Institutions on the march

Infrastructure debt is a big talking point these days, with institutional investors on the cusp of what many see as a groundbreaking move into the space. Andy Thomson met with four experts to discuss the reasons for this emerging trend

Iconic buildings are all the rage in London these days. From the 39th floor of London's "Gherkin" in St Mary Axe, four professionals – Robert Dewing of JPMorgan, David Ridley of Westbourne Capital, Tim Cable of Hastings Funds Management and Michael Nowak of Scotiabank – are assessing the progress made on the new generation of giants looming up from ground level. From the "Cheesegrater" to the "Pinnacle" to the "Walkie Talkie", a collection of exotically named constructions are in the process of changing the capital's skyline. »

» Momentarily, it seems that *Infrastructure Investor* has wandered into the wrong room and that a real estate roundtable of more interest to our colleagues on *PERE* magazine is on the agenda. But then talk swiftly turns to the subject of infrastructure debt – the real reason for the gathering of the aforementioned. As with the London cityscape, the infrastructure debt market is also undergoing dramatic change. The first signs of this are visible now. In years to come, the change will gather speed to the point of almost complete transformation.

"Look at the league tables in 2017," says Dewing, a New York-based portfolio manager for infrastructure debt at JPMorgan Asset Management, "and my guess is that you will see institutional investors accounting for one-third of the long-term infrastructure financing market. At the moment, it's less than 10 percent. There is such keenness on the part of institutional investors that long-term capital provision will move away from the banks."

Michael Nowak, an associate director in the global infrastructure finance team at Scotiabank in London, estimates that the market for new infrastructure lending is currently worth around $200 billion annually. Referring back to Dewing's estimate, this means that the $20 billion market share now claimed by institutions (primarily pensions and insurance companies) will grow to more than $60 billion by 2017 – a tripling of market share in just four years.

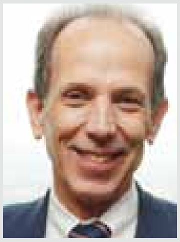
BALANCE SHEET PRESSURE

There are two main factors driving this trend away from banks providing infrastructure debt and towards institutional investors. One is the »

AROUND THE TABLE

Tim Cable, director, infrastructure debt, Hastings Funds Management

Cable joined Hastings in 2012 and is based in London. He is responsible for capital raising, origination and asset management. He has extensive financial services experience, having worked for Westpac Banking Corporation for more than 13 years in a number of different roles and on numerous debt transactions. Most recently, Cable was director, infrastructure and utilities, at Westpac where responsibilities included the management of a significant portfolio of infrastructure funds, utilities and transport infrastructure clients, and origination and execution of a wide range of transactions. Prior to that, Cable was director, corporate and institutional banking, with responsibility for a portfolio of hedge fund and diversified fund manager clients in Europe.



Bob Dewing, managing director & portfolio manager, JPMorgan Asset Management infrastructure debt strategy

