A fast-growing niche

DC Placement Advisors' **Nina Dohr-Pawlowitz**, chief executive & head of fund placement, and **Metodi Shopnikolov**, vice-president, explain why investors are finding better risk-adjusted returns in infrastructure debt and why the asset class is here to stay

Q Last year seemed to be a particularly good year for the infrastructure debt market. How did you find it and how is the asset class evolving?

NDP: Last year was indeed a good one for closed-ended infrastructure deb funds raising capital. What was interesting is that there was a trend of diversification in structures and strategies coming to market. Mezzanine was a success story highlighted by the AMP Capital fundraise we worked on. In addition to the closed-ended vehicles raised, there was also a healthy appetite for co-investments and managed account solutions, offered by firms like AMP Capital, BlackRock and UBS. What the overall solid level of interest demonstrates is that the asset class is deemed very attractive by investors.

Q What do you think is driving this high level of growth?

MS: After years of record amounts of institutional capital going into closed-ended infrastructure equity funds, we've reached a point where it is harder to find high-quality deals and the increased competition is dragging returns down. When you add to that the overall need of investors to diversify portfolios with other sources of alternative fixed-income – and when you consider infrastructure debt's superior position in the capital structure, offering similar, or in some cases even better risk-adjusted returns – the growth is logical in the current interest rate environment.

NDP: We have been one of the first-movers in the infrastructure debt asset class together with AMP Capital in 2012. When we were mandated to raise institutional capital in the German market for AMP Capital's first vehicle, nobody understood the reason for such a fund. In fact, only a few investors saw the value of AMP Capital's strategy. Since then, the market has developed nicely but it is still a niche compared to equity, though you have more and more investors looking into it. For example, the infrastructure debt market has been traditionally attractive for insurance investors, but over the last years, pension funds have started to come into the market too. An additional boost for European insurers was given by the improved Solvency II framework for infrastructure debt – in some cases we saw unrated/mezzanine debt treated better from a SCR-perspective than longer-term senior, investment-grade debt. Overall and bit by bit, more investors have started taking a closer look at infrastructure debt strategies which is driving the growth, but there is plenty of potential for the asset class to grow even more.

Q AMP Capital's third debt fund was one of the largest funds of 2017, raising $2.5 billion. But what was also striking about it was that it garnered $1.6 billion for its co-investment programme. Co-investments have become a staple of equity strategies, but what's driving their growth in the debt market?

MS: As in the equity market, there is a healthy investor appetite for deployment of capital in good deals on an opportunistic basis. With investors gaining more and more in-house expertise in the sector, large, more sophisticated houses have more appetite for good dealflow from which they can select independently. In addition, the larger investors will normally seek to deploy larger amounts. However, if you look at the still relatively small market, there are not too many managers that can offer a credible co-investment pipeline.

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Dohr-Pawlowitz

Q How is the infrastructure debt market segmenting?

NDP: When you look at the figures last year, it's hard not to acknowledge the importance of mezzanine debt strategies.

Mezzanine debt provides attractive

returns, steady income and a moderate risk profile. Investors are hungry for steady and stable income and this is what infrastructure debt funds can deliver. When you look at mezzanine, that proposition becomes even more attractive.

MS: That's right. Mezzanine is still new for some investors, though. When speaking to investors for AMP Capital's third fundraise, we still had to highlight the benefits of mezzanine debt, such as the better position in the capital stack, low default and high recovery rates and point out the risk-adjusted returns they could expect, even in comparison to other private debt strategies. However, experienced debt investors are looking to add a subordinated component to their portfolios because the return compression in senior debt over the last four or five years has been quite significant.

Q Realistically, how big can the mezzanine opportunity get?

NDP: I can see growth being maybe a little restricted by the quality of the deal pipeline. From our experience, we can see that it's not easy to source high quality assets. That's one of the main reasons AMP Capital decided to raise a bigger third fund, so they could invest in larger, more attractive assets – something only very experienced managers can offer.

MS: Overall, it is hard to put a figure on how big this market can become. According to McKinsey, meeting the UN sustainable development goals alone by 2035 would mean up to $4.7 trillion in overall economic infrastructure investment needs per annum globally, so the upside is big. As of now, we're observing year-on-year growth in mezzanine and think that there is still a good opportunity for growth.

Q Would you say mezzanine strategies are easier to raise?

NDP: I'd argue the opposite: mezzanine is much more 'niche-y' than senior debt and as such harder to place. To state the obvious, no one has a mezzanine allocation – investors have infrastructure debt allocations for senior debt, or even just a general allocation

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for private debt strategies, so you need to carefully select the investors that will invest in mezzanine infrastructure debt, or even educate the ones who are new to the strategy.

MS: In addition, the market for mezzanine is not very broad. Managers need to be really experienced to be able to provide a credible mezzanine platform and most of the teams out there are senior debt teams. If you venture into mezzanine, you need to be even more careful about covenant structures and downside protection and be able to show significant expertise in managing risks – all capabilities which investors examine very carefully.

Q What is needed for the infrastructure debt market to keep growing?

MS: Political stability is always important for all sides of the capital stack and ranks highly in importance among investors and managers alike. Further improvements in capital charges could encourage more investments from institutional investors looking to cover long-term liabilities with steady, predictable cashflows. An increased supply of quality operational projects issuing debt will certainly contribute further to the growth of the market.

Q How do you plan to grow your business? And speaking as a placement agent that has raised both infrastructure debt and equity funds, do you see yourselves focusing exclusively on a particular side of the capital stack?

NDP: Our strongest track record is in the real assets sector, but we don't see ourselves focusing exclusively on infrastructure debt or equity – our strength is in infrastructure, renewables, real estate and debt products in the real assets arena.

In terms of growth, we've broadened our geographical focus. Traditionally, we've covered Europe but as of last year we've started covering the Asian market and this year we will aim to cover North America as well, which means we will become a global placement agent. That also means that, as a global placement agent, we are very keen to raise a global fund, which we've done in the past by the way. And, of course, we will also continue to be very open to raising sector-specific funds or vehicles focused on certain geographies.

MS: We also have the capability to provide tailored advisory and structuring solutions. I think that will become an increasingly important factor for growth, especially when raising capital on a global scale, as there is no one solution fitting the needs of all investors ■