Allianz Global Investors

Infrastructure debt: Much-needed resilience in times of market stress

CONTRIBUTORS

Paul David
Head of Americas, Infrastructure Debt
Allianz Global Investors
Paul David is based in New York and leads the firm's infrastructure debt team for the Americas, which has invested more than $5 billion in infrastructure projects in the United States and Latin America, ranging from roads to renewable-energy projects.

Jorge Camina
Director, Infrastructure Debt
Allianz Global Investors
Jorge Camina is based in New York and is a director and portfolio manager on the firm's infrastructure debt team.

Although the COVID-19 crisis has put financial markets and investment portfolios everywhere under intense stress, turbulence created by the pandemic has created at least one small silver lining for institutional investors: It gives them a chance to secure long-duration bonds that they need for asset-liability matching strategies at attractive prices in an environment of unprecedented monetary easing and tightening spreads for high-grade corporate credits.

This opportunity is found not in public credit markets, but rather in infrastructure debt — an asset class whose liability-hedging properties make it a natural fit for pension funds and other institutions employing liability-driven investment (LDI) approaches, and whose resilience to market stress makes it a particularly attractive fixed-income asset in this time of stress.

Even before the pandemic, institutional investors were having a hard time finding assets to populate LDI strategies. Institutions have been constrained by limited supply and high degrees of concentration in U.S. long-duration investment-grade credit, and by the trend of declining credit quality among investment-grade corporate issuers.

At the same time, in recent years, tougher Basel III bank capital requirements have opened up infrastructure debt as a new source of these assets for institutions by prompting banks to retreat from a market they had previously largely controlled.

As a component of an LDI strategy, infrastructure debt has some important advantages over corporate debt and other assets. The asset class offers superior credit quality relative to traditional corporate debt, often with stronger covenant protection and with historically lower default rates. It has a high correlation to corporate debt and U.S. Treasuries, but it has offered less volatility historically and, as a result, can serve as an effective liability hedge while also diversifying a portfolio. Finally, infrastructure debt offers the potential for enhanced yields. Historically, infrastructure debt investors have experienced a BBB-like spread for an asset that is equivalent in credit quality to a class A or better asset. On average, the asset class aims for a yield pickup of 40 basis points to 60 basis points over comparable corporate debt. That yield can be further enhanced through investing in deals in investment-grade countries in Latin America, such as Chile, Peru, Mexico and Colombia, which can help to boost returns at comparable levels of risk to similarly rated U.S. credits with comparable levels of default.

While all credit assets have been hit hard by the crisis, there is every reason to expect that infrastructure bonds will hold up better than comparative corporate credit. The reason: They are far less tied to vagaries of the economic cycle. Regardless of short-term economic and market conditions, electricity

will still be transmitted over distribution lines to homes, factories and offices, and people will continue to travel on toll roads and trains. Infrastructure debt finances physical assets that deliver these necessities, and often come with decades of contracted or regulated cashflows generated by projects that operate under stringent government oversight.

The key is being selective. Not all infrastructure projects and bonds are created equal. Assets from riskier segments of the infrastructure asset class can come with higher degrees of economic exposure.

So-called core infrastructure bonds — those considered to have the lowest level of risk — should prove especially resilient. Core deals generally finance indispensable infrastructure projects. These projects often include long-term purchase agreements that ensure stable cashflows, even amid a recession. One good example: a renewable energy plant with a long-term contract to supply energy to a highly rated utility company.

The key is being selective. Not all infrastructure projects and bonds are created equal. Assets from riskier segments of the infrastructure asset class can come with higher degrees of economic exposure. For example, container terminals can be negatively affected by drops in consumer demand, and merchant power plants and many other projects in the energy sector can be at risk from a steep drop in energy demand and pricing. Investors can largely avoid these risks — and minimize their exposure to any surge in downgrades and defaults in the broader credit markets — by sticking to the premium end of core infrastructure and investing in deals with regulated cashflows and strong covenant protections.

The summer months have brought a continued pick-up in yields for investment-grade infrastructure relative to the alternative yield in high-quality corporates, resulting in typical yields of 3.5 percent for U.S. deals and 4.5 percent in Latin America. After the brief pause of the crisis, following unprecedented support from the U.S. Federal Reserve to support credit markets, opportunities are now returning for deals in midstream energy and renewables. It remains difficult to complete transport sector deals in light of the pandemic's impact on travel patterns. With monetary policy in major economies focused on shorter-term liquidity easing, there has been a further steepening of the yield curve for longer-duration fixed-income assets — a circumstance that can favor infrastructure debt.

The COVID-19 crisis represents an unprecedented challenge for societies, economies and markets. For institutions, the economic shutdown and market volatility have intensified already daunting challenges related to funding levels. As institutional investors navigate the crisis and its aftermath, they should take advantage of any opportunity to improve the quality of their portfolios and the effectiveness of their liability-matching strategies. Current spreads on infrastructure debt present exactly such an opportunity by allowing institutions to acquire long-duration assets uniquely well fitted to LDI strategies — and to do so at historically attractive prices.

CORPORATE OVERVIEW

Allianz Global Investors is a leading active asset manager with over 760 investment professionals in 25 offices worldwide and managing $604 billion in assets for individuals, families and institutions, as of June 30, 2020. AllianzGI offers its clients a wide range of actively managed strategies and solutions across the risk/return spectrum and has established expertise in equities, fixed-income, multi-asset and alternative investments.

CORPORATE CONTACT

Ana G. Chapman
Senior Relationship Manager | Allianz Global Investors
+1 (619) 687-2784
ana.chapman@allianzgi.com
us.allianzgi.com/institutional

This article presents the authors' present opinions reflecting current market conditions. It has been written for informational and educational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product.