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Private Markets Newsletter

Infrastructure credit:
Five reasons why it’s a compelling investment in 2024

The team at Sequoia Investment Management Company (“SIMCo”) hopes that January has started well and that 2024 will be fulfilling, for you, colleagues, family, and friends.

While macro-economic shifts and geopolitics continue to challenge the market this year, we believe private infrastructure credit, which has truly come of age over the last decade as an investible asset class, should be high up on the list for institutional investment allocations. We make the case for this from five angles below. We look forward to the opportunity of engaging with you on this dynamic segment.



1. Infrastructure sector growth

The infrastructure sector’s impressive growth as an important investment asset class is being driven by key long-term interlocking trends. These include climate change, climate resilience, energy transition, energy security, digitalization, urbanization, efficient transportation, ageing populations, healthcare. Each of these represent huge demand-side factors.

On the supply side, the ageing, decommissioning, upgrading or replacement of first-generation infrastructure, such as power plants, railway tracks, bridges, cables, or accommodation assets, coincide with an era of government fiscal pressures.

These factors reduce the amount of public capital available for these challenges while providing private markets with wide-ranging new opportunities in the sector. Over $1 trillion of AUM of private equity capital (excluding secondaries and funds-of-funds)* is now allocated to the sector via funds (and is growing at a nearly 15% annual growth rate in recent years).

In a world driven by equity volatility and increasing concentration of market value in fewer stocks, the infrastructure sector is bucking the trend, with a proliferation of local and international operators in each of its subsectors. This is no longer just a world of major public utilities and listed energy groups.

2. Demand for private credit

The infrastructure market is underserved by credit. The recent proliferation in private infrastructure equity funds and direct investments has not yet been matched by a commensurate growth in private infrastructure credit funds, representing a total AUM of c. $160 billion, one-seventh the size of the equity equivalent ($1.1 trillion, as of June 2023)* with a compound growth of 30% over the last 10 years, reflecting the extent of market demand for credit.

After the GFC, banks have generally seen less favourable capital weightings for their alternative lending books. This is a key reason for the emergence of the private infrastructure credit fund market over the last decade.

There is also a major opportunity in the mid-market, representing private loans of, typically, $25 million to $250 million, where specific underwriting and structuring considerations are required and syndications are rare, and a yield premium can be obtained of 200bps or more over liquid bonds.

As equity target returns for "value-add" style infrastructure strategies increase on the back of higher risk-free rates, so it increases the demand within the capital structure for subordinated or mezzanine credit pieces. This is a sweet spot and a key differentiator for managers experienced in sourcing and structuring these types of loans.

3. Rare timing opportunity

The expected peaking of interest rates provides a unique timing opportunity – benefits include: (a) attractive double-digit, equity-like returns available in the near-term for credit, based on cash income rather than capital gains, (b) with high interest rates now established for a year or so, borrowers are likely to be more able to sustain the associated financing costs (compared to borrowers taking on credit when base rates were close to zero), and (c) investors can get ahead of the curve before the weight of broader mainstream capital reduces the return premia available in the private infrastructure credit market.

Recognizing this, some of the world's most well-established institutional investors have been building dedicated infrastructure credit teams, positioning the sector as a priority for expansion in 2024 and the years ahead.

4. Differentiation & diversification

The sector is a meaningful and growing part of broader private credit, and one which demonstrates differentiated performance. Infrastructure credit funds now represent a modest, but growing, 10% of the broader private credit funds market which itself amounted to $1.69 trillion of AUM in June 2023*. This proportion is up from 5% just 10 years earlier. The compound growth rate in infrastructure credit funds under management over the last decade has been some 28%, representing a real coming-of-age for the sector.

A 35-year analysis by Moody's across their global rated credit dataset reveals substantially lower sub-investment grade credit defaults and losses for infrastructure corporates and project finance versus broader non-financial corporates. For example, equivalent Ba-rated bonds saw average annual default rates over 10 years of 0.81% for infrastructure versus 1.65% for broader corporate credit. Annual loss rates were 0.40% for infrastructure versus 1.02% for broader corporate credit. Recovery rates for defaulted infrastructure loans were also consistently better than broader corporate credit. For example, recoveries achieved on senior unsecured credit were 61% for infrastructure vs. 38% for broader credit.

SIMCo sees infrastructure as offering access to largely uncorrelated risks across markets and sub-sectors, backed by normally defensive business models and long-term, demand-based, hard-to-replace, and/or critical underlying physical assets.

5. Efficient deployment & management

While some investment "supermarkets" are seeking to add this product to their offerings, there is a small number of specialised private infrastructure credit investment managers (i.e. pioneers) who can point to a substantial, established international track record. In addition, unlike investment grade infrastructure credit, there are even fewer managers with meaningful history in the higher yield space, which requires more specialized capabilities in sourcing, structuring, and credit management. This relative scarcity provides the opportunity for differentiated performance.

Meanwhile, with the ready availability of credit pricing parameters, a credit manager can report on portfolio performance on a more regular and transparent basis than for private equity products, whether corporate, infrastructure or real estate. While equity capital competes for controlling interests in assets, credit can enjoy "multiple bites of the cherry" through an asset's ownership cycle (i.e. original financings, refinancings, exits).

Credit is more fungible. For example, investors can lend more readily alongside peers to enable larger financings, reinvest upon a change of control, extend credit to facilitate a growth opportunity or acquisition, or sell down more readily to re-balance a portfolio.

Plentiful access to financing opportunities exists across multiple jurisdictions. SIMCo, for example, is currently invested across twelve mature economies. The demand dynamics of this fast-growing segment allow for the efficient deployment by a specialised manager of investor capital seeking attractive income-based returns.

*Market size data from Preqin.

SIMCo, based in London, is a specialist pioneer in the higher yield private infrastructure credit market, which typically offers annual returns 200bps higher than liquid credit. While SIMCo has experience globally, we continue to find excellent opportunities in the US market, where the supply of financing transactions is not matched by capital available, creating the opportunity for superior risk-adjusted returns, in a defensive sector, of more than 10%. Approximately half of SIMCo's 240 investments over the last decade have been in the US.

For any questions or further information on this promising segment, please do not hesitate to contact us below:

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