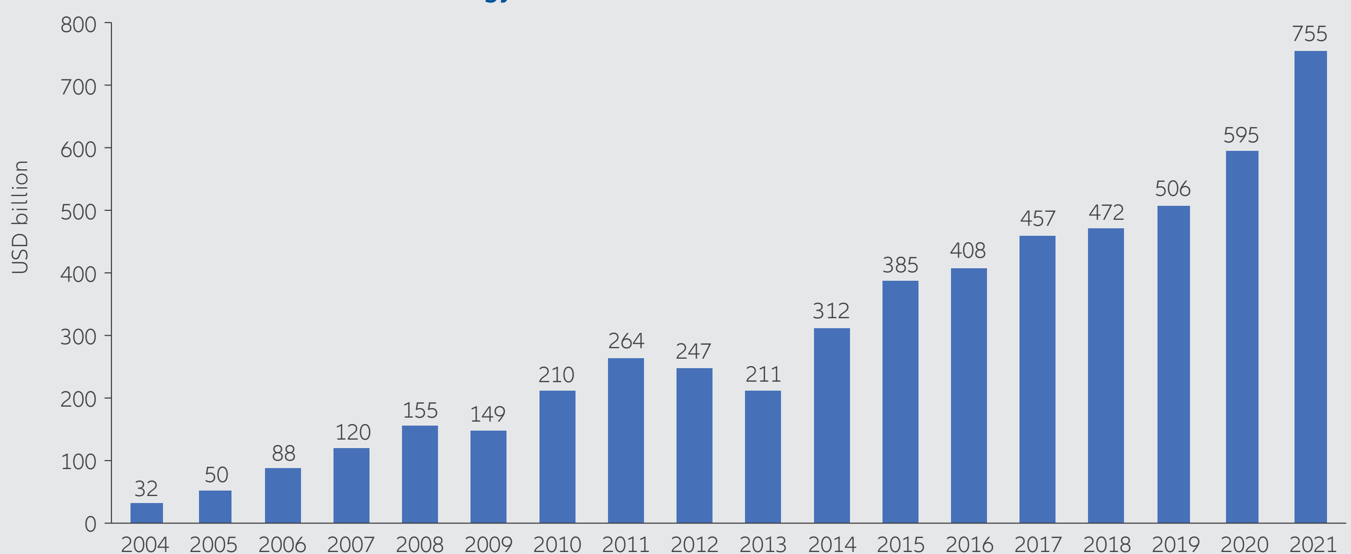
The infrastructure debt asset class is being affected by the increasingly large focus on regulation overall, and by regulators' desire to provide investors with more transparency and information. For example, the European Commission is intensively pushing the issues of sustainability and climate change – and, like other asset classes, infrastructure debt is having to adapt.

- One result is the EU taxonomy - a classification system designed to provide a common wording and a clear definition of "sustainable" business activities. This is intended to guide investments to achieve the European Union's 2030 climate and energy targets.
- Meanwhile, the Sustainable Finance Disclosure Regulation (SFDR) requires funds to disclose how they are increasingly incorporating sustainable practices into their activities and clearly defines which strategies qualify as sustainable investments.

Infrastructure debt investors can play a critical role in addressing the climate crisis and achieving carbon neutrality. However, the challenge with unlisted companies is often that ESG information is not as easily accessible as it is for listed firms. In addition, many industries have not yet defined common methodologies, reporting guidelines and metrics, making it difficult to assess progress. Investors, therefore, have to spend a lot of time and resources gathering information from borrowers on areas such as greenhouse gas emissions or alignment with the EU taxonomy.

How we can help
We work hard to ensure we fully understand the EU taxonomy and other regulations which are changing at increasing speed. As there's no standard way of accessing information, we conduct our own detailed due diligence and we are also an active member of the GRESB, (Global ESG Benchmark for Real Assets) an investor-led organisation which provides a solid database of ESG information collected from issuers. This can help investors focus on building a portfolio of sustainable assets.

Exhibit 2: Global investment in the energy transition



Includes investment in sustainable materials, carbon capture and storage, hydrogen, nuclear, electrified heat, electrified transport, energy storage and renewable energy
Source: BloombergNEF about.bnef.com/energy-transition-investment

5 Digital: growing demand for the infrastructure of the future

In the infrastructure sector, digital assets are in greater demand than ever before. Fibre-optic networks and data centres are particularly sought after. However, the Covid-19 pandemic, with a sharp increase in video conferencing for businesses and streaming services for the home, also highlighted the deficits in digital infrastructure. In Germany and the UK, for example, fibre-optic represents only around 6% of total fixed broadband, according to the OECD. That's compared to more than 80% in the market leaders of South Korea and Japan. But Germany, the UK and many other large economies are seeking to significantly ramp-up their broadband capabilities.

However, there are many more nuances to consider when it comes to business mo dels. This is because competition for digital infrastructure has increased significantly. For investors, the market segment presents exciting opportunities, but also harbours risks. Long-term investors therefore need to take a close look at the assets they invest in to ensure that they are appropriately positioned to respond quickly and adequately to a changing environment as market conditions change.

How we can help

We are focused on helping our clients navigate a fast-growing sector with dynamics that may be unfamiliar to some investors. With a traditional infrastructure provider, such as a utility supplier there is often certainty about revenues as homes are already connected to the power grid. But with a digital asset, like a fibre-optic network, there is sometimes less revenue stream clarity as the network is still being built. We aim to manage such risks by imposing key performance indicators – like minimum number of houses connected – that must be met before we consider financing.

Outlook:

The current market environment offers opportunities to build exposure to infrastructure debt, an asset class with a vital contribution to global societies and economies.

As the world recovers from Covid-19 and governments and companies pursue sustainable growth paths, we expect a pick-up in merger and acquisition activity, typically financed by debt. At the same time banks, traditionally one of the largest infrastructure debt financiers, are continuing to retrench from long-term funding markets because of regulatory hurdles. That opens the door for other institutional investors.

While there will be challenges, such as rising interest rates, the sector can serve as a long-term sustainable asset through which investors can help fund the infrastructure to keep economies moving.

Allianz Global Investors is a leading active asset manager with over 700 investment professionals in 23 offices worldwide and managing EUR 673 billion in assets.

We invest for the long term and seek to generate value for clients every step of the way. We do this by being active – in how we partner with clients and anticipate their changing needs, and build solutions based on capabilities across public and private markets. Our focus on protecting and enhancing our clients' assets leads naturally to a commitment to sustainability to drive positive change. Our goal is to elevate the investment experience for clients, whatever their location or objectives.

Active is: Allianz Global Investors

Data as at 31 December 2021

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Investments in Infrastructure debt are subject to adverse economic & regulatory risks affecting infrastructure companies. Infrastructure issuers may be subject to regulation by various governmental authorities and may also be affected by governmental regulation of rates charged to customers, operational or other mishaps, tariffs, and changes in tax laws, regulatory policies, and accounting standards.

Incorporating alternative investments into a portfolio entails substantial risks and is not suitable for all investors. Investors must be aware that an investment in infrastructure is highly speculative, and it is possible to lose your entire investment. Investments in Infrastructure are subject to adverse economic & regulatory risks affecting infrastructure companies. Infrastructure issuers may be subject to regulation by various governmental authorities and may also be affected by governmental regulation of rates charged to customers, operational or other mishaps, tariffs, and changes in tax laws, regulatory policies, and accounting standards. The market for infrastructure investments is highly illiquid, which could prevent an investor from purchasing or selling these investments at an advantageous time resulting in a loss to the investor. Investing in a limited number of issuers or sectors may increase risk and volatility.

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