Infrastructure Financing

2024 Market Update Sector Report

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Defining Infrastructure Financing

"Infrastructure" financing is not a well-defined term. It is a hybrid with characteristics associated with project finance, corporate debt, and LBO financings. However, market players all understand what infrastructure financing looks like and the value it can potentially drive for an infrastructure business.

Before 2015, infrastructure financing was predominantly a bank financed market; larger, more core infrastructure assets were also able to access the public bond markets. As regulation tightened for banks' capital models in the latter half of the decade, they began to restrict lending, particularly where there was a tenor of more than five years. This coincided with the evolution of infrastructure equity, with greater delineation across the risk spectrum. In this context, the infrastructure debt market emerged with the establishment of infrastructure debt funds and end investor capability particularly in insurance alongside a trend for sponsors to shift focus to the longer-term debt markets, filling the space vacated by banks.

This significant pool of global liquidity competed with banks and drove pricing down, while also offering enhanced structural flexibility for borrowers. In a low-rate environment, and with more appetite coming from the longer-dated private institutional market, owners of infrastructure assets were able to secure long dated debt at very attractive coupons meaning they could de-risk their investment over their entire hold period. Owners of smaller, more mid-market companies, unable to access the public markets due to size and rating considerations, were also able to obtain financing support from private institutional players.

Today, the European infrastructure financing market is a broad and substantial market, with numerous banks and institutional investors from around the world competing to lend to core / core+ assets in Europe on a rated or unrated basis.

DWS's Approach to Infrastructure Finance

At DWS, a key part of our value-add asset management approach is to put in place an efficient, long-term capital structure for our portfolio companies that will enable them to effectively pursue their business plans. For us, infrastructure financing is corporate in nature but with financial covenants (typically leverage and ICR), that contains large flexible capex facilities and allow regular dividend payments. The debt is provided by infrastructure relationship banks and long-term institutional investors, and normally has bullet repayment profiles at maturity. This type of financing is important for us as it allows us to support the growth of our portfolio companies whilst in parallel seeking to deliver a robust yield to our investors.

To secure this type of financing structure, we typically invest in perpetual operational infrastructure assets that have stable and predictable cash flows while also having a business plan that requires significant investment over our investment horizon[1].

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Stephen Davies, Partner, DWS Infrastructure

[1] There is no assurance that investment objectives can be achieved.

Current Market Environment

A decade of cheap and relatively accessible debt followed the global financial crisis, particularly 'for good infrastructure assets with strong sponsors. During this period, there were relatively few examples of failed debt raises; where a financing was unsuccessful, it could typically be attributed to a tainted asset history or an overly aggressive structuring. The European infrastructure debt market remained open during market turbulence, including the Covid-19 pandemic; conversely, the LBO / High-yield markets are much more volatile both in terms of cost and leverage levels and have experienced periods of complete shut down over the same period.

Despite the recent challenging macroeconomic environment and rising interest rates, the infrastructure finance market continues to exhibit remarkable resilience. While M&A activity has taken a hit, financing and refinancing activity has remained robust, due in part to the credit profile of infrastructure assets, which has shown no material decline in quality. This highlights the inherent appeal of infrastructure in volatile times: the underwriting premise of the asset class is its stability and predictable long-term cash flows.

However, there was a shift in financing strategy and sentiment observed as a result of the pandemic. Companies seeking waivers soon realised that this required engagement with multiple investors across the globe, with whom – in many cases – there was no real relationship. This coincided with a rising and higher rate environment, making many businesses and sponsors reluctant to lock in long-dated fixed rate date. It is not yet clear if this is a short-term strategy shift or the beginning of a longer-term trend to finance assets with relationship lenders on a shorter basis, with bank debt offering a more flexible source of capital.

We have seen lenders become more selective, due to the higher rate environment (see figure 1) coupled with heavier regulation across the European banking market. However, the market remains open for good assets with appropriately structured debt financings. Moreover, while the total cost of debt has increased due to the increase in benchmark rates, margins (the risk premium above the benchmark associated with the financing company) have been more stable and are at levels broadly consistent with the previous five years (please see figure 2, which shows the BBB infra index and the High-yield infra index).

Figure 1: 7 year mid-swap rate from period January 2019 to May 2024

Source: BlueGamma, as of 8 April 2024.

Figure 2: EUR iBoxx Infra BBB index and the High-yield Infra index from period January 2019 to May 2024

Source: iBoxx EUR Infrastructure BBB: BlueGamma, as of 8 April 2024; EUR HY Infra spread, S&P, as of 9 May 2024.

Figure 2 (above) also demonstrates the relatively stable investment grade infra market versus the more volatile infra high-yield market.

The Future of Infrastructure Finance

Looking ahead, we expect acquisition financing and refinancing activity to remain strong, fuelled by:
– continued demand,
– the potential M&A market recovery, and
– an improvement in fund raising for strong infrastructure sponsors.

Additionally, the long-term outlook for infrastructure remains fundamentally strong, with many operational assets requiring future capex to align them with major thematic investment trends such as decarbonisation and digitalisation, driving further debt demand. Higher interest rates will translate into increased debt service demands and potentially lower valuations, but the inherent stability of the assets should help to mitigate this concern.

