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# THE CASE FOR RESILIENT HIGH YIELD PRIVATE CREDIT

MAY 2024

With inflation lingering and rates moving at a much slower pace than expected, infrastructure debt, particularly in the higher-quality sub-investment grade space, offers attractive returns and resilience for investors seeking a safe haven in a changeable market, explain Infranity experts.

- We strongly believe that now is the right time for asset-backed lending with strong and resilient cash flows.
- We see a lot of attractive relative value infrastructure opportunities from traditional investment grade to the younger and more dynamic sub-investment grade (sub-IG) space.
- There is a sweet spot in the BB-rated segment, where default or loss rates are only marginally higher compared to loans with investment grade quality, but investors can harvest an attractive yield pick-up.

'Transitory inflation' was the talk of the town when inflation picked up for the first time towards H2 2021 and then more forcefully following the war in Ukraine, the energy crisis and the shift in central bank policy in major markets around the world. It was all supposed to be a quick affair, with central banks getting inflation under control quickly via sharp rises in interest rates. Interest rates would then fall quickly and settle in or at least around the same low territory they occupied in years prior.

Today, however, markets have stubbornly refused to return to their pre-crisis inflation and interest rate levels and the days of 'low for longer' are long gone and not expected to return any time soon. Finally, even longer-term investors have begun to adjust their allocations to the new market regime. Since early 2023, the macroeconomic landscape has manifested itself towards an environment with sticky inflation and higher interest rates. While it's true that inflation is moving towards the levels targeted by central banks, it is increasingly clear that this happens slower than anticipated. As a consequence, rates are moving at a much slower pace than expected, too.

## Infrastructure debt shines in a higher-for-longer world

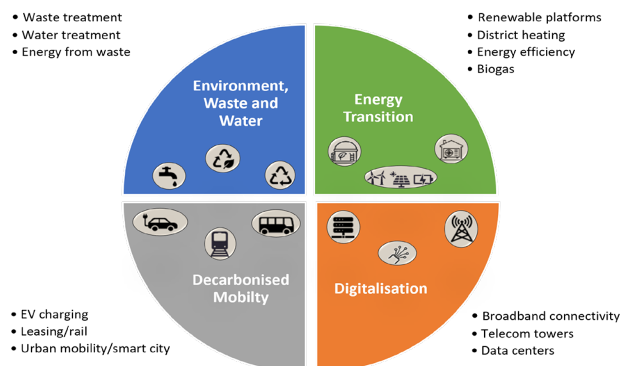
From our perspective, higher interest rates over a prolonged period can possibly impact a borrower's ability to service debt obligations over a credit cycle, which can lead to performance dispersion between managers. While entry levels for liquid or illiquid speculative grade investments look attractive, it is important to re-evaluate those allocations in the context of the new market regime. In high yield there are many different shades of credit quality, which in the current market environment, makes it necessary to be highly selective to ensure that attractive yield levels can be captured while mitigating downside risks as well as negative rating migration scenarios at the same time. We strongly believe that now is the right time for asset-backed lending with strong and resilient cash flows. Especially in the context of infrastructure we see a lot of attractive relative value investment opportunities across the spectrum with resilient credit quality, be that in the traditional investment grade segment of the market or in the younger and more dynamic sub-investment grade (sub-IG) space.

As infrastructure investments have grown in popularity over the last decade (according to Preqin, AuM of USD 278 billion in 2013 to USD 1,373 billion in 2023) on the back of a long-term trend and continuous need to build out infrastructure assets in key sectors such as energy transition, digital and transportation and other critical installations. The financing needs of operators or companies are constantly growing and modern societies are driving the trend towards more renewable energy and further digitalisation.

## BB-rated infrastructure offers optimal risk-reward

While historically the investment opportunity was more focused on private loans with investment grade quality, we are experiencing the appearance of a more substantial and dynamic infrastructure debt market in the sub-investment grade space in recent years. Particularly in the higher quality sub-IG space, typically rated around BB, good deals can be found with many of the defensive characteristics that so many institutional investors are looking for. The investment universe is not only focused on a few sub-sectors but is already quite broad, which allows for good portfolio diversification that creates a level of resilience and robustness not seen in the past.

Infrastructure Debt sub-IG sector themes supported by long-term macro trends




Better market liquidity has also allowed for an increase in transactions while the fundamental needs to finance capex or new projects are driving the demand. There are attractive relative value opportunities across rating segments, but we believe that there is a sweet spot in the BB rated segment, where default or loss rates are only marginally higher compared to loans with investment grade quality, but investors can harvest an attractive yield pick-up. The strong risk-adjusted nature of infrastructure debt and its resilience against economic

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and real world shocks – as just witnessed post 2022 – makes the moderate step-down in credit quality from BBB to BB much smoother and less steep than especially in public credit markets, all the while investors are being very well compensated for the added illiquidity risk they are taking.

