ARTICLES

PUBLICATION DATE 15 FEBRUARY 2023

Infrastructure debt: An emerging investment strategy among private investors

WRITTEN BY

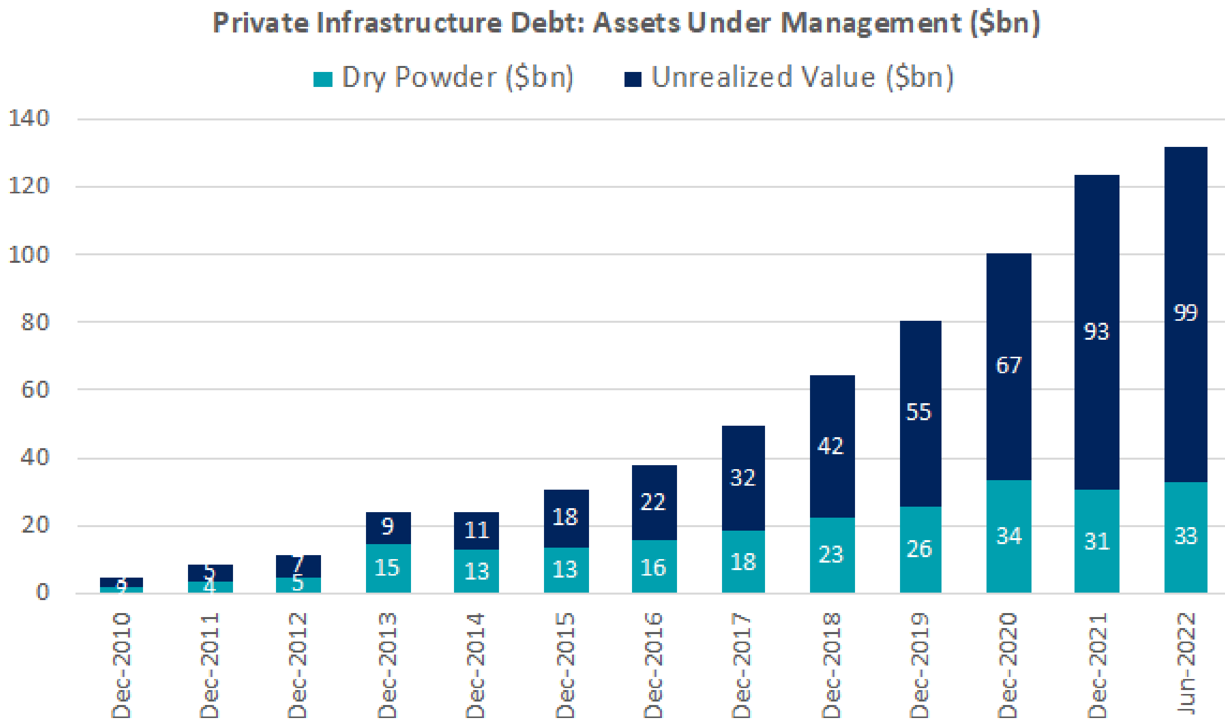
Alex Murray, Vice President, Research Insights, Preqin

A tightening of monetary policy through 2022 has encouraged private investors to re-visit their portfolios in light of the impact that increasing interest rates is having on the wider economy. These rate increases are helping lenders across public and private markets to increase their returns on new facilities as well as some existing ones.

As investors in private markets increasingly choose to allocate their capital to infrastructure debt funds, they diversify their portfolio and lower overall risk associated with their infrastructure allocation. But will the growth in infrastructure debt continue? How will it be affected by inflation and rising interest rates?

Infrastructure debt is an increasingly attractive investment strategy for private investors

Assets under management within infrastructure debt funds have increased fourfold since the end of 2015. Funds pursuing this strategy now account for 13% of the infrastructure asset class globally as of Q2 2022 at USD 132 billion, compared to less than 3% in 2010, with prospects to see this climb further as the asset class matures, according to Preqin.
The emergence of the infrastructure debt strategy since 2013 has been part of the wider development of the asset class. The different risk profile of infrastructure debt has broadened the available investment opportunities, offering investors the chance to diversify within the asset class through exposure to debt's economic characteristics.



