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Bright spots in U.S. middle-market infrastructure debt

A Q&A with Nick Cleary, senior partner with Vantage Infrastructure

Infrastructure debt's time has come. Where are the bright spots?

Infrastructure debt is getting more attention because it offers investors greater choice and value as the market continues to expand beyond the capacity of the traditional lenders. During the past decade, the market has grown from approximately $400 billion to more than $1 trillion of annual debt issuance, which is straining existing lending capacity and opening several bright spots for investors.

But infrastructure debt's quality and value attract a good deal of lending competition, mostly from banks and increasingly from direct investors and the capital markets as it matures. This means finding the bright spots of value increasingly requires a specialized and targeted approach.

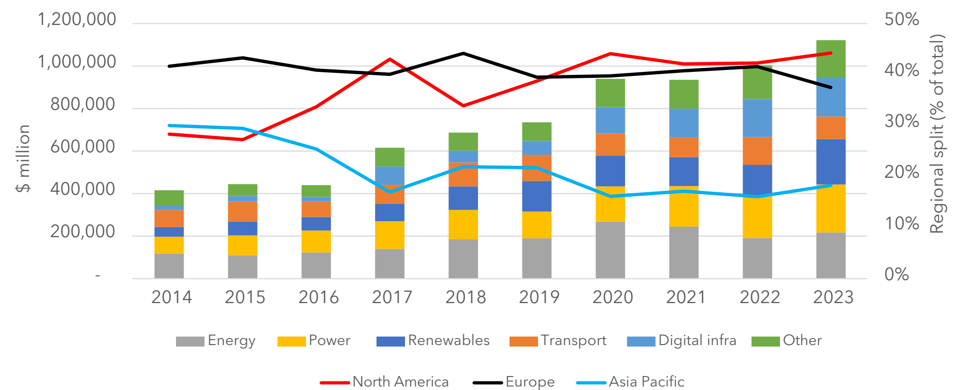
During the past 12 years our team has been dedicated to infrastructure debt, we've seen three consistent themes underpinning the brightest spots of value across different regions and market cycles. These themes are: (1) high investment growth, (2) transaction scale and complexity, and (3) dislocations at either the asset or market level.

Today, all three of these themes coincide in U.S. senior middle-market infrastructure debt, making it one of the brightest spots globally for private debt investors seeking higher yields with the resilience of an essential real asset–backed credit investment.

How has the investment market for infrastructure debt evolved?

The market has not only grown to more than $1 trillion but diversified, as the next generation of infrastructure gets built. Figure 1 helps explain the market evolution during the past decade.

Figure 1: Global infrastructure debt by sector and region



Source: IJGlobal, April 2024

In the early 2000s, Europe was the largest market, which is why many early investors came from Europe and managers focused on Europe, particularly in the wake of two major dislocation events, the global financial crisis (GFC) and European sovereign debt crisis. Since around 2016, North America has seen the strongest growth, as it starts to catch up on a decades-long underinvestment in traditional infrastructure and tackles energy transition. Since 2020 this growth has propelled it to the largest infrastructure debt market globally, growing at more than twice the rate of Europe during the past five years.

This relatively rapid growth in North America has made it the new kid on the infrastructure block that is creating opportunities for global investors to diversify into the region and giving local investors more opportunities in their backyard.

How would you characterize the scale and complexity of the infrastructure debt market?

Small and complex financings are less attractive to banks, certain direct investors such as insurers, or large generalist asset managers for whom volume is often more important than value. For a specialist asset manager, the lower lending competition associated with small and complex financings creates a consistent opportunity to apply their experience to deliver bespoke financings that provide greater financing flexibility for sponsors and the potential for investors to achieve higher returns and more control – an attractive mix.

