Diversification, high quality risk-reward and cashflow stability

Head of Asset Management, Antonio Garate provides a short primer on Infrastructure Debt and the benefits of an allocation to Emerging Markets

Introduction

'Emerging Market infrastructure debt' might seem something of a mouthful to say, let alone be an asset class to which many investors are familiar or naturally allocate. And yet the opportunity set has capacity of c. $5-600bn[1] annually, so it is not exactly niche either. This short primer sets out some basic principles defining the asset class and the potential benefits for investors interested to know more.

Some basic principles

Infrastructure investments involve the construction and financing of hard assets with long useful lives, demonstrable societal and/or economic value. Its income is typically tied under long-term contracts (often with some form of government backstop) ensuring adequate returns on the investment made upfront.

[1] Independent High-Level Expert Group on Climate Finance, mandated by the COP 28 presidency - November 2023 https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2022/11/IHLEG-Finance-for-Climate-Action-1.pdf

Specifically, infrastructure debt investments focus on providing debt financing for infrastructure assets, which typically span across various sectors: power, healthcare, transportation, water and sanitation, to name a few.

Investor appeal

While the average allocation to private markets more generally in typical investment portfolios remains low, it has been significantly higher and growing among institutional investors for several years. The same is similarly true for infrastructure debt strategies as a subset of private markets.

These investments have appealed to institutional investors as a source of diversification and yield-enhancement over the last decade mired by lower returns in fixed income markets. Various market participants have stated it has been historically possible to achieve premiums over comparable public fixed income investments (e.g. corporate regulated utilities) above 50 bps, and often higher (above 100 bps) for strategies with a particular focus on sub-investment grade credit.

The specific appeal of an archetypal infrastructure debt investment resides in its cash flow and credit ratings stability owing to it being highly contractual in nature. Portfolio diversification, achieved through inherent cash flow stability, has shown its value to market participants as bonds failed to act as an effective shock absorber in traditional portfolios.

These cash flows allow investors to closely match assets and liabilities while also providing a source of yield enhancement (investments typically price at a premium to comparable indices for illiquidity). This appetite amongst institutional investors compounded once it received a more favourable capital treatment from insurance regulators in Europe halfway through the last decade.

Supply – demand imbalances

It is worth noting that the growth in popularity of the asset class happened even despite the limited number of greenfield investment opportunities in developed markets, aside from renewables and fibre networks, with activity primarily focused on acquisitions and refinancings of existing infrastructure assets.

More recently, the number of greenfield opportunities has grown as multiple governments are providing various forms of subsidies and incentives to continue decarbonization efforts and rebuild supply chains and manufacturing capacity closer to home, with an increased focus on energy security. This trend continues despite the publicised shift in priorities towards defence.

The combination of growth opportunities and stability of the asset class has attracted greater competition (tightening premia or pushing investors into accepting uncontracted risks) and is encouraging investors to develop projects involving less established technologies (e.g. green hydrogen).

Meanwhile, the Independent High-Level Expert Group on Climate Finance (IHLEG)[2] has noted that the yearly need for climate-related investments in emerging markets and developing economies is estimated at USD 2.4 trillion. And yet, according to OECD, private finance mobilised for sustainable

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[2] IHLEG, ibid.

development by bilateral and multilateral providers in emerging markets has historically hovered around USD 50 billion. Thus, the potential opportunity from a supply perspective is significant.

Developed technologies, emerging nations.

The investment expansion of infrastructure in emerging markets remains for the most part very focused on developing well-established technologies which already are cost-competitive, with projects still underpinned by long-term contracts. Strong demographic growth warrants continued investment to ensure widespread access to basic public services.

Investors can benefit from strategies providing ample geographic reach to access investment opportunities in infrastructure projects that deliver similar risk profiles as those in an OECD jurisdiction and obtain above-inflation diversified returns.

Publicly available data point to historical annualised returns for infrastructure debt investments in emerging markets close to 8.5% over the last decade (compared to 4% for infrastructure debt in developed markets, according to GI Hub data[3]). All while delivering similar levels of credit performance, primarily explained by its conservative debt structures and involvement of development finance institutions.

Alongside well risk-adjusted returns, publicly available studies such as the latest survey from the GEMs database, point to a history of low default rates and high recoveries (also noting Moody's Analytics and the GI Hub disclose and periodically update similar data[4]), not too dissimilar from that of infrastructure debt investments in developed markets, and considerably better than those observed in high yield and EM credit index strategies. Recoveries above other EM credit classes, notably corporates, are a product of the robust contractual and/or regulatory provisions that underpin the revenue-resilience of these investments.

Global asset (re-) allocations

As noted above, the vast proportion of investor capital into infrastructure has gone to developed markets. For infrastructure debt specifically that figure is around 91%[5]. This then paints a picture of an ever-widening gap between those regions have and those that do not.

Government backed and multilateral agencies have traditionally been big players in mobilising capital towards developing regions in the face of this gap. As noted by IHLEG though, this figure has never been enough to deliver what is needed. This fact coupled with the recent highly publicised retracement of some aid-based sectors, points to an even bigger role for private, institutional capital to work alongside public agencies to offer commercial financing, with official sector support.

Getting this mix right can deliver investors an innovative and uncorrelated investment opportunity, whilst simultaneously stimulating developing economies and meeting global sustainability ambitions.

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[3] GI Hubinfrastructure-monitor-2024-report.pdf

4 GEMS Database https://www.gemsriskdatabase.org/#Recovery%20Statistics%20Publication, Moody's Analytics Examining Infrastructure as an Asset Class (moodysanalytics.com)

[5] Preqin Pro+ data

In addition, given the rise in volatility and geopolitical tensions, many investors may benefit from repositioning some regional allocations towards those emerging markets not currently facing the same headwinds.

Diversification solution

While it is an asset class that we love, we recognise that EM infrastructure debt may not be the core building block of all clients' strategic asset allocation. However, it is our view that the strong contractual cashflows, their highly structured nature, the historical risk performance and the geographical diversification benefits delivered by this asset class should make it an attractive component of any well risk-managed, cashflow-seeking portfolio.

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Over 14 years of experience in investment management across infrastructure, project finance and real assets, with previous roles held at Allianz Global Investors, Pension Insurance Corporate and Fitch Ratings.