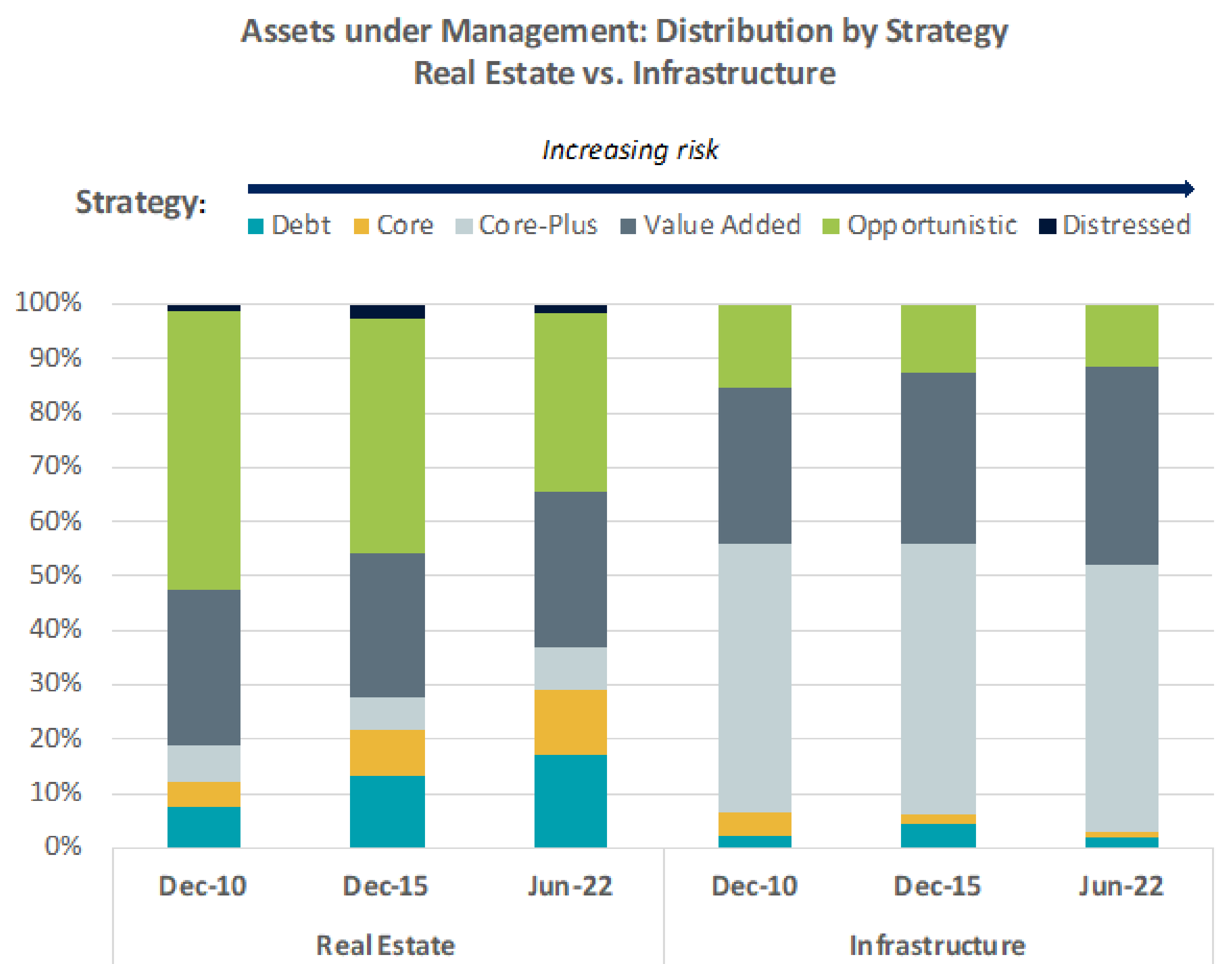
Source: Preqin Pro

Diverse pool of low-risk investment opportunities

Investor interest in infrastructure debt, a low-risk investment strategy, reflects the core reasons for broader interest in infrastructure as an asset class.
Preqin analysis, see graph below, shows that a large share, 58%, of infrastructure assets being managed by funds falls under low-risk equity categories (core and core plus) compared to say real estate, where these low-risk categories account for only 20% of real estate assets. It is this concentration of lower risk funds in infrastructure that creates a more receptive market for expansion of investor interest in the lower risk infrastructure debt strategy.