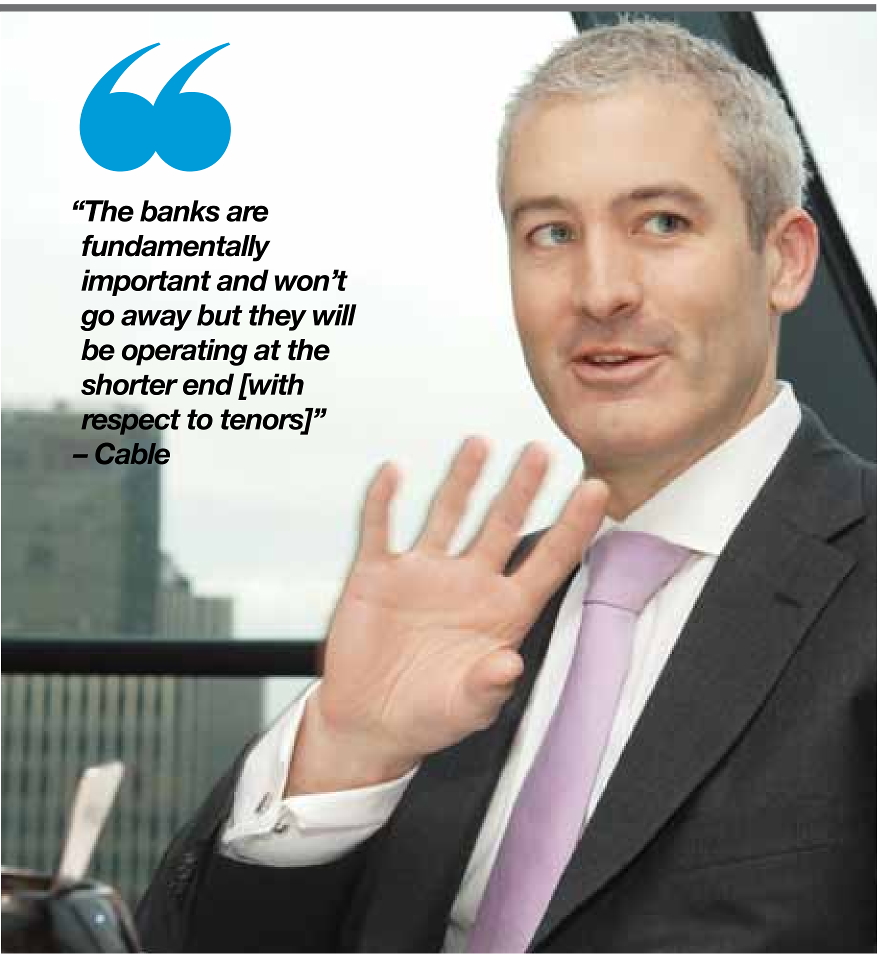
Dewing spent 26 of his 30+ years' professional career at Citigroup, where he held various leadership positions building business units. He was a managing director of infrastructure and energy finance in New York, managing director of project finance in Hong Kong, general manager with Citibank Ltd in Australia, and a vice president with Citibank in New York. He helped conceive and manage the Standard & Poor's Project Finance Default and Recovery Consortium and is an Adjunct Professor at Columbia University's Graduate School of Business teaching project finance.

Michael Nowak, associate director of global infrastructure finance, Scotiabank

Nowak joined Scotiabank's London office in 2007 and is an associate director within the Global Infrastructure Finance group where he has a particular focus on regulated utilities. He has been involved in many of the largest recent infrastructure financings in the EMEA region and has acted as arranger on transactions with a combined deal value of over $23 billion. Nowak has worked closely with international clients advising them on fundraising and M&A, in sectors ranging from regulated transmission and renewables to transport across various geographies. Prior to joining the Global Infrastructure group, he was a key member of the team responsible for developing the Structured Products/Credit Derivatives desk in Europe for Scotiabank.

David Ridley, chief investment officer, Westbourne Capital

Ridley is the chief investment officer of Westbourne, with overall responsibility for investments and divestments, portfolio management and risk management. Prior to joining Westbourne, he spent nine years with Hastings Funds Management. Ridley was head of UK and Europe (2006 to 2008), head of alternative debt (1999 to 2008), chief operating officer of the Hastings Yield Fund (1999 to 2006), a member of the Hastings investment committee (1999 to 2008), and a member of the senior executive management team (1999 to 2008). Prior to joining Hastings, he held executive director roles in the equity derivatives and fixed income divisions at UBS, an executive role in the project and finance division at National Australia Bank, and a supervisor role at Coopers & Lybrand.



pressure on banks' balance sheets caused by incoming capital adequacy requirements, particularly those specified by the Basel III banking regulations. The other is institutional investors hunting for suitable new homes for their money in the face of low interest rates, volatile equities and depressed fixed income yields. For these investors, infrastructure debt fits the bill as well as anything else.

