

KEYNOTE INTERVIEW

Unlocking the mid-market premium



*Taking time to work with borrowers to develop innovative financing solutions is the key to mid-market success, says UBS head of infrastructure debt **Alessandro Merlo***

Q What makes infrastructure debt an attractive investment opportunity today?

This is an asset class that has grown significantly in recent years. Infrastructure debt has gone from being relatively unknown to an established part of investors' private markets allocations. It is an attractive addition for investors, primarily because of its resilience and non-cyclical characteristics throughout times of economic stress, including during the pandemic. Infrastructure has continued to perform well despite all the disruption caused by covid.

That is particularly true of the energy and telecoms sectors, with a surge

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in demand for digital infrastructure. This increased as a result of lockdowns and pervasive working from home. But, with the exception of airports, even the transport sector has proved to be far more resilient than many anticipated at the start of this crisis. The volume of traffic on toll roads has remained stable, whilst the volume of shipping has actually increased.

Meanwhile, in an environment characterised by compressed base rates, investors are searching for yield and

infrastructure debt offers extremely attractive long-term cashflows, as well as liquidity premium and complexity premium, which can create additional return. Finally, there is a regulatory overlay to take into account. Infrastructure debt is treated favourably under Solvency II, due to its resilience and other positive characteristics, and that provides a further incentive for pension schemes and insurance companies.

Q How has your infrastructure business performed and grown against that backdrop?

We launched our first strategy in 2014 and started deploying capital the

following year. Since then, we have closed more than 30 transactions and invested more than €2 billion as of February 2022. We started out with a senior debt strategy in Europe, where we knew we could source interesting transactions that offered an attractive risk/reward proposition. And we have grown the business steadily, as investors have become increasingly focused on the asset class and borrowers have become increasingly aware of the non-bank, alternative lending source that we represent.

We have never raised a mega-fund, however. We have only raised the capital we believed we could effectively deploy and that has been a big part of the success of the platform and the reason why we have been able to deliver both strong returns and timely capital deployment to investors.

We have now finished deploying our second senior strategy and have launched a high-yield strategy that has been very well received by the market. The high-yield strategy is focused on non-investment grade infrastructure credit – either junior financing for brownfield assets or senior construction financing for greenfield assets, with a shorter duration than the senior strategy. We saw an opportunity based on growing interest from borrowers looking to raise more sophisticated capital solutions and we were ready to grab it. At the same time, investors have now experienced our success on the senior side. They recognise our ability to originate mid-market transactions and to deliver good returns, which is why they are comfortable joining us in our high-yield strategy.

Q Why have you made the decision to remain focused on the mid-market?

We estimate that European infrastructure finance totals around €130 billion a year, so it is a relatively large market. However, the data shows



Q What does it take to be successful in this part of the market?

Origination capabilities are important. As the largest wealth management business in the world, UBS clearly has strong relationships with a lot of medium-sized entrepreneurs. But in addition to origination, what you really need to be successful in this market, is the ability and willingness to work closely with borrowers to develop financing solutions. These are not large corporates with dedicated financing teams. They rely heavily on the lender to select a due diligence adviser and to draft financing documentation. That structuring effort can take two to three months and it is that effort that is key to unlocking the mid-market premium that I mentioned. This is why we have grown our team in order to process more investments in recent years – to increase our total capital deployed without losing that mid-market focus.

After all, 65 percent of infrastructure financing in Europe is still done by banks. It was 80 percent when we first started out. But what that means is that there is still a big opportunity there. Banks continue to be the main source of competition but the long-term nature of our commitment and the fact that we are a buy and hold strategy – we are not looking to trade or sell down our position to someone else – gives us that competitive edge.

“Infrastructure debt has gone from being relatively unknown to an established part of investors’ private markets allocations”

that 70 percent of the transactions that take place involve less than €250 million of debt capital*. Furthermore, the management teams of the companies involved in these transactions may be very good at running their businesses, but they are far less sophisticated than large issuers when it comes to raising financing. Historically, they would have looked to finance themselves through the banking system. They are less price sensitive to spread and more focused on deliverability. And we believe that results in a better risk/reward opportunity.

Q What other competitive edge do you have?

We can offer a great deal more flexibility as institutional investors – longer maturities, fixed rates and lower upfront fees. We are also not in the business of churning deals and maximising fees like a bank may be. We are in the business of forging long-term relationships with borrowers in order to create long-term stable returns for our investors. There is an alignment of interest there. It is our job to get out there and educate borrowers about these advantages and to work with them to structure innovative solutions that offer a win-win. If we do so, I believe the institutional lender community will continue to command an ever-greater share of the infrastructure debt market going forward.

Q Where do you see the most interesting deployment opportunities within the mid-market today and what are the mega-trends that are shaping those?

We have identified three key mega-trends that are driving our search for investment opportunities. The first, of course, is the energy transition – the global focus on a move towards a more sustainable way of using natural resources and on protecting the environment. We have invested heavily in renewable energy in the past and continue to look for the right opportunities in this space. But whilst our efforts in the sector have centred on solar and wind farms historically, we are now looking to other technologies and opportunities.

The second mega-trend that we have identified is digital transformation. That theme covers telecom towers, fibre optics networks and data centres. We began investing in this area four years ago and had completed several investments prior to the pandemic when demand for digital

“70 percent of the [infrastructure debt] transactions that take place involve less than €250 million of debt capital”

infrastructure soared and those investments have fared very well. The digital transformation continues at pace given the shift to a more decentralised use of technology and the need for better connectivity and the sector continues to offer a premium. It is a competitive space, of course.

We are not alone in recognising the strong demand fundamentals that exist. But you do need knowledge of the industry – an understanding of how the commercial dynamics work and the ability to assess risk properly – to be successful in financing this type of business. Having been an active lender for a number of years, we have the experience and resource to make this work.

The final mega-trend that I would like to highlight is the demographic shift that is taking place with an ageing population and working families, requiring to think and organise care for the elders and the youngsters. We believe significant investments are needed to improve and adapt our social infrastructure for childcare, healthcare and

elderly care. Indeed, that demographically driven social care opportunity set, which often benefits from state aid and is heavily regulated, is a promising investment space for us in the years to come.

Q What challenges is a changing macroeconomic environment likely to present for infrastructure debt as an asset class?

There are always risks in investment and those risks need to be managed carefully. We are coming out of a very long period of low base rates and we are seeing inflationary pressure creep up as well. Those macro factors will have an impact on infrastructure debt in the coming years. Our response to mitigating macroeconomic risk is to not overstretch the maturity of our loans and that will continue to be the case as we face a new economic environment in 2022.

Q What are your plans for the years ahead?

We began life as a Europe-focused investment team deploying senior debt. That is where we saw client demand and investment opportunity. Our ambition is to continue growing that European platform, which has been highly successful. With our second senior strategy now fully deployed, we will be looking to launch a new vintage in the coming weeks. We will also continue to grow the high-yield, non-investment grade platform. That is the plan for 2022. Beyond that, we will begin to look outside of Europe. UBS is a global financial institution. We have global clients. And so, it makes sense that we expand the platform internationally, with Asia and North America as the natural next steps. ■

* UBS Asset Management, Real Estate & Private Markets (REPM); Bloomberg; InfraDeals, June 2021. Annual average of 2019-20 private infrastructure financing.