A realistic approach to infrastructure investment

Adrian Jones tackles some of the concerns about infrastructure debt investing and discusses why pension funds should consider the first-mover advantage

Investing in long-term, low-risk infrastructure assets with an increased focus on environmental, social and governance impact and broad societal and macroeconomic positives seems intuitive to most. But while some investors are flexible and adapt to a changing market, others exclude themselves because of unrealistic return requirements or project pipeline predictability. As the range of infrastructure opportunities is likely to become more varied, this will favour more sophisticated investors who take a forward-looking, relative-value approach.

Since 2014, AllianzGI's clients have invested approximately £750 million in primary UK infrastructure investment-grade project bonds (and ten-times that amount in EUR and USD) with an average spread over sterling swap rates of 200bppa. Over the same period, average spreads on equivalently-rated listed UK utility bonds averaged around 140bppa[1]. During that time sterling rates fell from 3.5% to 1.5%, thus infrastructure debt generated 20%-30% more gross income than for those electing to stay in public fixed income markets.

Investors that ultimately decide not to invest in infrastructure debt worry about an insufficient 'illiquidity premium', an unclear future pipeline of opportunities, or political and regulatory uncertainty e.g. Brexit/Trump/Scottish independence. However for those taking a less reactive approach, the reluctance of other investors is good news – the logic of supply and demand indicates that the first-movers should extract greater value.

Illiquidity premium

Some investors appear to require an absolute (arbitrary?) illiquidity premium regardless of the broader yield and spread environment. Some fail to recognise that 'liquid' and 'illiquid' are not mutually exclusive quasi-quantum mechanical states. Rather, there is relative liquidity among the different private market opportunities and the listed debt products used to benchmark illiquidity. For example, in the indices of listed utility bonds a third of the index members are debt issues only just 'benchmark size' of £250 million. Within the index of listed bonds, companies in the same narrow sector with the same credit rating can price quite differently.

On the private investment side, infrastructure debt takes on a bond-like structure (fixed rate, fixed redemption profile, freely transferable, prepayment protection, formal investment-grade rating) and is therefore more fungible with traditional fixed income than other types of illiquid investment, so requiring a lower illiquidity premium.

In reality, it is only at the very high quality end of the credit spectrum that one can directly observe a pure illiquidity premium, eg when one looks at UK government guaranteed debt vs. gilts, one sees a clear pricing differential for identical credit risk. Moving down the credit curve, factors such as size, credit risk, illiquidity and complexity blur into a general requirement for some extra margin, but its specification is art, not science, and ultimately negotiation.

It should be recognised that liquidity is not a property of the individual investments, it is a property of the broader market. By definition, first-movers buy into a less liquid market than late-adopters who drive down prices while increasing liquidity.

Future uncertainty

In an environment of increasing uncertainty, the greatest risk is an inability to adapt to change.

Investors often fail to acknowledge the relative fragility of classic fixed-income contractual structures compared with private debt. From a contractual perspective, senior unsecured listed bonds are little more than tax-efficient preferred equity with a right to be paid ahead of shareholders on an insolvency. Indeed, the price of liquidity results in these bonds being structured so that the maximum number of potential buyers can hold them easily, meaning investors are mere spectators and not involved in the direction of the underlying enterprise.

Well-structured private infrastructure debt benefits from security and covenants that give creditors a say in how the underlying enterprise reacts to unexpected, especially adverse, change. And when one is investing in essential infrastructure for 30 years one should anticipate that change will occur and structure investments to allow an active role in managing that change.

Considering unforeseen events such as Brexit, the advantages of being an active investor with control rights are clear. The only alternative to control is to passively rely on liquidity remaining ….even when everyone else is running for the door as well.

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[1] Source: Bloomberg sterling utility indices

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