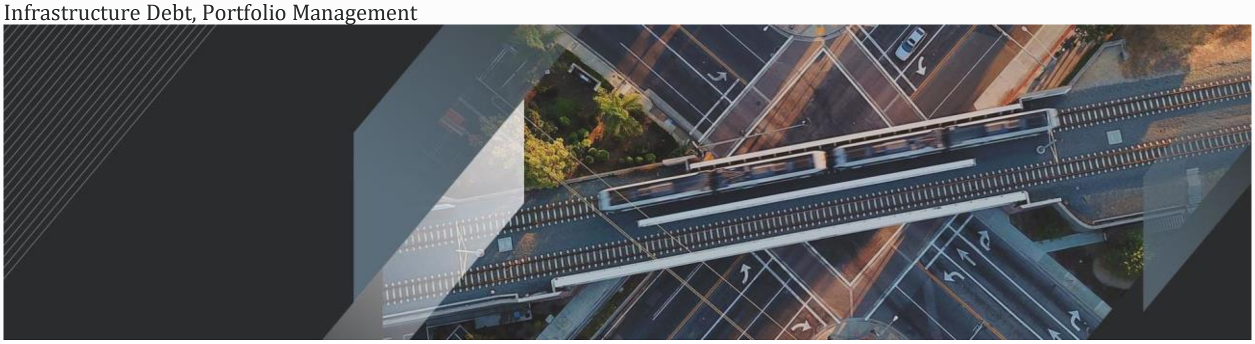
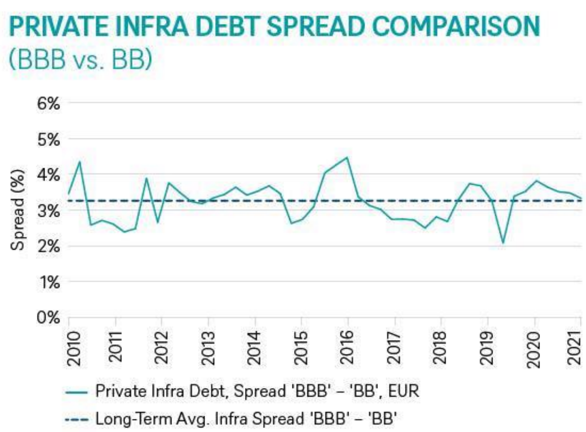
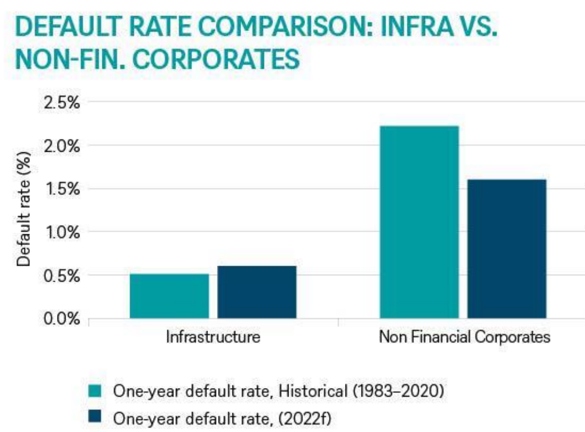
The Outlook For Private Infrastructure Debt

Resilient Credit Performance Despite Covid-19

Gianluca Minella
Head of Infrastructure Research, Alternatives
Benjamin Schmitt
Infrastructure Debt, Portfolio Management







Notes: f = forecast. Source: DWS, IHS Markit, Moody's, as at February 2022. **Past performance is not indicative of future results.**

Key highlights:

— **Economic Recovery and Decarbonisation:** As the global economy rebounds, the effects of the pandemic continue to weigh on the growth outlook. Fiscal and monetary policy continue to play a central role in supporting the recovery from Covid-19. However, as inflation accelerates, we expect a progressive increase in bond yields driven by central bank tapering efforts in 2022. With GDP already showing signs of moderation, the European medium-term growth outlook is now more uncertain and may rely more on public spending programmes. Decarbonisation increasingly appears at the top of policymakers' agenda, a factor that may prove supportive for green infrastructure and for the private infrastructure debt pipeline in 2022.

