Tariff Impacts and Infrastructure Debt's Resilience

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Infrastructure debt provides investors with access to a defensive asset class with lower correlation to economic cycles than general corporate debt given the essential nature of infrastructure assets. Nevertheless, tariffs will have both direct and indirect effects on certain infrastructure investments. Economic infrastructure assets and projects under construction, where there is exposure to supply chain issues or increased costs, will feel the greatest effect of tariffs. Defensive assets such as contracted-power generation, regulated transmission and utility assets, and availability-based public private partnerships will largely be unaffected by the additional tariffs.

MetLife Investment Management

Tariff Impacts

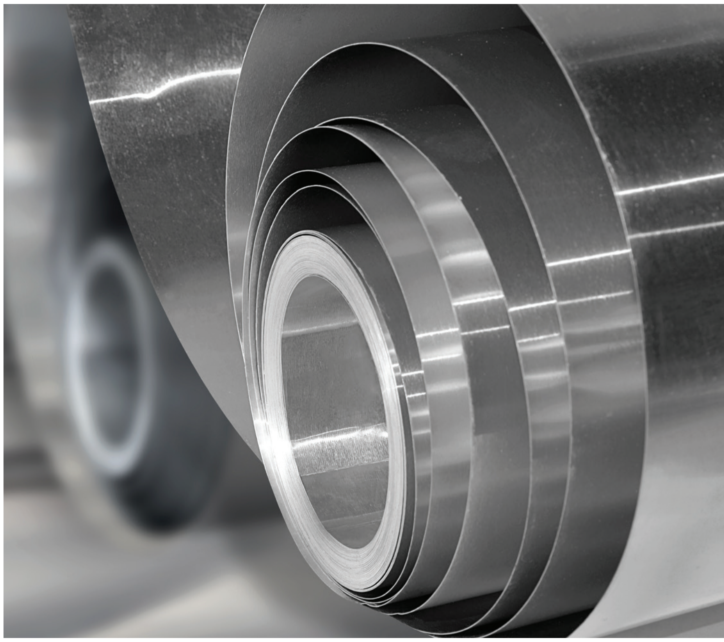
Economic infrastructure includes assets such as ports, airports, toll roads, and merchant energy projects. Revenue of these assets is linked to both market-based volumes and pricing. Tariff policies will directly affect assets, such as ports, where there is direct exposure to trade volumes. Other types of economic infrastructure will be affected by any volume and pricing declines caused by a slowing economy as tariffs increase prices and reduce consumer demand.

Direct Impacts

Ports, terminals, and rail lines will feel the direct effects of reduced trade. Reduced throughput at ports will directly affect revenues at ports where the number of "container lifts" is a driver of revenues. Most U.S. port issuers of private debt are operator ports exposed to volume fluctuations. Ports that operate on a landlord model, typically Australian and some European and U.K. ports, will be more insulated from tariff impacts given lessees pay a fixed rent; however, lessees themselves will feel the stress of reduced volumes. Lower trade volumes will also affect rail lines and traffic volumes on toll roads exposed to a high percentage of commercial vs. commuter traffic. While asset specific, passenger traffic generally accounts for approximately 65% of miles travelled with commercial traffic making up the remaining 35%.[1] For example, the tolled Detroit Ambassador Bridge serves as a major supply chain link between the United States and Canada as U.S. auto manufacturers ship cars and parts between plants in each country. The bridge sees three to five times the volume of commercial truck traffic versus passenger traffic. As a result, the Ambassador Bridge will be more affected by any slowdown in commercial traffic than the Chicago Skyway toll road which is approximately 90% passenger and light vehicle traffic.[2]

Since the tariffs were implemented in early April, we are seeing more of a disruption in the flow of trade than a systemic decline. Terminal and port operators saw both some front-loading of shipments ahead of tariffs and a subsequent halt in ships setting sail from China since April 10, the last day to sail before implementation of the 145% tariff on Chinese goods. However, new bookings have been seen from Southeast Asia including Vietnam, Korea, Japan, and Singapore. The situation is currently too fluid to determine the ultimate outcome, but depressed trade volumes are expected.

Construction of infrastructure projects is also potentially exposed to direct tariff impacts in the form of disrupted supply chains and increased costs of materials and equipment. The larger effect on greenfield projects will be their slowdown. Sponsors and governments will likely proceed with caution on new projects given the high level of economic uncertainty that tariff policies are causing. Financing costs are difficult to forecast given the potential increase in debt yields that investors may seek for increased assessments of risk. However, on-going, large-scale projects, such as LNG liquification plants in the U.S., typically are insulated from significant cost increases through fixed price, date certain contracts with construction companies. Of course, the shift of cost increases on items such as imported steel and aluminum under fixed-price contracts will increase the financial stress on contractors.



