VANTAGE INFRASTRUCTURE

INFRASTRUCTURE DEBT MARKET UPDATE

Q1 2020

In the midst of a social and economic disruption not seen for a generation, we are sharing our views on how the impacts to infrastructure debt may vary depending on an asset's characteristics

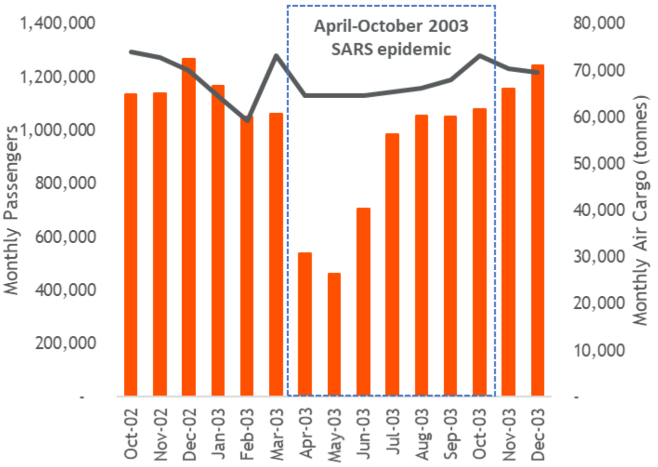
In previous updates, we have shared data and theory that explain infrastructure debt's resilience in generating stable and attractive risk-adjusted returns. We'll be able to put some of that theory to the test during this disruption!

This disruption is expected to highlight infrastructure debt's potential to offer a safe haven of opportunistic value and attractive long-term cash yields. Capturing this value requires experience in understanding the short- and long-term impacts on our communities and economies as a result of COVID-19. For example, what are the economic impacts as we drive and fly less and rely more on the remote working platforms that have quickly become the new reality?

Changes in how and where we work or live have a close relationship to transport assets and energy infrastructure globally. Below we will focus on and share some of our experience and market views on these two key infrastructure sectors that will have both shorter- and longer-term impacts as a result of COVID-19.

Transport

Transport assets have been the foundation of infrastructure financing for many decades. Since 2010, c. $300bn of global debt has been issued to finance transport. The sector's essentiality for moving people and goods is offset by volume-based fee income. The historic passenger and cargo volumes at Singapore's Changi airport during the 2003 SARS coronavirus epidemic is a useful example. Changi's experience of an immediate impact followed by a relatively short recovery is typical of a core transport infrastructure asset.



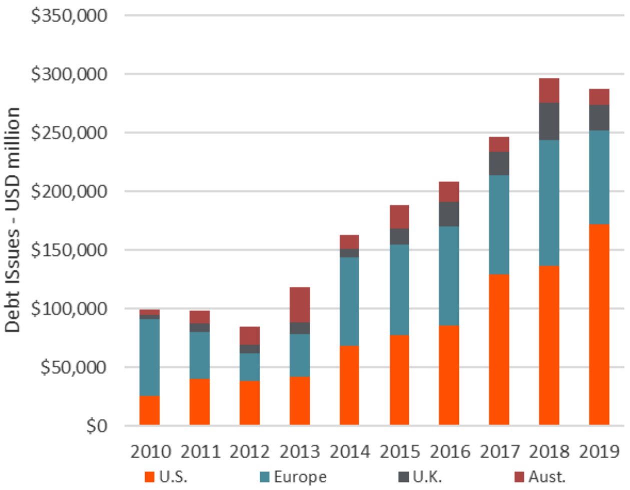
Source: Government of Singapore, data.gov.sg

- ➢ ***Event risk***: transport is impacted early and significantly but the impact on people and goods can be quite different. Managing liquidity instantly becomes the priority. Australia, Europe and the UK where private finance is used extensively for transport assets will be most affected.
- ➢ ***Recovery***: the essentiality of transport has meant it recovers quickly. However, over the longer term relatively small changes in traffic patterns can add up and require modifications to an asset's capital structure. Smaller regional transport assets will be most exposed to this risk.

Energy

Energy infrastructure is highly varied due to its exposure to economic activity and the contracts or regulations used to manage the volatile price and volume risks. For example, transport fuel storage can behave like core transport, a renewable asset's performance may be linked to how sunny it is, while an oil pipeline may be exposed to upstream development or oil price risks.

Since 2010, c. $900bn of global debt has financed energy infrastructure and c. 50% of this has been in North America. Yet we estimate less than 30-50% of this market meets our infrastructure standards of low to nil direct price and volume risks through market cycles, a critical factor in delivering risk-adjusted value.



