KEYNOTE INTERVIEW

# Rethinking risk

*Risk, by its very nature, is hard to predict, and has not always been accurately reflected in the pricing and structuring of deals, says Alexander Waller, head of infrastructure debt at Whitehelm Capital*

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**Q Why is infrastructure debt an attractive proposition for investors right now?**

Infrastructure debt gives investors all the advantages of exposure to the infrastructure sector, but without that first loss risk. It gives investors protection against inflation. It gives them non-volatile cashflows. But it also gives them protection in the event that markets perform weakly. Just look at what happened in March last year.

The pandemic caused panic and equity asset valuations fell off a cliff. Debt valuations also declined, but the fall was less precipitous and the bounceback faster. In short, infrastructure debt offers all the desirable characteristics of infrastructure equity at a slightly lower return, but with added protections.

**Q How has that translated into investor demand for the asset class?**

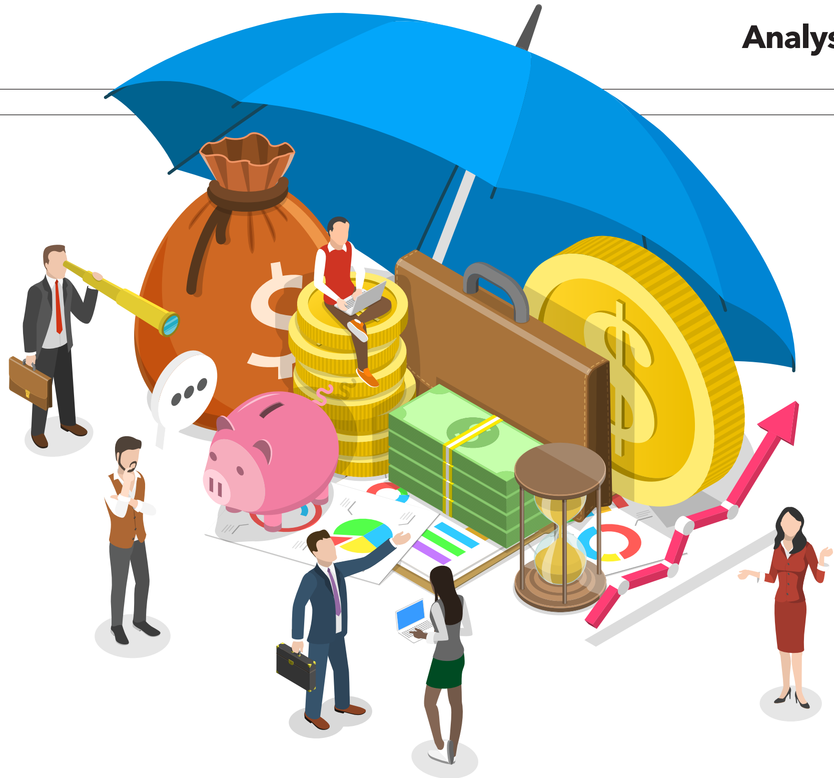
For us – as an investor in higher yield infrastructure debt, looking to deliver 400 to 600 bps over Euribor, and having delivered around 10 percent in the past – we are seeing lots of interest from pension funds, in particular. The reason we see greater appetite from pension funds than insurance companies is that pension funds are less constrained by solvency capital requirements. They are able to identify the best risk/reward strategies and commit to them. The solvency capital requirements that insurance companies face mean it is less about finding the best risk/reward proposition and more about finding opportunities that deliver a strong return on capital.

Virtually all of the LPs that have come into our vehicles so far have been pension funds, and predominantly European pension funds, although we also see appetite from the Asia-Pacific region, especially Korea, Japan and Australia.

**Q And have you managed to continue to deploy those funds, throughout the pandemic?**

Deployment was slower in 2020. There were pockets of opportunity, but it was a difficult time to commit capital with conviction. Markets were uncertain and so we preferred to keep our

**Can a low-risk product like infrastructure debt flourish in this protracted low interest rate environment?**
Risky strategies are untested in a low or zero interest rate environment and managers of more conservative products can get overlooked in favour of those products that benefit from a distorted market. But there will always be investors out there that favour a prudent approach and stable returns. Low interest rates may inhibit the growth of our asset class, but they won't imperil it.



capital dry. Certainly, transaction volumes were lower than we would have hoped for last year. That said, in most cases, deals didn't disappear. They were merely postponed.

So, as we head into 2021, the pipeline is actually far larger than we would normally expect, because there is still that backlog to get through. We are well positioned to get significant capital invested this year. There is a lot of sponsor activity. Deals need to be financed. There are refinancings that need to happen and growth plans that need to be funded. The underlying dynamics are healthy.

We have never had a default or loss on any of our investments in over 20 years of debt investing, and are focused on keeping it that way.