Figure 1 Based on Moody's 2023 data report for Ba rated issuers (Infrastructure default and recovery rates, 1983-2022) as of December 2023.

| | Default rates | Loss rates | Recovery rates | | |
|---|---|---|---|---|---|
| | | | Senior Secured | Senior Unsecured | Subordinated |
| **Non-Financial Corporate** | 0.83% | 0.52% | 55% | 38% | 32% |
| **Private Infrastructure Debt** | 0.39% | 0.15% | 70% | 61% | 38% |

While economies, companies and households have weathered the sudden rise in interest rates quite well over the last two years, it is important to emphasize that the development is not a one-way street. According to S&P *"corporate default studies and middle-market credit estimates, both show defaults and negative rating transitions at multiyear highs."* [1] Earlier in the year on 24 February, the Federal Reserve also published a report, warning about emerging credit risks in private credit markets where the *"concentration of dry powder and the risk of structuring deals poorly going forward to boost internal rate of return"* [2] , could lead to *"future defaults, hurting fund performance and investors' returns, given relatively low recovery."* [3] The comment about lower recoveries sounds logical as the feature of contracted or regulated cash flows combined with a real asset security is a very unique and much sought-after characteristic for investors in the asset class.

## Infranity: Robust risk analysis, diversification and selectivity

While we don't want to join those who portray a potentially very gloomy picture of highly stressed liquid or illiquid credit markets in the near future, we want to emphasize that loan or bond investments will always remain investments with an asymmetric return profile. Therefore, it's essential to get it right when managing the downside risks of credit investments. At Infranity, our focus is on detailed cash-flow analysis, robust fundamentals, moderate leverage and a substantial equity cushion, serving as a buffer against asset value declines or debt increases, thereby limiting downside potential. We prioritize assets with limited market price risk to mitigate volatility, employing deep structuring to enable swift de-risking of the financing profile.

Additionally, we seek to add protective packages as part of the loan structuring process, where we negotiate robust mitigants and protective covenant packages, including lock-up and default provisions, as well as comprehensive security packages. As a result, our internal rating methodology delivers a more conservative as well as balanced rating outcome. Following our zero-loss target, our ability to pick the best risk-adjusted opportunities combined with our excellent structuring capabilities, provides significant downside risk protection features to our portfolios. We philosophically aim to build well diversified portfolios with minimal correlation to market risks and GDP fluctuations.

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## ABOUT INFRANITY

**Infranity** is a European asset management company specilising in infrastructure investments. Founded by Philippe Benaroya, Alban de La Selle and Gilles Langaigne together with Generali Group as **part of the Generali Investments** ecosystem of asset management firms. Infranity operates around a disciplined model focused on infrastructure debt and equity investments that generate sustainable financial and non-financial returns with a positive, stable and long-term impact.

Figure 1: Based on Moody's 2023 data report for Ba rated issuers (Infrastructure default and recovery rates, 1983-2022) as of December 2023.
Source: [1]https://www.spglobal.com/ratings/en/research/articles/240501-rising-global-defaults-will-test-private-credit-funds-in-2024-13089868 (1 May 2024) [2]Moody's Report: Private credit performance is diverging, bank partnerships are growing (May 2024) [3]See footnote 2

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Infranity S.AS is a simplified joint-stock company (société par actions simplifiée) existing under the laws of France, with its registered office at 6 rue Ménars, 75002 Paris France, registered with the Paris Registre du Commerce et des Sociétés under number 831 266 721, acting in the name of Generali France Infrastructure Investments and is a portfolio management company approved by the AMF under n° GP-19000030 on 24 June 2019. The company is specialized in infrastructure investments. The Company founded by three Managing Partners, Philippe Benaroya, Alban de La Selle and Gilles Lengaigne, as part of a strategic partnership with the Generali Group, is part of Generali Investments ecosystem of asset management firms and currently manages nearly €7 billion in capital from institutional investors. Infranity's investment solutions leverage the resilience of the asset class and its long-term stable returns, as well as its ability to contribute to sustainable development. The investments address major societal challenges such as the energy transition, green mobility, digital transition and improvements to social infrastructure. This positioning, combined with a high degree of selectivity in the investment process, enables Infranity to generate sustainable value for its clients. For more information: www.infranity.com. Information on our sustainability commitments is available on our website.

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