PRIVATE CAPITAL

European Infrastructure Debt Aligns with ESG Goals

Discussion

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Guy Haselmann, Head of Thought Leadership at MetLife Investment Management (MIM), recently sat down with Annette Bannister, Head of European Infrastructure and Project Finance, to discuss European Infrastructure. Annette examines the portfolio benefits of the asset class and its alignment to green goals and initiatives.

Guy: ***Let's start with the bottom line. What are the benefits and simple reasons why a global diversified portfolio should seek exposure to European Infrastructure investments?***

Annette: There are numerous reasons but let me offer 3 core tenets. First and foremost, we believe infrastructure is a very stable asset class due to the essentiality of the assets being financed. Infrastructure debt has historically provided attractive returns with downside protection via covenants and/or collateral backing. Private infrastructure debt offers diversification to a portfolio of public bonds. And we see projects are typically strongly aligned with environmental and social targets and goals.

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Guy: ***I sense that you could have provided a longer list of infrastructure attributes. What else should a potential investor know?***

Annette: Infrastructure is indeed a unique space and one which requires experience and expertise. For instance, there are high barriers to entry, but there is often direct or indirect government support which has its advantages. In my view, it is the stability of the asset class that has led to the low historical loss rates. For all these reasons, I firmly believe infrastructure debt can bring meaningful benefits to a diversified portfolio.

Guy: ***Infrastructure and project finance encompass a wide breadth of projects, sectors, and areas. What are some of those areas that you might be involved in or are looking at?***

Annette: Yes, we will look at wide range of areas including utility networks, transportation, social, digital, and renewables.

Guy: ***I suspect that each of those area have their own sub-sectors? Upgrading and modernizing transportation and power infrastructure, such as roads, bridges, rail, utilities, and ports seems like a never-ending process. But areas like digital and renewables are relatively new and quickly changing as disruptive technologies improve. What are some of the sub-sectors within "digital"?***

Annette: Digital infrastructure, no doubt, involves newer technologies and are things that interconnect physical and virtual technologies. They often involve data or information capabilities that allow companies, governments, cities, and countries to maintain a thriving economy and modern quality of life. Some examples of what I am talking about are fiber broadband and long-distance fiber-optic cables, mobile telecommunication towers, and data centers. So yes, the sub-sectors themselves are extensive.

I had also mentioned "social" infrastructure. This also is a wide-ranging area. To me, I consider it any project that plays an important role in the development and improvement of a society's quality of life. It is often a project that most people would agree modernizes or improves the amenities of their community, such as, modern hospitals and schools or proactive protection against flooding, wastewater, or wildfires.

For a more specific example, we could look at the UK Social Housing bond market where a government survey noted £117 billion in financing facilities at end of 2021[1] with another £41 billion needed over the next 5 years. The bonds have attractive cash flows with maturities at issuance of 25-30 years and issuers typically rated single A.[2] There is continued strong demand for these projects due to high quality buildings and affordability of the units, and due to ESG-related aspects investors may expect to receive an asset with a positive impact.

Guy: ***I can see why most people and governments would support many of these projects. Let's get back to investors for a minute. We are in a challenging economic backdrop with rising interests that could bring about an uptick in credit market defaults. Is this a bad time to consider EU and UK infrastructure?***

Annette: Markets and investments always have challenges and changing risks. This is why a diversified portfolio is likely to perform best through market cycles. Historically, infrastructure debt has shown resilience during periods of economic cyclical slowdown which is partially due to the embedded protections mentioned earlier and due to inelastic demand of the underlying asset. In other words, things like water, heat, electricity, schools, hospitals, and transportation services are always in demand, and in many cases the types of assets that we finance are not exposed to volume risk.

Guy: ***Given the steady stream of cash flows, does inflation hurt the value of the underlying asset?***

Annette: I believe your question is asking whether credit quality erodes as inflation rises. Infrastructure-based businesses and projects often have contracted pricing mechanisms linked to inflation. And since the asset has a long life and stable demand, the ability to forecast or hedge input costs is relatively strong.

Guy: ***Earlier you mentioned renewables as an area of focus. There is certainly a powerful trend afoot for energy transition and decarbonization. Global extreme weather events seem to be occurring more frequently which might have contributed to more aggressive Paris Accord initiatives. Even in the United States (US) where they have been behind the EU, there has been an increased focus. The "Inflation Reduction Act" of 2022 and "The Infrastructure investment and Jobs Act" of 2021 have earmarked trillions of dollars for infrastructure and energy transition funding and provided billions in tax credits for businesses to direct even more capital. As part of the "Build Back Better" plan 2 years ago, the UK government announced £100bn in infrastructure spending. I assume you would agree that this trend is powerful and offers a great deal of support for infrastructure investments.***

Annette: Absolutely. It is a trend that should not be underestimated and could help to provide resilience that directly benefit investors. The entire global infrastructure eco-system is receiving wide-spread support from governments across the world. Energy transition alone provides enormous and varying opportunities for investment such as wind, solar, batteries, electric vehicles, hydro, and hydrogen. There are many nuances of each and many ways to diversify portfolios. We believe there are many highly attractive relative value opportunities whether in energy transition, digital, social, or other categories. As you mentioned, the link between infrastructure debt and decarbonization is a mighty powerful trend that we believe will continue for many years to come.

Guy: ***How does an investor find success in infrastructure debt given all the complexities, nuances, and choices?***

Annette: We believe investors need to partner with the right investment manager. The investment manager team needs to be highly experienced and tenured. They need to have boots on the ground, a vast network to source opportunities and the skillset to conduct deep fundamental research. MIM has been financing European Infrastructure Deals for over 10 years, and we are able to leverage to our advantage the broader resources of the 150-year history of MetLife, our parent company. We also focus on the key characteristics that make for a strong debt instrument: namely, credit, structure, and pricing. We allow our clients to operate of separately managed accounts and offer solutions customized for their portfolios. This philosophic approach has been the key to our long success and our way of seeking to provide long-term outperformance with minimal losses.

Endnotes

[1] Bloomberg

[2] Bloomberg

Guy Haselmann
Head of Thought Leadership
MetLife Investment Management

Annette Bannister
Head of European Infrastructure and Project Finance
MetLife Investment Management

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