However, not all corners of the infrastructure market are immune to challenges. Riskier assets, such as those with merchant exposure, face greater headwinds than their core and core-plus counterparts. Nevertheless, even these riskier assets should still be able to access the market, provided the financing is structured in an appropriate way and backed by strong sponsors.

At DWS, we believe that – by following our investment strategy of investing in essential operational infrastructure assets in sectors with positive tailwinds and ensuring that our companies are viewed as implied investment grade by the lending markets and are appropriately structured to mitigate credit risk for lenders – we will be able to continue accessing the infra debt markets on attractive terms. Despite the raising rates environment seen over the last 18 months and the more challenging debt market conditions, all our recent financings have been secured on favourable terms, were significantly oversubscribed, and met all the key financing objectives.

The DWS Approach[2]

Typically, when a DWS fund acquires a new business, the team raises a 5-7 year committed acquisition facility provided by relationship banks. We then aim to refinance this facility within 2-3 years, at which point we would implement a steady-state longer term financing platform provided by banks and longer-term institutional investors. In many cases, an investment grade rating is secured by a third-party rating agency; if not, the long-term metrics will be sized to investment grade and positioned to the market as such.

Case study: Ergea

ergéa

Ergéa is the leading European cancer care and advanced diagnostic imaging services platform, created through the integration of Medipass, RadioOnkologieNetzwerk and Althea UK. It was the first acquisition of the third DWS managed European infrastructure focused strategy made in November 2020, followed by two significant add-ons made in 2021 and 2022.

The team secured a private BBB flat rating (stable outlook) and successfully closed the c. EUR 560 million refinancing of the acquisition facilities in May 2023. The new facilities were provided by a mix of banks and private institutional investors on 5-, 7-, 10- & 12-year tenors, and the interest rate risk has been fully hedged. A EUR 150 million revolving capex facility was secured as part of the financing to support the business. It is intended that the company will return to the term debt markets on a regular basis to restore headroom in the capex facility as they deliver the business plan.

This was the first investment grade rated infrastructure financing achieved for a business in the cancer care sector. The debt, provided by a mix of leading infra banks and longer-term EUR and US private placement investors, was oversubscribed.

Case study: DGN

Deutsche GigaNetz

Deutsche Giganetz GmbH ("DGN") is a fibre-to-the-home ("FTTH") provider for residential, commercial and carrier customers in Germany, focused on rural and suburban regions. It was acquired in September 2022, also by the third European focused strategy.

DGN had secured EUR 365 million of capex facilities when we invested in the business, with the facility provided by a mixture of German and international infrastructure banks. In December 2023, DGN successfully raised further additional facilities of EUR 250m comprising a sustainability linked capex facility of EUR 240 million and a EUR 10 million Opex facility to help secure the company's continuous fibre roll-out activity.

Despite the well documented challenges in the European fibre market, the financing was oversubscribed with strong interest from both existing and new lenders (the financing also won the European Fibre Financing of the year from the Infrastructure Journal's prestigious annual awards process). The new facilities' terms were largely aligned with the existing terms and includes an accordion option to raise an additional EUR 200 million facility. The facility is also sustainability linked, meaning the margin will reduce as DGN achieves mutually agreed sustainability targets.

[2] Case studies are for illustrative purposes only and are provided to demonstrate the types of transactions entered into by the team previously. They do not represent all the transactions and are not representative of the team's investment experience as a whole nor are they representative of the transactions that may be available in the current market.

Case study: North C

NorthC was created by the 2019 acquisition and subsequent integration of NLDC and TDCG to form the largest independent provider of datacenter services in the Netherlands.

In November 2021 we implemented a EUR 282m long-term financing structure, raised from a mixture of relationship banks and longer-term institutional investors. The transaction was unrated (due to its relatively small size at the time) but attracted interest from leading infrastructure banks and EUR private placement investors; lenders were attracted to the essential nature of the business, diverse client base, and well invested and diverse asset base.

In September 2023 the company raised a further EUR 125 million from a sub-set of the existing lenders who were happy to support the business with increased commitments. The proceeds of the new financing were used to clean down the EUR 75 million capex facility and to pre-fund EUR 50 million of near-term investments.

Case study: Hansea

Hansea is one of the largest private operators in the public bus transport market in Belgium and a leading passenger transport operator in the Netherlands, acquired by the second European focused strategy in August 2019.

In September 2022 Hansea raised a EUR 151 million term loan, a EUR 100 million revolving capex facility and a EUR 15 million RCF, all on a 7-year tenor; the facilities were provided by a group of relationship banks and private institutional investors. This longer-term financing platform has a flat covenant profile and the flexibility to deliver the business plan over the next 5-7 years, including the electrification of the Hansea fleet. All new term debt has either been provided on a fixed basis, or been fully hedged, insulating the business from any further rate rises. There was strong interest from lenders, attracted by the company's alignment to the energy transition and Hansea's resilience and essentiality, as demonstrated by its robust performance during the Covid-19 pandemic.

Contributor

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