Large-scale infrastructure financings have grown during the past 10 to 20 years from approximately $500 million to more than $1 billion. This scale aligns with core infrastructure, where more standardized financing and investment-grade ratings attract strong bank competition for the fees. Direct investors such as insurance companies, whose regulations constrain them to investment-grade assets, also focus on these financings, which crowds lending competition into a subset that is less than half of the total opportunity set. This creates a large gap for financings less than $200 million, which is what we call middle-market for infrastructure debt financing.

What constitutes "complex" in infrastructure debt has also evolved. When the first airports and utilities were being privatized in the 1990s, or the first renewable and LNG financings were being structured in the 2000s, these were viewed as highly complex and innovative. Today, they are standardized, and it is the sectors such as data, telecommunications and new energy-transition sectors – energy storage, EV charging and energy efficiency – where complexity is highest. This complexity limits competition because there are less standardized structures, they are often unrated, and fewer lenders have the experience to understand the intricacies of these sectors.

This explains the evolution of the infrastructure debt market, where large generalist asset managers and a select group of direct investors are replacing banks in the more standardized opportunities focused on longer-term and investment-grade financings. It also explains why specialized and experienced managers have evolved to focus on the higher-value niches that are increasingly small to medium-scale transactions with complexity that limits lending competition.

Is market dislocation playing a role?

Dislocations come in lots of different forms. Some are more subtle and longer term, and others are more dramatic and short term. Both typically result in a pull back in lending competition from the banks that remain the most influential lenders in the market, and this creates more opportunity for investors, as well as persistently or opportunistically higher returns.

For example, in Europe, where banks provide approximately 80 percent of corporate lending, the longer-term dislocations caused by banking and insurance regulation, or short-term events can have a significant impact on the value on offer for investors. In the United States, where banks provide approximately 20 percent of corporate lending, the longer-term dislocation is about fundamental growth that today is exceeding bank and capital market capacity, which is most notable in the sub-investment-grade market.

But the most appealing dislocations we've seen are more specific and usually short term. These dislocations affect an asset, a specific lender or market. While these dislocations are episodic, in our experience, they are consistently present somewhere in the world. Having experience with these cycles – along with a global platform and flexibility to move quickly – is important to capture the alpha from these events.

How is the manager and investor community adapting?

The community is adapting by solving infrastructure debt's "allocation issue." One of infrastructure debt's attractions is it can be relevant across fixed income, private debt and real assets allocations. But this also creates an "allocation issue" because there is no clear home for the strategy. As infrastructure debt has matured, the manager community has responded by tailoring their teams' capabilities and strategies; this has improved alignment of managers and their strategies with investors' allocation objectives, which is enabling higher rates of investor participation.

For example, fixed-income strategies now focus more on core infrastructure that requires long-term debt that bank regulation penalizes. This was originally delivered by tailored mandates, and still is, but now there are a range of longer-term funds offering wider investor access to this strategy favored for long-term asset liability matching, or capital regulated investors such as insurers.

At the other end of the spectrum are mezzanine and sector-focused strategies, which access one of the narrowest opportunities and offer the highest returns, making them an attractive shorter-dated alternative to equity investments in real asset allocations.

In the middle of these is the most underappreciated opportunity in senior sub-investment-grade debt, which is "all weather." "All weather" means the senior debt focus offers the downside protection of a first lien on an essential real asset which typically performs like investment-grade corporate credit while offering the high cash yield of mezzanine. This is the largest and most diverse opportunity with the lowest lending competition that supports consistent value. It fits well in the growing appetite of private debt allocations, particularly allocations looking to diversify into real asset–backed strategies.

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Nick Cleary joined the business in 2012 and has more than 25 years of relevant experience. Cleary leads the North American business that focuses on debt investments. He is a member of the Debt Investment Committee and a member of the firm's global Executive Committee.

CORPORATE OVERVIEW

Vantage Infrastructure is a dedicated and specialized global infrastructure debt team with one of the most established teams in the market and is part of Capital Four, a credit boutique with more than $20 billion in assets, which offers global investors a broad range of specialist liquid and private market credit strategies.

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