Source: IJ Global transaction database, 2020

- ➢ ***Price/volume risk***: notwithstanding an asset's infrastructure appearance, price and volume risks can dominate the credit risk profile and result in performance more closely linked to commodities. Contracts that transfer price and volume risk play an essential role in achieving an infrastructure risk profile. This economic cycle will be a good thermometer in testing the investment discipline upheld by infrastructure investors in North America where price and volume risks are often higher.
- ➢ ***Counterparty quality***: transfer of price and volume risk to a counterparty alone does not remove risk. It certainly provides short-term protection, but the long-term support depends on the counterparty's underlying business and their ability to manage changes to continue standing behind the contract.

Whether it is transport, energy or other infrastructure sectors, an infrastructure asset's ability to manage significant disruption due to its inherent resiliency, long-term contracts or price regulation are unique differentiators to infrastructure versus other asset classes. Value preservation is then underpinned by infrastructure's long-term and essential role in the functioning of a community or market. However, events such as COVID-19 can be catalysts for significant changes in how communities or markets function over the long term. This requires constant testing of an asset's ability to meet an infrastructure standard and deliver on the resilient risk-adjusted return expected of our asset class through market cycles.

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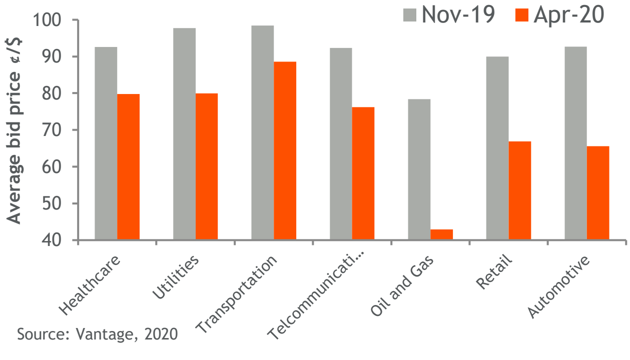
North America

The following graph sourced from multiple providers of leveraged loan trading levels gives a sense of the changes that have impacted more easily-accessed private senior credit assets in the US.



Source: Vantage, 2020

Unlike leveraged loans outlined above, private infrastructure debt has not seen this volatility due to its more essential role, robust loan structuring and typical buy and hold approach by investors. These wider market changes do, however, influence private infrastructure debt's deal flow, returns and terms, often to the investors' benefit.

In Q4 2019, our market was characterized by stable deal flow and gradual margin increases as rates declined. Entering Q1 2020, the building market volatility resulted in a sharp up-tick in deal flow, widening spreads and better influence over terms. Throughout Vantage's all debt activity, we ended Q1 with our busiest quarter yet and a strong pipeline heading into Q2.

Total market volumes have declined quickly due to the pullback of bank lending and changes in public markets. This has increased deal flow to our niche of small to medium transactions, which can be executed with sole and small lender clubs focused on higher quality assets with contracted cash flows to creditworthy counterparties. We expect this trend to continue throughout 2020 with additional deal flow from opportunistic secondary investments from sellers requiring or valuing liquidity. The most active sectors include renewables, midstream, utilities and transport.

Decling risk free rates will create some pressure on returns. With 3-month LIBOR holding above 1% this has yet to materially impact returns. If risk-free rates decline, returns can be preserved by our ability to increase margins, LIBOR floors and other fee income in periods of volatility. For example, in certain sectors we've seen risk free rates decline c. 1% while margins have increased 2%. These conditions may persist as markets take time to normalize.

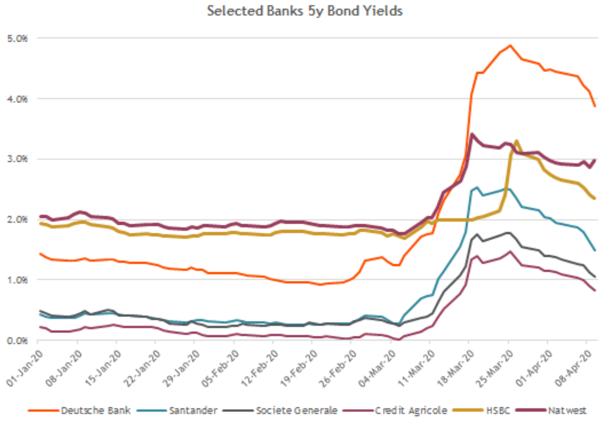
UK and Europe

In the UK and Europe, the focus of recent activity has been on liquidity – rapidly assessing how long businesses can operate in a 'lockdown' environment, notwithstanding the safety nets being quickly established by governments throughout the region.