None of this means that banks will disappear from the infrastructure debt scene. Nowak quips: "I would be worried if I didn't think there was still a role for the banks! As the market has changed, banks have shifted their focus more towards acquisition finance and bridge-to-bond style lending and we do that very well. If you look at capital expenditure, working capital, liquidity and short-term banking facilities you will see that certain higher-rated banks will have an obvious funding advantage in the current market. There will be a strong demand for these facilities going forward. Given the emergence of debt funds, banks may be taking a smaller slice of the pie overall in specific sectors and they will have to become more creative in structuring funding solutions."

Cable, a director of infrastructure debt in the London office of Australian fund manager Hastings Funds Management, agrees: "The banks are fundamentally important and won't go away but they will be operating at the shorter end [with respect to tenors]. But for long-term products, that space is best suited to institutional investors."

Dewing also believes that – through activities such as shorter-term funding, advisory and hedging – the »

CONSTRUCTION RISK: BEWARE 'KNEE-JERK' REACTIONS

A recent study from EDHEC Risk Institute – part of EDHEC Business School – concluded that construction risk has the ability to increase returns and reduce portfolio risk.

It said: "It follows that investors in infrastructure debt should actively seek to invest in construction risk. Moreover, if construction risk can be used to build efficient infrastructure debt portfolios there is little need to push it out of sight and into new public sector liabilities."

The study came shortly after the UK's National Audit Office (NAO) expressed concerns that if the UK government gave large construction risk guarantees to infrastructure projects – in an effort to attract pension funds – then substantial liabilities could arise for the UK taxpayer.

The roundtable participants felt that governments should be careful where they tread.

"The risk should be allocated to the party or parties best able to take that risk and control it," said Robert Dewing of JPMorgan Asset Management. "So when it comes to things like the availability of property and obtaining permits, government can take that risk. But whether the developer is able to build something on time should not be down to government. I'd say that would be a misplaced policy decision."

Added Michael Nowak of Scotiabank: "Having a government wrap has worked well, for example, in French high-speed rail deals. But it won't be the answer in all cases."

And Tim Cable of Hastings Funds Management said: "For investors, there is a place for construction risk with well-placed wraps. But you do see government institutions participating where they are not always needed."

banks will always be a dominant force overall. "Banks have the time and the resource when it comes to product development as they have so many different revenue streams and can offer so many services. The institutions can't do as much product development and relationship building."

"Credit quality is a combination of 20 or 30 years of knowledge. People have seen the problems and the same mistakes won't be made again, so the credit has improved" – Dewing

GAP IN THE MARKET

Of course, the mere appearance of a gap in the market does guarantee an attractive opportunity. But those around the table are convinced that the credit quality of infrastructure debt is good – and, indeed, has been improving in recent years. Part of this is to do with mistakes having been learned from the over-leveraging of infrastructure assets that was sometimes seen pre-Crisis.

David Ridley, managing director at fund manager Westbourne Capital, says that "credit quality has improved since 2006. Investors have seen the performance of infrastructure assets during times of stress so now have a solid reference point for credit quality".

Adds Dewing: "Credit quality is a combination of 20 or 30 years of knowledge. People have seen the problems and the same mistakes won't be made again, so the credit has improved."

For this reason, institutional investors are seeing an opportunity they are comfortable with. "They want good credit quality," says Cable, "and, while there is less liquidity in

REGULATION: 'NECESSARY AND PAINFUL'

"A necessary and painful aspect" of infrastructure investing is how Tim Cable of Hastings Funds Management described regulation.

He added: "You have a number of regulations at the investing level such as Solvency II and Volcker, and changes in the regulation of the underlying assets. You need to understand these asset level risks and deal with them. But you have to remember that this regulation is there because these are often monopoly assets, which makes them so attractive – regulation is the necessary flipside of that."

