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Infrastructure debt for **insurance**

In this short interview, Alessandro Merlo, Portfolio Manager highlights the case for infrastructure debt. He discusses why he believes our infrastructure debt strategy attracted a large portion of Solvency II regulated insurance investors from across Europe, as well as the impact of COVID-19 on this asset class.

Q1 – What are the key investment benefits of investing in infrastructure debt?

We believe that infrastructure debt represents a number of key benefits for insurance clients. In figure 1 below we outline some of these as well as key characteristics.

Figure 1

Characteristics	Benefits
Essential assets	Low-risk profile
High barriers to entry	Low volatility
Capital intensive	Strong cash flow generation
Low correlation to economic cycle	Diversification vs. corporate

Q2 – Why should insurance companies consider infrastructure debt in their portfolio?

Insurance companies are attracted to infrastructure debt because it provides lower-risk, stable features coupled with strong cash flow generation and is a very good diversifier for their existing portfolios.

When insurance companies are reviewing their investment options, they should also consider working with an investment manager that can support their reporting requirements. For example, many European insurance companies have Solvency II requirements that they need to meet therefore, working with the right partner is essential.

Insurance companies will want to seek knowledgeable, established managers that can help them qualify their investments in credit instruments such as "infrastructure investments" or "infrastructure corporate investments" for the purpose of Directive 2009/138/EC ("Solvency II") and any laws, regulations, rules or guidelines



implementing or otherwise associated with this important Directive. Managers that provide investors with quarterly look-through/TPT reports and quarterly Solvency II analysis are best positioned to partner with insurance companies.

Q3 – Which part of the market do you believe offers the most attractive opportunities and how have you been taking advantage of them?

We target the small-to-middle market size segment as we are able to deal directly with the borrower and structure the transaction, thus creating additional value for our investors. There is less competition in this area of the market as smaller transactions are less suitable for public bonds and institutional private placements, given the significant cost of a public rating and/or engaging an investment bank to intermediate. Furthermore, while large infrastructure projects tend to grab the headlines, the majority of infrastructure debt transactions tend to be in the small-to-middle market size segment with more than 70% of the financings being below EUR 250 million creating a large universe of opportunities.

In terms of sectors and opportunities that we have been focusing on, we follow a bottom-up approach, centered in scouting the best investment opportunities for our strategies. At the same time we have identified some key investment themes to focus our origination efforts around the most promising long-term trends. We therefore center our efforts around:



Digitalization: we are convinced that in today's modern society there is a growing need for essential digital infrastructure, supporting more and more interconnected and dematerialized interactions. Investment opportunities in this sub-sector span between fiber networks, telecom towers and data centers;



Energy transition: we believe the trends toward decarbonization will offer an expanding landscape of investment opportunities, not only in renewables energy, but also energy efficiency, battery storage, smart grids, as well as charging and filling infrastructure for electric and hydrogen vehicles;

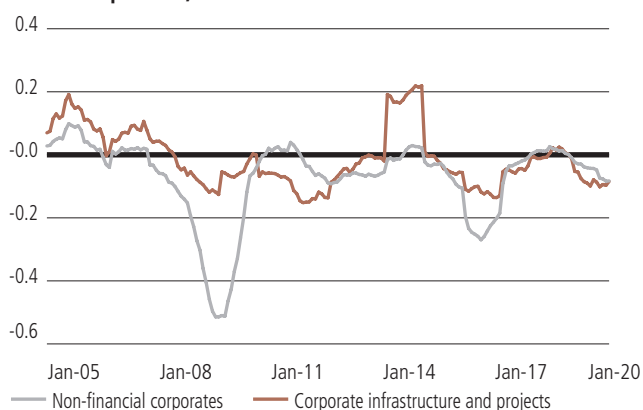


Demographic pressure: in the field of social infrastructure we expect investment opportunities to be linked to the provision of services toward the needs of an aging population such as specialized care centers often subsidized/contracted by the national health systems.

Q4 – How does the infrastructure debt market respond during crises/periods of financial stress?

The early signs are that infrastructure debt is holding up better than corporate issuers. Moody's published a study showing that from March to May, only two infrastructure issuers defaulted (0.1% of universe) vs. 66 corporates (1.3% of universe). While the rating agency forecast is for defaults to rise in 2020, they expect infrastructure to perform better as an asset class than corporates in this downturn, mirroring the experience during the global financial crisis (GFC), where the essential nature of the assets meant that revenues were less impacted. This was also reflected in the lower level of infrastructure downgrades versus corporates during the period (see figure 2):

Figure 2: Rating drift (upgrade to downgrades) of infrastructure versus corporates, 2005 - 2020



Source: Moody's, Defaults & Recoveries: Fewer coronavirus driven downgrades than non-financial corporates (June 2020)

This crisis is very different from the GFC though and we've already seen a wide range of outcomes across sub-sectors with transportation severely impacted by restrictions while utilities, renewables and digital infrastructure have performed robustly. Infrastructure financings are typically structured with covenants that prohibit the payment of dividends in a stressed environment. Additionally, financings are normally structured with at least six months of debt service reserves. These features allowed most assets to weather the impact of COVID-19 to date. Some of these companies will need to raise facilities to replenish reserves, restart capex plans or restore dividends which will create an opportunity for senior and mezzanine debt providers. The key outlier is airports which account for around 5% of total infrastructure investments over the past 15 years¹. As at July 2020, traffic remained substantially below pre-COVID-19 levels. Lenders have generally been amenable to waiving covenants given the attractive long-term fundamentals of airport assets. However, this will only last so long and many of these projects will need to be restructured unless volumes start to recover quickly.

Q5 – UBS Asset Management has a significant number of insurance companies who have invested in infrastructure debt offerings – can you explain what attracted them to invest?

Currently, over half of the investors investing in infrastructure debt at UBS-AM are insurance companies. Insurance companies are attracted to our platform because of our compelling offerings in both the traditional and high yield segments of small-to-middle market infrastructure. We established our infrastructure debt platform in 2015, and have completed 23 investments since then.

Our strategies have consistently outperformed their performance targets, delivered on the specific reporting requirements of Solvency II for insurance companies and we have a clear focus on ESG best practices.

The expertise of our investment team and tailored approach to working with insurance companies provides investors with a very compelling interest to partner together.

¹ Source Inframation, January 2020. Past performance is not indicative of future results. This publication is not to be construed as a solicitation of an offer to buy or sell any securities or other financial instruments relating to UBS AG or its affiliates in Switzerland, the United States or any other jurisdiction. Using, copying, reproducing, redistributing or republishing any part of this publication without the written permission of UBS Asset Management is prohibited. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any errors or omissions. All such information and opinions are subject to change without notice. Source for all data/charts, if not stated otherwise: UBS Asset Management. All information as at 30 September, 2020 unless stated otherwise. Approved for global use.
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