As expected, the most acute pressure is being felt in transport related assets, whereas some assets such as fiber optic networks are seeing an improvement in their position. This resilience is framing a number of fiber based pipeline opportunities in a very positive light.

What will be really interesting for infrastructure debt is how banks will react to new deals coming to the market. Banks compete with investors for deal flow and have a slightly muddy formulation when it comes to debt pricing. Bank funding is a combination of funding costs in the bond market, relationship pricing, a desire to protect market share and the performance of the loan book. The most immediate determinant – funding costs – has increased materially across the main banks, but is now subsiding. Bank bonds are key targets of the central bank quantitative easing programs, which have recently kicked off in earnest – particularly in Europe.

All things being equal, this means that as long as central bank QE programs remain in place, banks will act as a natural cap on private market infrastructure debt pricing. They provide a conduit for central bank credit when the relative value to public credit is not sufficient for institutional participation.

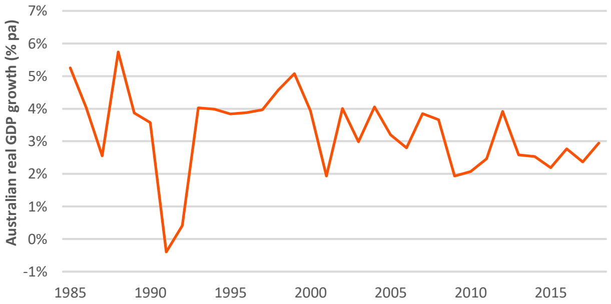


Source: Bloomberg, 2020

However, the nature of the impending recession could very well change this. If bank loan books become materially impaired by defaulting borrowers, it is likely that we will see them step back from the market. This will present a significant opportunity for institutional lenders to provide valuable liquidity to a sector which they are much more familiar with than they were 10 years ago.

Australia

Australia will not be immune to a recession due to COVID-19. However, the experience of a recession is novel for an economy that last encountered this almost 30 years ago.



Source: World Bank and Vantage, 2020

Having avoided a recession during the 2008 financial crisis, local providers of capital remained a strong source of liquidity in the Australian lending market. Thereafter, the comparatively strong performance of the Australian economy relative to other OECD countries resulted in additional foreign liquidity entering the Australian lending market.

Whilst the inevitability of a local recession is likely to result in a smaller deal pipeline, we expect to see support for the infrastructure pipeline due to the dominance of investment-grade rated borrowers in the Australian infrastructure market and government-initiated processes such as greenfield PPPs and privatizations.

At the same time, as liquidity from public capital markets has been impacted, local banks have been tasked by the Australian government to provide liquidity to individuals and small and medium-sized businesses adversely affected by COVID-19. Anecdotally, we are aware that this has flowed through to higher margins and declining liquidity for new loans to larger borrowers, including those in the infrastructure sectors. These conditions are generally of benefit to private debt investors as Australian infrastructure borrowers look to increase their access to alternative private funding sources that will come with higher margins and better terms.

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North America is seeing deal flow in contracted and resilient midstream and renewable assets, along with selective opportunities in utilities, telecommunications and transport. A trend we expect to persist into Q2-Q3. In the UK and Europe, pricing has stepped up materially, however cheaper bank funding is moderating such increases. Reduced liquidity in the Australian market is yielding attractively-priced investment grade opportunities with continual financing needs.

Global Pipeline Highlights[1]:

