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Corporate pension fund de-risking and infrastructure debt



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DB UK pension schemes have continued to de-risk over the last decade in an attempt to dampen the volatility of pension funding levels and lessen the likelihood of corporate deficit reduction payments. For many, the ultimate end game is buy-ins or buy-outs with Mercer reporting in June 2016 that bulk annuity sales reached GBP12.3bn in 2015, the second largest year on record behind the GBP13.2bn witnessed in 2014.

Flight path de-risking triggers and LDI matching portfolios have become the norm for corporate schemes that are, to a large extent, closed to new members and therefore represent legacy commitments that in many instances can rival the market capitalisation of the parent organisation. Such programmes see assets switch from growth to **matching assets** systematically over time as funding ratios improve in order to achieve full funding and be in a position to transfer the economic responsibility to insurers. Quarterly research from JLT Employee Benefits published in June 2016 analysed the pension scheme arrangements of FTSE 100 pension schemes. The average pension scheme **asset allocation to bonds according to this analysis has risen from 57% to 61%**, with 62 FTSE 100 companies reportedly holding more than 50% of pension scheme assets in bonds.

This inexorable increase in bond allocations comes at a time when long-dated index-linked Gilts are negatively real yielding. The 15-year Index Linked Gilt has been, for the most part, negatively real yielding since October 2011 and look set to remain at these levels for the foreseeable future post Brexit. Hence as corporates struggle with contribution payments and rising deficits they are also locking themselves into assets that will compound (literally) the problem.

The question therefore is whether there are asset classes that can meet the over-arching requirement for lower risk whilst offering pensions schemes incremental return over sovereign bonds? Allocations have been rising to corporate bonds, high yield and emerging market debt and whilst these have the potential for enhanced yield, they do lead to increased risk levels (with corporate defaults on the rise). Alternatively schemes have been increasing allocations to real assets, such as commercial real estate and corporate lending, but again whilst offering enhanced yield, they also introduce risk relative to sovereigns. In the instance of the former there may be short-term interruptions to income as a consequence of default by tenants and by corporate default in the instance of the latter.

Senior infrastructure debt is one potential asset class that meets a scheme's desire for **low risk assets** that can offer incremental improvements in return. Depending on the definition of assets under consideration, the income streams that are attached to infrastructure debt transactions are long-dated (a 15-18 year

weighted average life is typical) and in the case of UK PPP/PFI transactions are in essence an amortising contract with the UK government. Typically **core UK infrastructure receives an investment grade rating** (even during the 'risky' construction period) seasoning post-construction to single A.

Moody's default and recovery data for infrastructure confirms that relative to equivalently rated corporate bonds, infrastructure debt exhibits a higher quality with lower default rates and higher recovery rates.

Unlike secondary floating rate assets, fixed rate and index linked infrastructure debt transactions have no re-payment risk. Thus from an actuarial stand-point one can genuinely use these transactions as matching assets, as spens and modified spens protection are contractually attained.

As a guiding principle, institutional clients seeking to use infrastructure as a matching asset should focus on the **essentiality of the project and the stability and sustainability of future cash-flows**. Not everything that is labelled infrastructure will necessarily be appropriate as a matching asset. The performance of individual assets can be influenced by numerous associated risks such as corporate, patronage, commercial or financial risk.

- Whole business securitisations are commonly issued by utility companies, such as water companies, who can legitimately claim that debt raised is used to meet the CAPEX required to maintain the underlying physical infrastructure that drives their business. One could view these publicly traded, listed bonds as infrastructure. Can one argue that whole business securitisation in the public sector is essential? In many cases well managed companies have predictable income streams that may make attractive investments, but in order to qualify as a matching asset can one legitimately argue that the underlying assets are infrastructure, or indeed essential? If this is not the case there is likely to be long-term income variability which makes the asset **more aligned with corporate debt** than with infrastructure debt.
- Patronage risk can best be illustrated within the transport sector. For concession based availability PFI/PF2 motorway contracts this is essentially a long-term government lease payment stream. As senior debt holder you are obliged to construct and maintain a stretch of road and will be paid by the government providing it is available for use. In contrast, UK toll-roads, such as the M6, are debt obligations that will be repaid subject to assumed traffic volume growth and user payments. It was originally forecast that 72,000 vehicles a day would use the route but the daily average transpired to be 48,000.
- Commercial risk is comparable to patronage risk. Consider a speculative commercial port development whose underlying business is predicated on cargo tonnage or volume of container shipments. Its revenue base may look attractive on a cyclical basis but during times of declining global GDP growth more established commercial operations (with a long history of usage data) are likely to be less impacted and can be considered more **'essential' in nature**. The cash-flows of the latter, assuming minimum levels of usage during cyclical down-turns, could be considered matching assets.
- The essentiality of an underlying asset can help institutional investors determine whether it may be appropriate for use as a matching asset. In addition however, care must be taken to ensure that the contractual terms associated with a given asset do not turn it from one with stable and secure revenues to one that has clear financial long-term risks attached. If transactions are not heavily covenanted debt holders will not have the levers at their disposal to monitor and manage credit quality through the life of transactions. Equally the **financial gearing** applied to transactions can turn a fundamentally sound asset into one that will inevitably **require restructuring at some point in the future**. Both of these can have a material impact on expected stable cash-flows.



- Ironically, many of the above risks are materially more significant than the one oft cited as an impediment to pension fund investment in the asset class; construction risk. This risk can be mitigated through the use of turn-key, date certain contracts with construction companies that are required to provide security packages that act as a buffer in the event of default. Should these mechanisms fail, equity and mezzanine debt are impacted within the capital structure before a default driven loss to senior debt holders becomes inevitable. All of these mechanisms require **strict covenants and triggers** within the financial structure of the project and ongoing active management through the life of the project.
- A further consideration for corporate pension funds wishing to include infrastructure debt as part of their de-risking programme is the use of external versus **internal credit ratings**. One objection to illiquid assets like infrastructure debt is that in the event of buy-out these assets would not be eligible for transfer. In reality insurers are active within the sector, focused on assets that are externally rated and investment grade. Therefore providing a portfolio of infrastructure debt projects meet these criteria asset transfers are not difficult to achieve, assuming a buyer could not be found in the burgeoning secondary market.

Critics of infrastructure debt argue that the scale of bond allocations within corporate pension schemes, limited supply and barriers to entry to the asset class essentially preclude meaningful levels of investment. With the FTSE 100 companies allocating GBP330bn to fixed income presently, it is true that infrastructure debt could not account for a 100% switch to real assets. The UK's National Infrastructure Plan highlights GBP480bn of planned public and private investment to the end of the decade, including over GBP290bn to 2020-21. **Approximately 50% (or £145bn) of this is anticipated to be funded by the private sector.** This is a meaningful number though much of this will be energy related (e.g. nuclear power plants) and may not be suitable for pension fund investment. However, even allowing for this selectivity this pipeline would be sufficient to allow for a 10% allocation to the asset class.

Infrastructure debt demonstrates the characteristics required to assist corporate pension schemes during a period of protracted financial repression. **It allows pension schemes to de-risk** whilst **enhancing credit quality** (relative to liquid alternatives), providing positive real yields and diversification benefits. The time is now.

Disclaimer:

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