

Infrastructure Private Debt: *Opportunities for Premium Returns in the Canadian Mid-Market*

By: Theresa Shutt

Like other economies around the globe, Canada continues to struggle with aging infrastructure and limited government finances. As a result, the opportunities for private sources of capital to fund infrastructure projects have grown significantly.

While private sector financing for infrastructure requires both equity and debt, the opportunities for debt financing are considerably greater due to the higher levels of leverage that can be supported by the stable and predictable cash flows generated by infrastructure assets. Until recently, this debt was typically provided by large banking institutions with substantial balance sheets. However, with the introduction of more restrictive capital adequacy requirements following the financial crisis, the supply of infrastructure debt from traditional lenders has been significantly curtailed, paving the way for non-traditional debt providers to enter the market.



This development has led to the growing presence of other debt providers in the market such as infrastructure private debt funds and institutional investors, and has significantly enhanced/broadened the pool of capital available to meet Canada's infrastructure needs. This trend has also benefited investors by providing more direct access to the infrastructure debt market and therefore, to an alternative source of attractive and stable fixed income returns in an environment of depressed yields and volatile equity markets.

In Canada, the appetite for infrastructure among institutional investors (pension funds, life insurance companies) has grown dramatically leading to steep competition for desirable infrastructure investments. In particular, the strong demand for larger infrastructure assets ("P3" projects) for which there are limited opportunities has resulted in compressed spreads and inferior returns for both debt and equity investments. Even as yields diminish further for these deals, the majority of institutional investors and private debt funds in Canada continue to compete for larger projects resulting in excessive capital chasing only a handful of opportunities.

As a result of this focus on larger deal sizes, there is a shortage of capital available to fund small to mid-sized infrastructure projects (project size < \$150MM Cdn) which due to their smaller size are unable to access the large P3 market. This market gap is further accentuated by the inability of Canadian banks to provide longer term financing to match the project life and the unwillingness of traditional private placement players such as insurance companies to provide financing for small projects (i.e. loans of less than \$50MM). The shortage of capital combined with the robust supply of mid-market infrastructure projects in need of financing has created highly attractive debt opportunities with favorable risk-reward profiles. In particular, experienced mid-market debt providers who are able to offer longer and more flexible financing terms will be able to source high quality credit for premium returns.

In addition to providing more attractive risk adjusted return, debt investments in mid-sized infrastructure projects offer other key benefits that include: i) longer maturities that align with pension and insurance liabilities; ii) low observed correlation with other asset classes and iii) superior diversification to that available through participation in larger P3 projects and/or public infrastructure bonds.

These benefits are particularly important for small to mid-size pension plans in Canada where access to infrastructure through direct investment is constrained by a limited ability to participate in large P3 deals due to smaller investment sizes and the lack of internal resources to properly source and assess infrastructure opportunities. For these plans, with few exceptions, the most cost effective and efficient way to gain exposure to infrastructure will be through private debt fund managers. Not all fund managers are the same, however, and smaller pension plans must take care when selecting the manager and investment strategy that best meets their needs. As the demand for infrastructure grows and as more capital continues to chase the limited number of larger deals, returns will likely become more compressed. However, experienced infrastructure debt fund managers targeting niche and underserved markets with attractive risk adjusted returns will continue to stand out. This is particularly the case for the Canadian mid-market.



Our research has further identified a robust pipeline of mid-sized projects across Canada (approx. \$30 billion) where the average estimated debt investment will be \$30-50 million. Identified by various government agencies as major projects to be completed over the next 5 years, these projects represent over 500 opportunities across a variety of infrastructure sectors and in every province in Canada.

A number of these projects will have significant “greenfield” risks attached to them. By properly managing the risk associated with greenfield projects, it is possible to obtain additional return for investors by providing the financing as a single loan tranche and maintaining the risk premium charged for the construction period throughout the remaining life (i.e. 20-25 year take out period) of the loan. In addition to the higher yield, greenfield investment can also provide the opportunity to significantly influence the project with respect to key decisions which will impact the project economics such as choice of contractor, ultimate debt/leverage structure, service provider and risk allocation.

Typical investments in this space will be characterized by the following criteria: i) stable and predictable source of cash flows from high quality counterparties; ii) strong market position and proven sponsor; and iii) project well secured by long life assets providing essential services. Loan terms will vary from 10 to 25 years with the majority of loans having maturities of 20-25 years.

Successful managers must have established relationships with engineering firms and project developers who are, or will be, initiating mid-market infrastructure or infrastructure projects in the near future. In addition, an effective manager must also have an extensive network of referral sources including existing borrowers, financial organizations and advisors who provide continual deal flow. These relationships combined with a deep knowledge of the regulatory environment and key industry trends will enable the manager to identify and execute on the best investment opportunities for the fund.

As a result of the many advantages offered by infrastructure private debt, we anticipate that investor appetite for this attractive asset class will continue to grow and may one day outpace the demand for infrastructure equity.

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