**How well have existing assets performed in the face of the pandemic?**
Extremely well. Listed infrastructure debt bounced back briskly and we saw virtually no impact on our own portfolio. We didn't need to write down any assets and all assets performed resiliently throughout the year. Even where there were assets that might have appeared to be exposed, performance remained strong.

For example, we have a toll road investment that enjoys a minimum revenue guarantee from the local government. The revenues provided by that guarantee are enough to cover debt payments. Philosophically, we avoid assets that have market risk. We don't do deals where success is reliant on oil prices remaining high, for example, or where revenues are linked to other commodity prices.

*"The perception is that risk wasn't being correctly priced in the run-up to March of last year"*

And so, overall, there were no material cashflow impacts as a result of the pandemic and the values of our investments remain where they were in January and February of last year. I think that was broadly the case across the asset class, at least for managers pursuing lower risk strategies. Where we may see more difficulties arise, however, is in the pure mezzanine space.

**Do you think covid-19 has caused investors to rethink the nature of risk?**
Yes, I think it has. The perception is that risk wasn't being correctly priced in the run-up to March of last year. Idiosyncratic risks weren't being accurately reflected and that has been a wake-up call for investors. There are segments of infrastructure that were very popular prior to the pandemic – airports being the obvious example – that have suffered deeply negative impacts.

While that is unfortunate, I don't think it is unhealthy for investors to be reminded that risk, by its very nature, is hard to predict and needs to be reflected in the pricing and structuring of deals. I also think the pandemic has underlined the importance of portfolio diversification.

**Q What sectors and geographies are most interesting to you at the moment?**

We are heavily focused on Western Europe. That is our area of specialism. Coming off the back of a uniquely challenging 2020, I don't think this is the time to stray from what you know best and so our geographical remit will remain unchanged this year.

When it comes to sector, we are largely agnostic. We look at the underlying merits of the deal, rather than the industry that the asset is operating in. That said, we are wary of some of the renewables opportunities we are seeing today, and I don't think we are alone in that.

We would like to do more in the space, but the sheer amount of capital in the market has pushed down pricing and pushed up risk. Around 40 percent of the transactions we see are in the renewables sector, so it will be interesting to see how that market evolves. But, at the moment, deals are being structured and priced rather too aggressively for our liking.

**Q How would you describe competitive dynamics more broadly?**

If you look at all the managers out there with infrastructure debt operations, it seems a crowded market. But dig a little deeper into the specific investment parameters within those strategies, and you start to see some clear differences between them.

At one end of the spectrum, you have managers that are focused on senior investment-grade infrastructure debt – usually long-dated, 'project finance replacement' debt that is popular with insurers. Then, at the other end, you have the large mezzanine investors that are seeking returns in line with or above those of infrastructure equity. And then there are the managers in the middle, like us, that are investing in largely sub-investment-grade debt, but looking for cash-paying, secured, covenanted instruments at that implied double B-rated level.

When you look at the market in terms of those distinct buckets and then also consider the other nuances of manager approach, suddenly it doesn't feel all that crowded. Of course, you have the additional overlay of investors that aren't infrastructure specialists but may dabble in the infrastructure world, such as the private credit arms of the big sovereign wealth funds. Overall, we are happy with the competitive dynamics. There are more than enough transactions to go around.

**Q What is your take on the central bank policy response we have seen to the covid-19 crisis and what impact has that had on the infrastructure debt market?**

Central bank action has significantly distorted the market, both through interest rate cuts and the buying of corporate bonds. While it is a rational reaction to a significant underlying problem, it has made life harder for credit investors. We adapt and learn to live with it. In fact, we have been living with it since the global financial crisis. But, at some point, that central bank intervention will have to taper off.

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When the intervention is eased, it would be reasonable to expect discount rates and risk premia to crawl up again. If that happens, there will be an adverse impact on values. That impact will be more noticeable for infrastructure equity assets, but we are all interlinked. That is the future that we have to prepare ourselves for and it is the future that our investors are keen to protect themselves against.

The past 10 to 12 years have seen the longest bull markets that the credit world has ever experienced, and discount rates have got lower and lower. That can cover up a whole host of risky behaviours. Risky investment is great when you are in a roaring bull market. That is when you want to pile money into lowly rated bonds, mezzanine and risky equities. But all that has to unwind at some point. Risk premia will go up and discount rates will go up. The great thing about infrastructure debt is you get a lot of the positive characteristics that come with some of those riskier infrastructure investments, but without the first loss exposure.

**Q Do you think government plans to boost economic recovery though infrastructure spending will prove a boon for the industry?**

It would be nice to think so. But we have heard it all before. The US announced ambitious infrastructure investment plans. The UK set a whole host of ambitious infrastructure targets in the wake of the financial crisis. But I am not sure we have actually seen any of that come to fruition to a notable degree. Any additional focus on infrastructure will be warmly welcomed by those in the industry. It would be good for the asset class and good for the relevant economies. But I am guarded. I am not sure how much will actually happen and how much of a difference it will truly make. ■