The impact of Covid-19 on infrastructure debt

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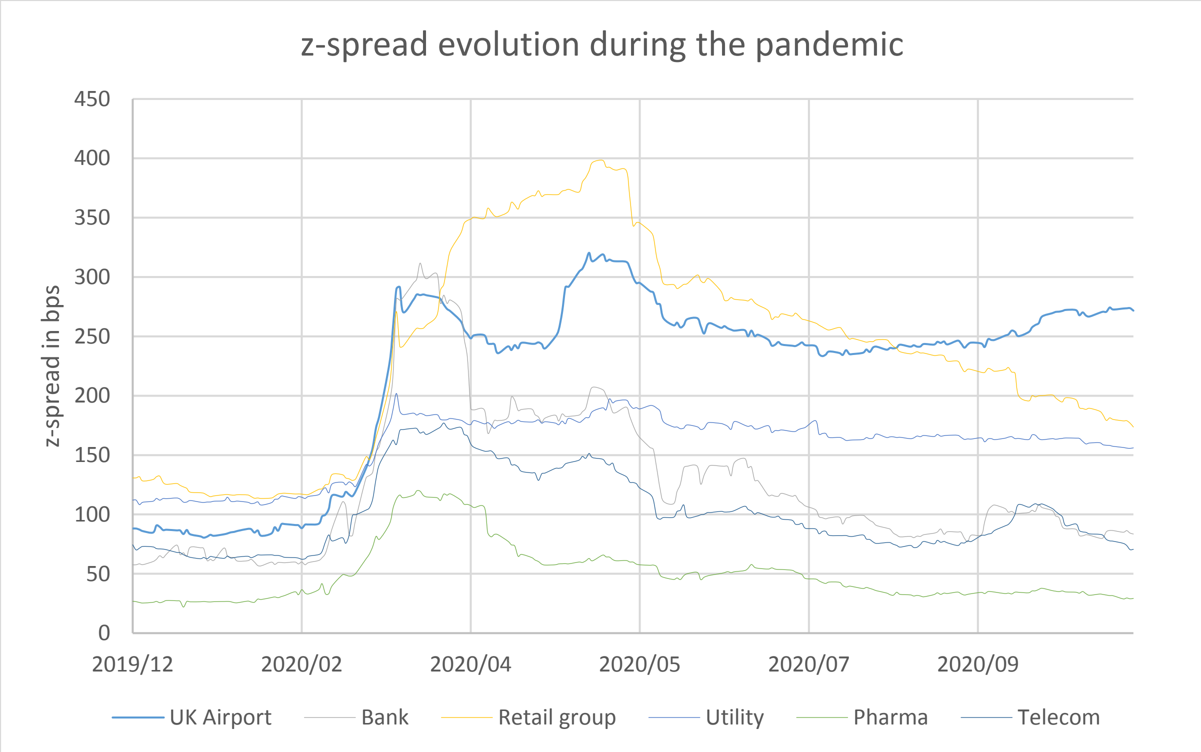
Covid-19 pandemic brought the whole world to standstill and caused major disruption in the global economy. In this short article we discuss how the virus has been testing the resilience of the infrastructure investments in a number of sectors and if a major repricing of infrastructure risk has happened.

Infrastructure debt market in Europe has been traditionally dominated by banks. Since the Global Financial Crisis (GFC) we have witnessed a dramatic increase in lending from non-bank institutions, such as life insurers and other long-term investors. The asset class was deemed to be a great fit for the liability driven investors, as it provided a long-duration, stable income. Given that the majority of the transactions are private and not actively traded, the infrastructure loans also provided the investor with a spread pick-up (vs public credit bonds) to compensate for illiquidity. Finally, the essential nature of many of the infrastructure assets should provide the investors with additional security and resilience against the broader fluctuations in the markets and the economy.

It is tempting to draw comparisons to the GFC, when discussing the current pandemic, however upon closer inspection these may prove to be unfounded. The GFC was first and foremost the liquidity crisis, while at present the liquidity seems abundant and there has not been (so far) a dramatic rise in the cost of liquidity. What potentially could change is the idiosyncratic risk of the borrower, and consequently the credit risk premia.

Since the start of the pandemic, public credit market suffered major spread widening and bouts of volatility, across all sectors. Subsequently the spreads normalised and by the end of the summer return to the pre-Covid level, for the majority of sectors.



Source: Eikon, Schroders

Prior to the pandemic, EUR-denominated senior, investment grade (IG) equivalent private infrastructure debt tended to price with a spread of 180-225bps[1] over swaps, depending on tenor, sector and geography. The effect of the pandemic on pricing has been somewhat different to the public credit, given the inherent lag in pricing (the spreads tend to be agreed some weeks in advance). The market has witnessed polarisation within the infrastructure sector: the transactions in sectors less impacted by the pandemic (for example renewables or utilities) have generally closed without repricing. In other sectors, with more Covid-19 induced uncertainty and merchant risk[2], deals were postponed or scraped all together, particularly when the borrower was in a position to wait out for the dust to settle.

This has been reflected in infrastructure debt issuance figures[3]: the total volume issued in Europe was €10bn (a fall of -9% vs Q2 2019) and €12bn (a fall of more than 50% compared to Q3 2020), in Q2 and Q3 2020, respectively. The fall of issuance in Q3 in particular illustrates that a number of deals frozen during the lockdown have not been restarted. Majority of the new issuance came from the renewables and telecoms, indicating that investors believe those sectors to be more resilient to the pandemic crisis. The reduction in infrastructure debt volumes may also be driven to some extent by public credit assets looking relatively attractive when spreads blew out at the peak of pandemic.