Indirect Impacts

Other economic assets will feel the indirect effect of tariffs through their impact on the U.S. and global economies. Reductions in GDP growth, spending pullbacks by consumers, and/or a full-blown recession will lower overall demand. Lower demand will likely translate into softer energy prices, reductions in discretionary spending (e.g., sporting events at project-financed stadiums), and less vacation travel. Airport revenues are driven primarily by passenger traffic and not trade volumes. Commuter and vacation travel on toll roads is affected by economic contractions and not the transport of trade goods. Merchant energy prices are driven by companies' need for power and can be affected by economic slowdowns.

Infrastructure as a Defensive Asset Class

Despite direct and indirect exposure to tariffs, debt supported by revenues even from economic infrastructure assets is sized to withstand inevitable economic cycles. Rating agencies typically "rate through a cycle" such that six months or one year of lower-than-expected performance doesn't necessarily result in a downgrade. Project finance debt structures also typically require a six-to-twelve-month liquidity reserve. Therefore, ratings and covenants are structured to provide a buffer before a downgrade or default occurs.

MetLife Investment Management (MIM) has spoken with various port operators and the consensus is that it's too early to forecast any financial implications given the variability in tariff policy to date and the uncertain time frame of any tariffs ultimately implemented. However, past slowdowns in U.S. imports, such as the ~10% decline in 2009 during the global financial crisis or the ~20% decline in 2023, inform the potential impact of the new tariff regimes. After the U.S. avoided a recession in 2023, imports subsequently fully recovered lost volumes and returned to growth in 2024. When a port's EBITDA falls by 20%, this generally adds an extra turn of leverage to port balance sheets. Even in a stressed scenario, ports continue to have strong balance sheets with adequate liquidity, including cash on hand and undrawn bank facilities. Port operators also have the flexibility to defer planned capital expenditures if necessary. U.K. and European port operators report that tariff impacts are expected to be manageable, given a combination of factors including (i) minority exposure to U.S. trade volumes; (ii) revenues which are diversified across non-volume/contracted sources, and (iii) the current lack of reciprocal tariffs on U.S. exports to the U.K. and Europe.

Furthermore, indirectly affected economic assets, such as airports, are also well positioned to withstand a general economic slowdown based on recent experience. During the COVID 19 pandemic, airports saw passenger volumes reduce essentially to zero. Yet in 2020 and 2021, ratings on approximately 20 airports in the portfolio predominantly saw a one notch downgrade with only three being downgraded two notches. The airports benefited from debt structures requiring sufficient liquidity to withstand the cycle, government support as essential assets, and a constructive approach by creditors.

Areas of Opportunity

Infrastructure assets can also provide a safe haven away from the direct and indirect effects of tariff policies. Contracted, demand-pull midstream assets such as pipeline systems serving local utilities will see limited impact from increased tariffs. The same is true for contracted power plants and FERC regulated transmission lines. Also, another growing segment of the infrastructure space is digital infrastructure and data centers. Major tech companies such as Microsoft, Alphabet, Amazon, and Meta continue to plan to spend billions on the development of hyperscale data centers to support cloud and artificial intelligence applications. These data centers benefit from contracted lease revenues with these strong revenue counterparties. While these companies may adjust their spending plans, the fundamentals for increased digitalization and data usage continue to remain as tailwinds to the sector.

Areas to Monitor

As the global tariff and economic story continues to unfold, MIM will continue to monitor infrastructure credits for signs of stress such as lower debt service coverage ratios or increased leverage. The Infrastructure Debt team will regularly check in with issuers for market color and updates on liquidity positions. Port volumes will be watched closely to determine the impact on financial performance that an extended global trade slowdown may have. Construction projects will be followed with an eye on potential delays and cost overruns due to supply chain issues and higher costs related to tariffs. Finally, all economic infrastructure assets will continue to be monitored for any impact from the second order effects that a trade-triggered recession or economic slowdown would present.

Endnotes

[1] https://www.ibtta.org/sites/default/files/documents/2022/S%26P-Global-Ratings-US-Transportation-Infras-Toll-Sector-November%202022.PDF

[2] MIM, September 2024

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