In search of relative value

John Mayhew, head of infrastructure debt at M&G, explains why it is important to maintain investment discipline at this point in the cycle, in order to preserve returns over the long term

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Q Just how competitive and price-rich has the infrastructure debt market become?

JM: In some areas, such as straightforward infrastructure corporates, the market is very competitive because it can be easily understood by a wide variety of debt investors. That has a consequent impact on pricing. From our perspective, those kinds of deals often offer little or no value for our investors.

The other thing that we sometimes observe are deals that are priced and presented as investment grade, but which we don't see as being of the same credit quality. In effect, we see them as under-priced sub-investment grade deals. That can be another product of a frothy market.

But our investors aren't paying us simply to invest in infrastructure. That bit is easy. Our role is to be selective, and to gain access to the asset class at good relative value.

And, while there are areas that are competitive and price-rich, there are also areas where it is still possible to find that value. Some of the funds we manage are classic, long-dated investment-grade books – absolutely. Others are high-yielding funds. We have inflation-linked strategies and we have a new floating-rate debt fund. That range gives us the ability to look across the whole market and pick and choose those opportunities that we believe offer value.

Q How do you ensure that you achieve that relative value on a consistent basis?

JM: Our key metric is investment performance, not how much we deploy. The last thing we would ever want to be is a forced investor because that is when you have to make compromises. To that end, we have a very strict separation between the team that originates and structures transactions and the fund managers.

The job of the origination and structuring teams is to ensure that we see the market – not only deals that come to the market as a whole, but also things that are off the beaten path. A deal may come to us pre-baked or we may have an early inkling of a deal and the origination team structures and negotiates the transaction from scratch.

The investment decision is then taken by one or more fund managers who sit separately. They are the arbiters of price. Just because a deal team has worked hard on a deal doesn't mean you should make the investment. The price has to be right. We can love a credit and think the borrower is a great business. But the price at which they are looking to borrow may mean that an investment makes no sense from a value perspective. That separation really helps us to maintain returns.

Q Where are you seeing that relative value?

JM: I don't think that you can pick just one part of the market. If you look at the deals we invested in last year, they range in maturity from the shortest at six years to the longest at 46 years. They range in rating from AA to B. There was senior debt at an opco level; mezzanine debt; holdco debt; floating-rate deals; fixed-rate deals; RPI and CPI deals; sterling,

euro and dollar. We pick deals across the full spectrum. The common theme is that we judged they offered good relative value for the respective funds which invested.

Q There have been a lot of new entrants to the infrastructure debt space. How do you expect the make-up of the industry to evolve going forward?

JM: It's an interesting question. Twenty years ago, when the private debt team here at M&G was established, there were relatively few people interested in infrastructure debt, whether fund managers or investors. If you look at the number of platforms established over the past five years, that market has certainly changed and that increased demand is impacting value.

Have we reached a peak in terms of the number of managers? Ultimately, we need to let the cycle run, and investors will see which managers have achieved their return targets without compromising credit quality. Infrastructure is a long-term business and so that will take time.

We are definitely seeing some large investors pause for thought. I was speaking to the CIO of a very large European insurance company that has invested heavily in the sector over the past five or six years who intends to wait now until value returns. But we also continue to see new investors enter the market, particularly those from further afield.

Q Is political uncertainty across Europe also creating a challenge?

JM: Because infrastructure debt finances essential assets that are the backbone of the economy, whether that debt is repaid through public sector payments under concessions – so effectively general taxation – or user payments, for example through traffic tolls or water and energy bills, we clearly invest in the real economy. That has an impact on society. There is an interface there with the public sector and there is an interface with the public.

> "In recent years, we have seen a number of other businesses transition from the leveraged-loan market and try to present themselves as infrastructure"

Some countries welcome that private sector investment in infrastructure and others find it less appealing. And the view within a country can change as the political situation changes. Political uncertainty can affect the supply of projects, and the risks involved. That can affect our view on the attractiveness of one country over another or one sector over another. The challenge for us is deciding where to dedicate our time given the wide range of opportunities we see through our origination capabilities.

From a country perspective, we focus on the rule of law, ability to enforce security, stability of regulation, respect for private investors' rights and so forth. And because we invest for the very long term, these things can change and that can be a challenge.

Q Of course, it's not just about deploying new capital. What is your approach to managing existing investments?

JM: We spend a lot of time managing our existing investments. Given the long-term nature of the market, even those investments made by the team 20 years ago are still being repaid. So, we talk a lot to our borrowers. And we listen to them. We also listen to our independent advisors and stakeholders, whether that be government or public sector counterparties.

At a transactional level, infrastructure deals tend to be highly structured. We have an array of covenants and tests and information rights and we look at that information carefully. We engage early with the borrowers. If problems arise, we can address them before they become something that can affect the credit. It is definitely a sector where you need to pay close attention to the detail.

Q It is widely understood that we are nearing the top of the cycle. Just how do you expect infrastructure assets, and the infrastructure debt asset class, to fare in any downturn coming our way?

JM: In general, I expect infrastructure debt to stand up well in a downturn. We have known, for a long time, that infrastructure assets have very strong defensive characteristics. They have the stable cashflows and low correlation to economic cycles that investors look for. We now also have a body of empirical evidence from the likes of Moody's, S&P and EDHECInfra to support that.

But in recent years, we have seen a number of other businesses transition from the leveraged-loan market and try to present themselves as infrastructure. Interestingly, those are often companies that we have already financed through our leveraged-loan funds.

We characterise those as cashflow lending propositions rather than infrastructure. When they seek to reprice to the infrastructure debt world, we often fail to see value. How those assets will fare in a downturn I think is less clear. But I expect true infrastructure will perform well as it has done in previous downturns, most recently the financial crisis. ■