With this in mind, going forward, the market expects an increase in spreads to the tune of 50-75bps[4] on average. However, the pricing may become discriminative: more widening in affected sectors (transportation) and less in more resilient ones (digital, renewables).

[1] Source: Working Party research

[2] Merchant risk relates to the risk of a project being exposed to market price fluctuations, rather then secured using long-term contract

[3] Source: Infrastructure Debt Update, Q3 2020, Schroders

[4] Source: Working Party research

In terms of more sector specific themes, the market has seen a continuing interest in renewable energy financing, which remains a core sub-sector within infrastructure. The assets remained largely unaffected by Covid-19 and there is no change in debt structure expected. An ongoing trend in the sector has been a gradual move from subsidies to a model with more of a merchant risk. Going forward, there could be a short-term pressure on those assets, particularly in the case of a prolonged economic slow-down.

Digital infrastructure has been another segment showing tremendous growth during the pandemic, as new trends emerged almost uniformly in Europe and the rest of the world. Our daily patterns have very quickly changed, with a anything from working, shopping, social interaction through education and entertainment more and more happening online. For those reasons, and unsurprisingly, data traffic erupted and increased by 30-50% from pre-Covid-19 levels. According to market participants, interest in financing digital infrastructure continues to be strong.

Utilities sector has also held up well, as majority of the assets are heavily regulated and contracted. Those with a degree of merchant risk may face the same pressures on financing cost.

Finally, the transportation has been the sector most affected by the Covid-19 lockdowns (See Sector focus below), as the global mobility ground to a halt. While airports may take years to recover, other projects operating in the subsector, such as ports, ferries and motorways, seem less affected and are slowly regaining momentum. The uncertainty however remains – for example on ports' side, there is a question around "reverse globalisation" and changes to supply-chains. Projects within the sector needs to be assessed on the case-by-case basis, as the risk dynamics could be very different for an otherwise "similar" asset. For example, some car parks are operated using a public-private partnership (PPP) availability-model, while others have revenues exposed to the volume risk. Clearly in the current context the latter is much riskier proposition.

For existing infrastructure investments, the pandemic also resulted in breaches to the loan covenants that were in place (e.g. EBITDA to interest coverage, DEBT to EBITDA ratio etc), particularly for the sectors mentioned above, where revenues have been significantly affected. The approach typically adopted in such cases was to provide covenant waivers or renegotiate for interim covenants, as opposed to taking more severe actions such as triggering the workout processes. In some cases where there is strong confidence of a recovery, investors may also decide to provide additional equity to the infrastructure projects to maintain covenant levels.

Importantly for insurers the market has also witnessed an increase in downgrade in the infrastructure sector. According to Fitch[5] there have been 62 downgrades in the sector in H1 2020, of which 15 were from investment-grade (IG) to high yield. Unsurprisingly, majority of the downgrades were due to the impact of Covid-19 and related lockdowns and thus almost three quarters were in the transportation sector. Fitch notes only one default early in 2020, of an Argentinian energy producer, following delinquencies from the sole off-taker.

Sector focus: Transportation / Airports

Transportation sector has been arguably the most affected sector, given the worldwide lockdowns. This has been particularly acute for global mobility and also more affecting travel than cargo. Airports tend to derive a large part of their EBITDA (around 40%) from so called non-aeronautical revenue streams, such as duty-free retail, car parks and food and beverages (effectively acting like a

[5] 2020 Infrastructure Downgrades Far Exceed 2019 Levels, July 2020

large supermarket). With the disappearance of the global passenger travel, these revenues collapse close to zero. The total quarterly revenues worldwide are projected to fall by over 55% in 2020[6].

Rating agencies proceeded with rating actions in the last days of March 2020. For example, Moody's placed six airports (including two UK ones) on review for downgrade and changed outlook for four others from stable to negative. The private market refinancing for airport had closed and remains so to date. The operators rely on liquidity lines from the banks to fund their cashflows needs or may seek fresh equity injection.

In spite of the potential for downgrades in the airports sector, stronger issuers were able to tap the market, however at a price. In the UK, Heathrow (through Heathrow Funding Ltd) raised £1.4bn in the global bond markets in October 2020 at a z-spread of c.230 bps, c.130 bps above pre-COVID levels seen in mid-February. Heathrow has a strong liquidity position with cash reserves of £4.5bn. Heathrow have communicated this would be sufficient for the next 12 months under an extreme scenario of no revenue and sufficient until the end of 2023 under their base case scenario that assumes a 72% decline in passenger numbers in 2020 vs 2019 and 54% decline in passenger numbers in 2021 vs 2019.

In July 2020 Azurra, the owners of airports in southern France (including Nice's Cote d'Azure), have issued €600m of debt, to repay its existing credit facilities. The issuance was rated Baa3 (negative outlook) by Moody's. Interestingly, the debt included features previously not found in IG documentation[7], such as pledge on shares and bank accounts as well as limits on borrower's ability to upstream cash to shareholders. The issue was priced at mid-swaps (MS) + 300bps. For comparison, the issue from APRR (motorways) in September 2020 for a similar tenor was priced at MS+48bps (A- rating), reflecting investors' preference for local ground-based transportation.

[6] The Impact of COVID-19 on Airports. An Analysis, IFC
[7] Source: Bloomberg