Infrastructure debt, BREXIT and the search for yield

Adrian Jones, Portfolio Manager Infrastructure Debt, and
Philip Dawes, Head of Institutional Sales UK, **Allianz Global Investors.**

Following the cut in August 2015, interest rates have fallen to new record lows, making the search for yield as relevant today as in 2012 when infrastructure debt opened to institutional investors.

Allianz Global Investors key facts

- Team of 15 investment professionals.
- >£6bn deployed since 2013.
- 29 transactions closed.
- Active in GBP, EUR and USD.
- Allianz UK Infrastructure Debt I Fund launched in June 2014.
- Focus on high quality, private placements of core infrastructure.

Pension funds remain short of the long-dated, inflation linked instruments that would best match their liabilities whilst suffering from financial repression with respect to those instruments they can easily buy. Central bank buying programmes of government and corporate securities are, in effect, suppressing spreads by raising secondary market prices and reducing primary market new issuance yields.

Senior infrastructure private debt remains a valuable alternative, offering enhanced spreads, which generate positive real returns in a negative real yield environment and diversification benefits. Investors are also beginning to attribute more value to the cash-flow matching benefits of infrastructure debt, (particularly those with amortising structures): Insurance companies benefit from the matching asset adjustments available to insurers under Solvency 2 while maturing pension schemes realise the value of cash-flow as well as balance sheet hedging.

But the asset class is not without its challenges. Continued rises in government indebtedness, mean policy-makers continue to be faced with a funding shortfall for long-term infrastructure expenditure while as a result of the trend toward zero or negative rate monetary policy they have fewer tools than ever before to stimulate economic growth. Across the globe political risk and uncertainty is on the rise, characterised in the UK by the recent and ongoing BREXIT debate, leaving investors facing uncertainty. UK government debt now tops £1.5trillion.

BREXIT has led some to question whether the European Investment Bank (EIB) will have the appetite to continue to invest in UK infrastructure as we extricate ourselves from our Continental European partners. It does seem that these record levels will not be met in 2016 but the EIB remains active in the UK, most recently with the closure of an £82m financing package for the Humber Gateway offshore transmission project. While the loss of EIB subsidised funding may marginally increase the average margin on projects, given all-in yields are at an all-time low and investor appetite for the sector remains strong, loss of EIB funding, even if it happens, should not be an excuse for reduced infrastructure spending.

The new Conservative regime is increasingly looking to favour pro-growth investment rather than continued austerity. HM Treasury has indicated a willingness to work with pension funds and insurance companies to attract investment but the dearth of projects suggest that PF2 has yet to establish itself as the obvious mechanism to facilitate this investment. A seemingly never-ending search for "innovative funding" mechanisms obscures the reality that beyond a few "mega projects" such as the Thames Tideway where genuine novelty was needed to ensure unusual and outsized risks were appropriately apportioned and priced, public-private-partnerships have a long track record in the UK and beyond as a financing model that has delivered hundreds of projects off balance-sheet, on budget and on time. The Autumn statement will give a good indication as to the government's plans with respect to attracting institutional investment and the form that this may take.

Away from the social infrastructure sector, the energy sector continues to offer a tantalising prospect, if only pragmatic reform of the wholesale energy "market" could give the new conventional generation capacity needed to balance the intermittency of renewables (and replace the soon-to-be decommissioned older coal-fired stations) the same certainty of revenue (subject to performance) granted to virtually all other forms of UK generation i.e. wind, solar, new nuclear, probably tidal lagoon, and to a limited extent inter-connectors.

The project finance techniques needed to fund new-build CCGT under PPA, CfD, tolling (or similar performance-linked but market-neutral revenue mechanisms) are well established and as the revolution of funding in social infrastructure projects since 2012 has proven, institutional investment working in partnership with shorter-dated bank debt could deliver the dozen or more CCGT plants which are largely permitted and just await funding. One possible result of Brexit may be that UK policy makers may look again at the existing wholesale energy "market" mechanisms in and recognise that fuel supply mix is a largely political question given the eponymous "tri-lemma" of balancing affordability, security of supply and environmental obligations.

Central government has been unequivocal in its expectation that local government pension funds are one sector that should be at the forefront of investing in infrastructure in the UK. Given the characteristics of the asset class and the maturity profile of these schemes this is a sensible assertion. However, the creation of regulated regional asset pools is a significant under-taking that has in effect pushed infrastructure investment further down the agenda for local authority schemes. This gives an advantage currently to corporate pension schemes and insurers to take advantage of this inertia and gain access to the pipeline of greenfield and brownfield projects that do exist.

Notwithstanding the (largely) political issues that impact the prospects for senior infrastructure debt there remain logically consistent reasons for accessing the asset class. As in previous investment cycles low yields force institutions to consider alternatives to long-dated sovereign bonds that typically increase the risk of their overall portfolio e.g. High Yield or EMD. That does not make them bad investments but investors need to recognise that there is no free lunch. Equally there are other emerging asset classes such as ground rents and commercial real estate debt that offer enhanced returns but these too do not come without risks such as patronage risk, market risk, merchant risk and deployment risk. All may have a role to play in a diversified portfolio but are they comparable alternative to sovereign bonds and can investors meaningfully deploy assets in these sectors? Senior infrastructure debt can be originated and structured to offer many of the characteristics that institutional investors are seeking. Transactions include the following characteristics:

- Fixed rate and index linked tranches.
- Genuine long-dated transactions with a weighted average life of 15-18-years.
- No or limited market risk.
- Pre-payment protection via spens and modified spens mechanisms.
- Spreads of 175-250bps over equivalently dated mid-swaps.

- Positive real returns.
- Investment grade.
- Externally rated transactions.
- Bond format (unlisted registered notes or listed bearer bonds).
- Diversification benefits versus other asset classes and among individual transactions.

Many institutional investors are attracted by these characteristics but lack the expertise to originate, structure and monitor transactions. For this reason it is often seen as the preserve of the larger investors. However, just like other asset classes, platforms have been created that provide access to these private debt transactions. Pooled vehicles are available that will accept investments of £25m from individual investors meaning an allocation of 10% from a pension fund portfolio makes the asset class available to schemes with assets in excess of £250m. Equally co-investment opportunities exist that mean relatively small allocations can be made to even the largest individual transactions. Examples of such transactions funded in the UK since 2012 include the M8, Aberdeen Western Peripheral Ring-Road, and DBFO2 refinancing with average spreads >200bps.

Largely political questions remain over the involvement of institutional investors in funding private, senior infrastructure debt transactions (in the UK) but the methods exist to capture the opportunities. As the US and the rest of the world embrace institutional investment there is a danger that this uncertainty leads institutional investors to consider the emerging pipeline overseas before facilitating the investment that will stimulate UK plc.

Contact Us

Margaret Frost, Head of UK Institutional
Tel: 020 3246 7385
Email: margaret.frost@allianzgi.com

Philip Dawes, Head of UK Institutional Sales
Tel: 020 3246 1443
Email: philip.dawes@allianzgi.com

Corinne Crawford, AllianzGI, Head of Consultant Relations UK
Tel: 020 3246 1474
Email: corinne.crawford@allianzgi.com

Address: Allianz Global Investors GmbH
199 Bishopsgate, London, EC2M 3TY

Telephone: 020 7859 9000

Web: www.allianzgi.co.uk

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