Dewing pointed out: "There is no mitigant other than having a diversified portfolio. Even if everyone decides they like a single industry sector, such as prisons, you have to recognise the need to build a portfolio of co-variant assets."

On Solvency II specifically, Ridley noted: "Some institutions can afford to take a stronger view whereas others will be very cautious until the full implications are clear."

infrastructure than in other fixed income asset classes and it also has some complexity, pensions and insurance companies can generally live with that and capture a return premium."

Indeed, there are some markets where institutional investors already play the role in infrastructure financing that they are expected to play in Europe and elsewhere in the years ahead. One of these is Canada. Nowak, a Canadian national whose home city is Toronto, points out: "In Canada the capital markets work very efficiently when it comes to project bonds. So there are already markets where bank lending is not seen as the only solution."

Dewing continues: "Canada is a developed market where liquidity has blossomed and there are 40 or 50 institutional investors that have an interest in projects and where the banks are happy to underwrite. Other markets will eventually go the Canadian way."

Cable points out that Canada did not see a monoline industry develop to the same extent as in Europe and this means institutional investors in the country have a history of doing their own homework on infrastructure credits and getting comfortable with them as a result.

"In Canada the capital markets work very efficiently when it comes to project bonds" – Nowak

EXPERIENCE LACKING

In other markets, however, this experience is lacking and a view is expressed around the table that institutions will need to show impressive adaptability in order to take over a long-term financing role traditionally performed by the banks.

"Borrowers want to see a long-term partnership," says Dewing. "Something adverse is bound to happen at some time during a 25-year credit and, when it does, you need to be able to sit around a table and sort out the issues. Institutions will have to show a willingness and an ability to do this as the partnership element is really key."

"They [institutions] will have to learn how to work effectively with the banks and with each other," agrees Cable. "After all, we're likely to see a dramatic change in a short period."

Ridley believes that there is no substitute for experience and that, once institutions have been down the same track a few times, there will be no looking back. "For institutional investment to become more mainstream, one needs to see investors being put together on deals and then you have a blueprint. You will have uniformity and deals occurring on a repeat basis with banks and institutions co-existing. Once there is a solution that is seen to work, it can be replicated."

There is a note of caution sounded, however. The umbrella term 'institutional investors' may encourage the perception of a homogenous grouping, all with similar plans and aspirations. It is more likely that one of the biggest challenges of greater institutional involvement in infrastructure debt will be attempting to reconcile different views. "Ask ten institutional investors what they want and you will get a wider spread of answers than when you ask ten banks," suggests Cable.

In terms of how institutional investors in infrastructure may be divided up, Ridley says: "The sources of money are in two pots. One is pension funds seeking absolute returns. These will invest in private debt of which infrastructure debt is a subset and will typically seek exposure to economic-type

infrastructure rather than public-private partnerships. These investors have the capacity to invest over 7 to 12 years and will be flexible enough to do junior and senior debt and take on construction risk."

He adds: "The other is the defined benefit pension and insurance market where it's about very long-term liability matching. They will become very major players in the long-dated scene."

> ***"It's a logical development that investment in infrastructure debt follows the maturing of the infrastructure equity market"***
> *– Ridley*

REPLACING PLACEMENT

Ridley goes on to say that the development of the institutional market in Australia would be a good thing given the reliance (some might say 'over-reliance') in that country on the US private placement market. "Ideally, you will see enough capital among institutions to become an alternative for Australian borrowers going to the US private placement market," he says. "It would make more sense to go to the domestic market given the additional cross-currency costs. The same would be true in Europe."

The US private placement market has already provided some evidence of the potential for institutions to provide an alternative funding source to the banks. According to data from Barclays quoted in the *Financial Times*, the market was worth \$50.4 billion in the first 10 months of 2012 compared with \$45.1 billion in the whole of 2011. While 40 percent of total activity involved US companies, the remainder was of a cross-border nature.