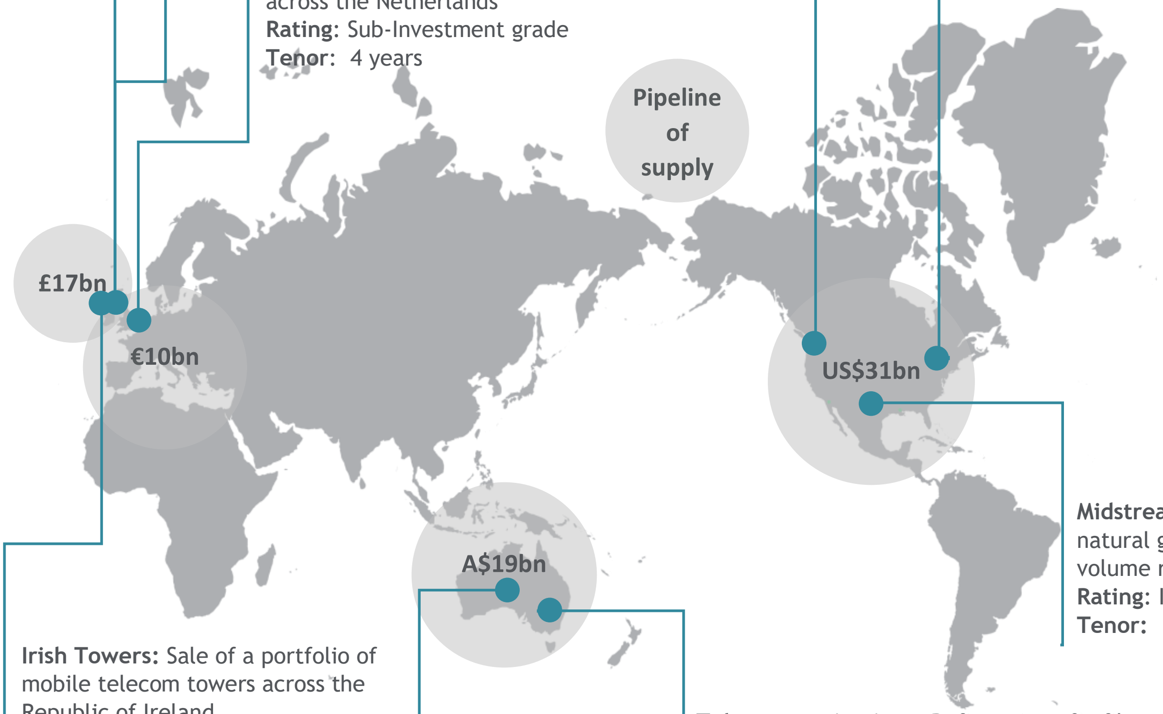
UK Energy from Waste: Sale of an operational energy-from-waste facility in London by current shareholders
Rating: Investment Grade
Tenor: 5 years

UK Smart Metering: Refinancing of a portfolio of domestic smart meters
Rating: Investment grade
Tenor: 15 years

Netherlands Fiber: Term out of a capex facility to a major provider of metro-area fiber network across the Netherlands
Rating: Sub-Investment grade
Tenor: 4 years

Renewables: Residential solar holding company financings against contracted and mature operating portfolios
Rating: Sub-Investment grade
Tenor: 7-10 years

Telecommunications: Refinancing of a regional fiber infrastructure business with a mix of contracts and regional exclusivity
Rating: Sub-Investment Grade
Tenor: 5-10 years



Midstream: Fully contracted natural gas pipeline with no volume risk
Rating: Investment Grade
Tenor: 10+ years

Irish Towers: Sale of a portfolio of mobile telecom towers across the Republic of Ireland
Rating: Investment Grade
Tenor: 10-12 years

Telecommunications: Refinancing of a fiber infrastructure business with intra- and inter-capital networks and deep sea cables
Rating: Sub-Investment grade
Tenor: 5-7 years

Airport: Long-tenor financing of a monopoly capital city airport
Rating: Investment Grade
Tenor: 10-20 years

Regional Pricing Trends[2] (bps)	Prime (BBB and better)	Hybrid Senior (BBB- to BB)	Yield Junior (BB- to B)
Europe	+175 – 250	+225 – 300	+300 – 600
UK	+200 – 275	+225 – 400	+375 – 600
USA	+250 – 350	+350 – 450	+500 – 750
Australasia	+250 – 400	+350 – 550	+500 – 800

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2- Regional pricing trends source: Vantage Q1 2020

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If you would like to discuss the contents of this market update, or understand the global infrastructure debt opportunities in more detail, please contact our global team:

Level 2
50 St Mary Axe
London, EC3A 8FR, UK
tim.cable@vantageinfra.com
+44 20 7337 6724

Tim Cable
Senior Partner (London)

575 Fifth Avenue
39th Floor
New York, NY, USA
nick.cleary@vantageinfra.com
+1 212 681 2910

Nick Cleary
Partner (New York)

Level 2
50 St Mary Axe
London, EC3A 8FR, UK
lisa.shaw@vantageinfra.com
+44 20 3462 1347

Lisa Shaw
Director, Debt Asset Management (London)

6A Shenton Way #04-02 to #04-08
OUE Downtown Gallery
Singapore 068815
kevin.law@vantageinfra.com
+65 6216 2351

Kevin Law
Director, Business Development (Singapore)

575 Fifth Avenue
39th Floor
New York, NY, USA
jennie.park@vantageinfra.com
+1 212 681 2591

Jennie Park
Vice President, Business Development (New York)

Vantage Infrastructure
London, New York, Singapore, Sydney
www.vantageinfra.com

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