— **Infrastructure Credit Outlook:** Infrastructure has demonstrated low correlation to business cycles and long-term cash flow predictability compared with equally rated debt in other sectors, particularly during bearish credit cycles.[1] As a result, infrastructure debt has historically enjoyed higher credit ratings, lower default probabilities, and significantly lower ratings volatility.[2] So far, the credit profile of infrastructure debt has been resilient, despite Covid-19. In 2020, we have observed a widening in credit spreads, particularly for assets affected by the pandemic, such as passenger transportation; however, credit spreads had normalised by 2021.[3] Nevertheless, the full credit effects of Covid-19 on private infrastructure may take time to fully emerge, particularly for sectors that may experience a structural shift in business fundamentals due to Covid-19: despite continuing to demonstrate a comparatively resilient credit profile, the one-year default rate for infrastructure is expected to increase to 0.6% from 0.51% in 2022. This is still materially below non-financial corporates.[4] A thorough assessment of credit risks has become increasingly important, particularly for high yield infrastructure debt. Infrastructure debt recovery rates have been historically higher than non-financial corporate debt, at ca. 95% for senior secured infrastructure debt and 67% for subordinated infrastructure debt.[2] Moreover, we believe that the disciplined approach to leverage, and resilient valuations supporting equity cushions observed across the asset class, may provide additional support to infrastructure recovery rates.

— **A Widening Opportunity Set:** The European private infrastructure debt opportunity set appears to be widening. We anticipate that European infrastructure debt issuance will pick up in 2022 following a decline in 2021 due to Covid-19.[5] The deal flow is expected to be sustained by a large pipeline of capex projects supported by EU decarbonisation and digitalisation policies. Beyond large-scale renewables, we expect opportunities in distributed generation, small-scale renewables, and energy services. Technological innovation is also contributing to the emergence of new sustainable infrastructure sectors, such as battery storage or transport electrification (e.g. EV recharging, electric/hybrid ferries, rail/rolling stock). As governments increasingly focus on reducing the digital divide, we see more fibre and datacentre projects in markets such as Germany, where historically there were a comparatively lower volume of private infrastructure transactions. In 2022, we anticipate solid M&A activity (acquisition financing), while refinancing activity may be more muted as interest rates rise. We also expect infrastructure equity sponsors to look increasingly at junior debt solutions to create a competitive advantage in bidding processes, particularly for well-contracted and regulated assets.[6]

— **High Yield's Strategic Role:** Private infrastructure debt has become a favoured investment due to its long-term income stability. The gradual yield compression observed in the investment grade space has led investors to complement investment-grade portfolios with high yield or junior exposure. With high yield private infrastructure debt allowing for enhanced returns, but also higher credit risk, in-depth credit analysis and collateral valuation are vital, especially as the credit environment may remain exposed to the effect of Covid-19 over the medium-term. With emerging infrastructure sectors, such as EV recharging infrastructure, positioned for the most part in the high yield credit space, we anticipate the opportunity set for high yield infrastructure debt to grow. Some investors may prefer to access emerging infrastructure deals via the lower risk private debt route rather than through equity, as these sectors may still need to demonstrate resilient long-term infrastructure characteristics. Private infrastructure debt remains underpinned by a return premium over bonds, with additional lender protection achievable via ad hoc structuring and covenants.

— **Floating Rate Allocations Up:** The last decade was dominated by "lower for longer" inflation expectations. However, it remains to be seen if the current uptick in inflation is transitory. Global supply chains are operating at high capacity due to the post-Covid demand supply imbalances, and pressure on commodities and goods have compelled central banks to embrace tightening policies, with the Bank of England being the first major Central Bank to increase the Bank Rate and the FED indicating that 2-3 rate hikes may be possible in 2022. In this market environment, more investors may see relative attractiveness in floating rate infrastructure debt exposure as it may provide a form of inflation hedge. Floating rate infrastructure loans' coupons are linked to a short-term reference interest rate such as EURIBOR, with short-term interest rates generally linked rising inflation expectations.[7]

— **The Role of Sustainability:** With the enactment of the European Union's Sustainable Finance Disclosure Regulation (SFDR) and the publication of the EU Taxonomy Technical Criteria in 2021, sustainability has become central to infrastructure investment.[8] Infrastructure lenders are increasingly focusing on green and social loans where proceeds serve a specific sustainability objective. For loans not directly linked to sustainability objectives, it may be increasingly important to incentivise the borrower to improve its sustainability footprint, such as by targeting a specific set of ESG KPIs to form a basis for loan margin adjustments. We expect a gradual adoption of ESG rating frameworks and new ESG covenant packages to drive asset selection and borrower engagement. Investors may increasingly incorporate a structured approach to ESG credit risk. Adopting an ESG methodology to evaluate the materiality of industry and sector-specific ESG factors in a transparent way may represent an opportunity to mitigate the impact of ESG related risks on credit ratios, default and recovery rates, supporting risk-adjusted returns, particularly for longer duration assets. While we observe a focus on assessing the financial materiality of ESG risks, the industry is increasingly focusing on double materiality, reporting on ESG issues also from a non-financial perspective.[1]

Source: DWS, February 2022. Past performance is not indicative of future returns. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

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