The potential of the institutional space was also picked up on recently by Standard & Poor's (S&P), the ratings agency, in a report entitled *Out of the shadows: The rise of alternative financing in infrastructure*. The thrust of the report was positive, saying that new sources of financing for infrastructure are "of great benefit" and "may help reduce the cost of borrowing for projects and introduce financial innovation into the marketplace".

However, there were also words of warning in the report. "On the downside, our view is that the somewhat opaque nature of the shadow banking system could lead to a build-up of systemic risks within the infrastructure sector, as occurred prior to the global financial crisis of 2007 to 2009. To date, though, this has not been a major cause for concern," said S&P credit analyst Michael Wilkins.

Asked what they think of the 'shadow banking' reference, with its implications of operating away from the prying eyes of regulators, Dewing admits that the terminology is "a bit pejorative". He adds: "Everyone knows that central banks are concerned about unregulated credit."

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Cable chips in: "Insurance companies and pension funds sit within a robust regulatory environment. I think the most significant conclusion of the [S&P] report is that the increase in funding sources is a positive development – albeit, one to be treated with a little caution."

THE FUND OPTION

Certainly, investors appear to be viewing infrastructure debt as a positive development, with commitments to still-nascent infrastructure debt funds increasing all the time. Having barely registered a couple of years back, placement agent Probitas Partners noted that debt funds accounted for 12 percent of overall infrastructure fundraising in 2012.

However, Nowak notes that "some people are shying away from the word 'fund' these days". In part, this is because the main focus is on doing what's best for clients with a more bespoke solution – and doing what's best may or may not fit a conventional fund structure. In many cases it involves partnerships between banks and long-term infrastructure investors, such as debt funds.

"These are long-term opportunities and, for a fund, you need investors with an identical view to investing over the long term," points out Dewing. "If they're identical, then the fund structure works. Above all, limited partners need to think about the people running the fund. Will they get good support from people who will be around long enough to manage the assets?"

Adds Cable: "There is value to be had from origination [of long-term infrastructure investments] but there is just as much value from effective monitoring," says Cable. "If it's a 25-year investment, you can bet the originator will not be the one who sees the asset to maturity. It then comes down to the organisation being able to evolve and change as well as having the right strategy. Charging a high upfront fee and then a low fee to manage the assets is probably not the right approach."

All around the table acknowledge that there is a lot of diversity in terms of solutions. For investors which have only modest amounts of capital to invest, pooling their resources with others in the form of a fund may be the only way of achieving the diversity they need. For large institutional investors, meanwhile, a tailored approach may be more appropriate, perhaps in the form of a managed account.

PORTFOLIO MUSCLE

Through whichever channel they choose, investors in infrastructure debt see an opportunity to make what Ridley describes as an "excellent risk-adjusted return". While infrastructure assets are perceived to be relatively safe, they crucially offer higher yields than government bonds. Typically, an infrastructure debt instrument offers about 3 percentage points more than a US Treasury in yield terms.

This means that infrastructure debt is likely to increasingly muscle its way into institutional investor portfolios. Described by Cable as "quite specialised" and "an alternative fixed income product", Dewing adds that, in his view, infrastructure debt "will replace mortgage products [in portfolios] first as investors come out of the mortgage market. Then it will replace sovereign debt after that".

The last word goes to Ridley, who says: "It [infrastructure debt] is a subset of the private debt markets. Its development may follow the development of the real estate debt market where institutions initially invested in real estate equity and then once the asset class was well developed extended investment to real estate debt for which the market has matured. So it's a logical development that investment in infrastructure debt follows the maturing of the infrastructure equity market. Activity in debt has been accelerated by the dynamics in the banking industry."

The subject under discussion has thus, quite unintentionally but rather neatly, reverted to real estate. And it doesn't end there. With the 'official' conversation now wrapped up, all attendees stay in the room for a good while longer, chatting about various matters including London house prices. If infrastructure debt sees the same kind of upward trajectory as property values in the capital, everyone here will be extremely busy in the years ahead. ■