

An Elephant in the Infrastructure Room

Stockholm (HedgeNordic) – During a recent trip to the Nordics, Allianz Global Investors' Portfolio Manager, Adrian Jones spoke to HedgeNordic about the attractiveness of Infrastructure Credit, and explained how a large investor can attract more interesting deals.

Hedging liabilities with long-term assets has become a struggle for any institutional investor. Especially the very long-dated hedging is no longer suitable. This is where infrastructure debt comes in, with an attractive proposition. Debt can be linked to a specific infrastructure project and the risk of violent changes is limited. Projects typically involve energy distribution, renewable energy or water. In many cases, especially in the past, the projects were financed by banks, but their challenge is to match shorter-term liabilities.

The competition for smaller deals is intense, but this is mostly an issue for smaller funds. In Europe, Allianz Global Investors has the largest platform and does not face many competitors. "Being a large investor is an advantage," comments Jones, "the borrowers prefer not to have many counterparts, as it may complicate the start of the project. In case of refinancing, it may also be more difficult to deal with several relationships."

From the investor's perspective also, Jones believes that the best opportunities are found when a direct relationship can be established with the borrower. "You can write terms & conditions that are specific to the project and tailored to the investors' needs," Jones explains.

Environment, Social and Governance (ESG) considerations are also an important component that can be more easily raised within a close relationship. "ESG is important in its own right, but also as a criteria for credit," says Jones. As a standard, the goal is to reduce coal as a source of power and to increase renewable energy, but there are some cases that are borderline, like gas for example. "You have to be able to look at your investment in context," adds Jones. The Social and Governance aspects are also important. "If the projects are connected to governments, we have to ensure that the tendering process is transparent. We also score favourably projects that employ local people for instance. With a private direct relationship to the borrower, we can ensure a sustainable dividend policy and avoid situations where inappropriate distributions are made. This permeates good credit practice."

Of course, the asset class comes with a certain illiquidity and investors need to come prepared. "You are rewarded with an illiquidity premium," says Jones, "but what does it mean? As an investor, you need to behave with this in mind: how you acquire the deal, what rights you have, and how you would remediate if things went wrong." In addition, Jones points out that good practices in listed debt are different than with private debt. "With listed debt, you can rely more on ratings. With private debt, it makes sense to have a special relationship with the borrower; then your voice carries weight. You also need a certain type of experience when a problem occurs. You have to have the managers who can work things out without panicking."

The illiquidity premium is about 70-100 basis points according to Jones. "It depends on market conditions. We tend to observe that margins are stable; the other assets we measure the margins against are unstable." This premium may not sound like much, but in the current market it represents a large portion of the total yield.

Allianz Global Investors offers a platform with both funds and managed accounts to meet external investors' needs. The underlying investments are generally proposed in the format of a bond, which

can be bought directly by the client; alternatively, investors can buy units in a pooled vehicle. In either case, the investors are treated equally of course. The portfolio currently comprises 43 discrete credits of €200 to 300 million. "Perhaps there is not much diversification within the portfolio, but we consider that this investment is a diversification for the investor's very large fixed income portfolio," Jones observes. In addition, the downside risk in these types of investments is lower than for typical bonds, given the covenants and the type of underlying assets. Recoveries are in the 80% range compared to 30% on average for other types of bonds.