AMP Capital

Using infrastructure debt in a diversified portfolio

A Q&A with Patrick Trears

Can you tell us a little about AMP Capital and its infrastructure debt program?

Private infrastructure debt is growing as an asset class offering downside protection, and investors are recognizing its increased value in asset allocation, which has been highlighted in the recent market turbulence.

AMP Capital has successfully built on a strong track record, having deployed capital for three prior infrastructure debt funds over the last few years. Most recently, AMP Capital reached a $6.2 billion record fundraise for its fourth infrastructure debt strategy, which includes the final close of the AMP Capital Infrastructure Debt Fund IV (IDF IV), co-investment rights and separately managed account commitments. This makes AMP Capital one of the largest infrastructure debt managers in the world by capital raised.[1]

What is your specific strategy for infrastructure debt investments?

The AMP Capital infrastructure debt strategy provides private and subordinated debt to infrastructure businesses in North America, Europe and Asia. The strategy focuses on higher-yielding subordinated/mezzanine debt investments across our four verticals of infrastructure, which include Energy, Transportation, Digital Infrastructure and Utilities.

We focus on consistent cash yield and low volatility. The duration of the loans is long term — six- to eight-year legal maturities — and, as such, the investment is illiquid and pooled in a 10-year closed-ended vehicle.

And what place does this kind of investment hold in an investor's overall portfolio? What are investors looking for from an allocation to infrastructure debt?

Investors have been attracted to the strong risk-adjusted returns, which can complement diversified portfolios; the long-term yield it aims to provide; and the risk diversification from lower volatility and lower correlation to traditional assets. Investors have increased their allocations to private credit, with infrastructure debt proving to be a successful addition to their portfolios.

What are the characteristics of private subordinated infrastructure debt, from an investor's perspective?

Private subordinated infrastructure debt as an asset class is still relatively nascent, but institutions are increasingly recognizing how it can play an important role in improving a portfolio's risk/return profile, especially in an environment of low interest rates. Private credit markets yield a higher risk-adjusted return with stronger protections when compared against public markets. Also, the deals are highly structured, offering much stronger protections and covenants, allowing for a stronger credit profile. Private subordinated infrastructure debt can play a defensive role in a portfolio, providing attractive risk-adjusted returns with a strong cash yield, higher resilience in market downturns as a result of lower defaults and higher recoveries, and a natural hedge against inflation.

When investing in private subordinated infrastructure debt, are investors including it in their alternatives allocation? Real assets? Fixed income?

Many investors are grappling with where in their portfolio this allocation should sit. Does private subordinated infrastructure debt belong in a private credit bucket, or is it more appropriate in an alternatives or fixed-income bucket? Classifying investment strategies within certain asset classes can be straightforward. For example, there is a clear distinction between equities and fixed income, or real estate versus hedge funds. However, there are some investment strategies that fall into a gray zone without an obvious home — and a good example is infrastructure debt. Institutional investors may classify subordinated infrastructure debt in different asset classes for various reasons unique to their diversified portfolio.

So, what might be the rationale for assigning it to the real-asset "bucket" within the portfolio?

Allocations within this bucket are said to be tangible investments with intrinsic value due to their physical properties. And investors may include private subordinated infrastructure debt in a real-assets allocation, as they are physical assets with intrinsic value, they can serve as a hedge against inflation, they have low correlation with equities and bonds, they have long-term horizons, and they comprise an illiquid asset class. These characteristics drive the overall asset allocation to real assets, which is generally a decision based on risk/return trade-offs and liquidity profile. We believe private subordinated infrastructure debt investments can generate gross IRRs of 10 percent, which would be consistent with the real-assets allocation. Additionally, the illiquid nature of this strategy makes private subordinated infrastructure debt an appropriate fit, as investors take a long-term view in these investments. Subordinated infrastructure debt is less driven by macroeconomic conditions than property investments, which tend to be more cyclical and sensitive to the market environment, but its stability throughout cycles is comparable with infrastructure equity.

What would be the rationale for including this type of investment in the infrastructure portion of a portfolio?

Adding infrastructure debt to an infrastructure equity allocation can also serve to help balance the risk profile, as infrastructure debt tends to have much lower volatility than infrastructure equity investments and can offer more defensive characteristics to the portfolio. Within an infrastructure portfolio, which typically largely comprises infrastructure equity investments, subordinated infrastructure debt can serve a variety of roles, depending on an investor's existing portfolio and investment strategy. For investors seeking the low-volatility, high-yielding cashflows of core infrastructure assets but who are finding it difficult to deploy capital at attractive returns, subordinated infrastructure debt presents an excellent alternative. For those with exposure to higher-returning value-add infrastructure strategies, subordinated debt can complement and drive cash yield across the portfolio on a blended basis. Value-add infrastructure equity funds will typically target lower cash yields in the first part of the fund's life, as capital is reinvested to drive business growth. Pairing such an investment with a high-yielding infrastructure debt strategy helps ensure the portfolio is highly cash generative from the outset.