The addition of a debt strategy within an already comparatively lower risk asset class provides a strong tailwind to infrastructure's further growth among institutional investors. Many active infrastructure debt funds anticipate considerable demand for their assets on the secondary market, which addresses liquidity concerns that investors typically have for infrastructure asset class.

Fund managers have successfully invested allocated capital for infrastructure debt. The proportion of dry powder (capital committed by investors and available to fund managers but not yet invested) within assets under management for infrastructure debt fund managers is lower (25%) than the low-risk infrastructure equity categories (core or core plus), both of which have 29% of asset under management in capital yet to invest, according to Preqin. GI Hub's *Infrastructure Monitor* report shows that the credit performance of infrastructure debt has continued to improve over time with newer infrastructure debt reaching investment grade faster than older infrastructure debt, particularly in the last decade.



Source: Preqin Pro

Link between infrastructure debt's growth and maturing of the infrastructure asset class

Infrastructure debt seems to be following a similar trajectory to that taken by real estate debt in the last decade. Preqin forecasts that infrastructure will begin to catch up with real estate in terms of assets under management (AUM) size by 2027, increasing from 76% in 2022 to 88% by 2027. By then, wider infrastructure AUM is forecast to be USD1.9 trillion compared to just under USD1.1 trillion as of Q2 2022. Some investors will be drawn towards infrastructure for its resilience amid an emerging low growth and high inflation scenario.

In the last decade, debt funds have risen to represent a higher share in the real estate asset class AUM, increasing from 8% in 2010 to 17% in Q2 2022. By comparison, infrastructure asset class has seen its debt funds grow their share from 3% to 13% over the same period (see Figure 2).

Infrastructure debt is expected to continue growing as investors become more familiar with the asset class and look to displace some of their broader fixed income allocations with infrastructure debt. Preqin forecasts infrastructure debt strategy to grow its AUM by a 11% compounded annual growth rate between 2021 and 2027.

Higher inflation hedging prospects retains private investor interest

Some infrastructure assets have high levels of inflation protection in terms of either the contractual agreements in place that index revenues to inflation, or the monopoly-like business models allowing cost increases to be passed onto prices charged to users. This feature makes such assets lower risk prospects and more able to sustain higher levels of debt financing, further underpinning the prospects for infrastructure debt's continued growth.

The level and persistency of inflation caught many central banks off guard in terms of their readiness to tighten monetary policy. The persistent rise in interest rates will have implications on the demand for debt finance across unlisted infrastructure, and reduced primary investment in any ensuing downturn will further dampen demand for debt raising. Higher rates will also weigh on the attractiveness for re-financing of operational assets, as the monetary environment encourages sponsors to stick with their current arrangements, unless they are pushed to refinance by the maturing of their debt facilities.

Policymakers must continue to facilitate the role of private capital to enable policy ambitions

Despite the lingering risk of a global recession, private capital raised for infrastructure had an incredible first half of 2022, raising over USD127 billion - a record figure for any full year to date.

Policymakers have a vital role to play in helping turn the desires of investors for increased infrastructure investment into reality. The capital is on the sidelines, but the business models required to unlock the current USD329 billion of dry powder available globally (as of Q2 2022) needs to offer the right level of risk and reward, particularly for infrastructure debt that takes all the downside risk if projects go wrong.

The progress being made by reforms to Solvency II, the prudential regime for insurance and reinsurance undertakings in the European Union, and the Basel III framework, are examples of where adapting rules can help release capital towards scaling up infrastructure investment. The GI Hub is enhancing collaboration between public and private stakeholders to enable a prudent but conducive regulatory treatment of infrastructure as an asset class to increase investment in infrastructure. However, these efforts need to be reciprocated across markets if investors are to maintain the benefits of geographic diversification. This will also ensure that the potential of private capital to aide in the energy transition is more evenly spread, delivering greater equality in the benefits of private capital across global regions.