And what about investors who locate this type of allocation in alternatives?

Alternatives can be a catchall category that encompasses all assets that are unlisted and illiquid. The benefit of including private subordinated infrastructure debt within an alternatives allocation is the low correlation compared with other alternative strategies within the bucket and compared with the broader diversified portfolio. We think private infrastructure debt should be considered a defensive alternatives investment, whose main purpose is to help diversify the alternatives allocation, as well as the broader multi-asset portfolio.

You mentioned some investors might place private infrastructure debt in the private debt portion of the portfolio.

Private debt has been a growing allocation to investors' portfolios in recent years — it's also sometimes referred to as private credit, alternative credit or enhanced fixed income. Within private debt, the subcategories can include corporate private debt or asset-backed lending strategies. Within corporate private debt strategies, the focus is on cashflows of the borrower to secure the loan, while asset-backed lending strategies are secured by collateral on real estate debt, infrastructure or other assets, such as aircrafts. Another key characteristic of private debt is the unrated and illiquid nature of the strategy, which is the source of illiquidity premiums.

An allocation of subordinated infrastructure debt within a private debt allocation should be viewed as a long-term investment opportunity that offers diversification and resilience compared with the traditional and publicly listed allocation of a portfolio.

And for what reason would investors place it in the fixed-income part of the portfolio?

The main drivers of a fixed-income allocation are the yield and lower volatility of the investment. Investors who may consider private subordinated infrastructure debt as part of their fixed-income allocation look to the allocation as a liability match from cashflows. They are not necessarily allocating to the space to generate outsized risk/returns, but rather for stable cash yield. However, due to the illiquid nature of private subordinated infrastructure debt, it is not generally considered a typical allocation in the fixed-income bucket.

How is the COVID-19 situation impacting your strategy?

We are clearly going through a period of completely unprecedented market volatility. We have quite a bit of exposure in North America and Western Europe, regions which have obviously been significantly affected. However, our investment strategy targets companies that provide essential services — for example, regulated utilities that might be generating electricity under long-term fixed-price contracts. These businesses have been designated "essential," which means they have not been locked down, they are still able to operate and their cashflows are not GDP linked, so we're seeing resilience across the portfolio. The crisis is still developing, of course, but at the moment we're expecting continued consistent performance. Our expectation is that our loans will remain insulated from the risks presented from the impact of economic volatility, restrictions on movements of labor and volatility in commodity prices. This will be a good test for our strategy, the first real test since the financial crisis, so we're pleased it's performing as we expected.

Are you seeing any bright spots in the current crisis?

The illiquidity in markets has created invesment opportunities for us, which we were expecting, but we have been surprised by the extent. Certainly from an overall perspective, M&A activity has slowed down around the world, but what we've seen is that asset owners who would typically look to access public markets have been caught in a hold. So things like high-yield markets being effectively closed has meant we've been approached by leading sponsors with whom we've developed relationships over the years to help with refinancing activities for existing businesses they own, which is driving significant pipeline opportunities.

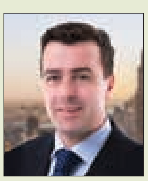
We're also seeing opportunities in the digital infrastructure space — for example, data centers and telecommunications towers. There was high demand in this sector already, but that's been accelerated by the restrictions around the world, with more people working from home and demanding greater access to connectivity, which is creating investment opportunities.

In the current market conditions, we're really seeing benefits flow through in terms of the relationships we have built with sponsors around the world over many years. In volatile times, having a source of capital that's reliable is valuable to sponsors, and we're making the most of that in the current environment.

Notes:

[1] *Infrastructure Investor,* February 2020

CONTRIBUTOR



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Patrick Trears has more than 20 years' experience in infrastructure investing across the Americas and Europe. Patrick is responsible for heading up AMP Capital's Infrastructure Debt team in the Americas, focusing on mezzanine and subordinated debt opportunities.

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CORPORATE OVERVIEW

AMP Capital is a global investment house with around $140 billion assets under management as of Dec. 31, 2019, and more than 130 infrastructure equity and debt investments throughout North America, Europe, Asia, Australia and New Zealand. AMP Capital has a lengthy track record of infrastructure investing across multiple geographies and sectors. We're recognized as one of the largest infrastructure managers globally, with more than $19 billion in infrastructure equity and debt funds under management. Backed by a truly global infrastructure platform, we're able to capture the best investment opportunities from around the world. With 30 years' experience, we bring a unique breadth of insight that spans energy, power, transport, utilities, airports, seaports, communications infrastructure, social infrastructure, aged care and more. The combined expertise of 100-plus infrastructure investment specialists globally also allows us to cover all aspects of capital structure — giving our clients more investment options for their future. AMP Capital Investors (US) Ltd. provides non-discretionary recommendations to AMP Capital Investors Ltd., its affiliate, through a services agreement.