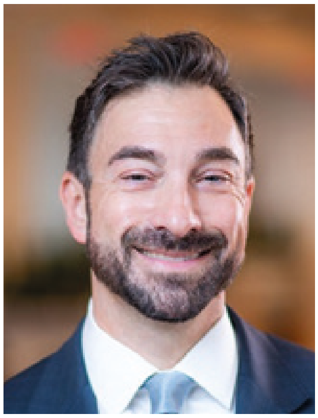
KEYNOTE INTERVIEW

Mind the (economic) gap



Despite a volatile economic environment, infrastructure debt allows investors to find opportunity in the gaps, says Nuveen's Don Dimitrievich

Capital-intensive infrastructure projects will continue to find investors, despite inflationary pressures and interest rates affecting capital availability. Providing flexible capital solutions and structuring discipline will be key, says Don Dimitrievich, portfolio manager and senior managing director for energy infrastructure credit with Nuveen, a TIAA company.

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Q What areas of infrastructure debt represent the most compelling opportunity today?
If we are going to decarbonise, we will need to electrify as much of the energy supply as possible, and renewable generation is obviously an area that is well established and attracting a lot of capital. As a result, you are seeing energy storage opportunities attracting a lot of interest and capital because storage can offset the intermittency challenges associated with renewable generation. In addition, under the Inflation Reduction Act there are now standalone credits. Previously, storage had to be coupled with renewable projects to qualify for the tax credits.

Between 2000 and 2010, there was significant growth in onshore wind, and in the following decade we saw the proliferation of solar. I think this decade will be the decade for the development of energy storage, with capital gravitating there.

From a digitalisation perspective, data centres and the proliferation of AI data crunching are incredible consumers of electricity. The view is that over the next five years, electricity growth in the US will rise almost 5 percent, which is very significant. Historically, electricity demand in the US has been relatively flat annually, and to see this type of growth over the next five years will require a lot of capital. Data centres will proliferate and so will the capital needed for power to support that growth.

Q How is the current interest rate environment affecting the cost and availability of capital?

In my opinion, this is the pivotal question for 2024. Since the Great Financial Crisis beginning in 2008, we've had a virtually zero-rate interest environment until this past year. With capital-intensive infrastructure projects where cost of capital matters a great deal, an increase in rates affects the profitability of projects. It is going to cause some projects to ultimately get cancelled or delayed, and some will have their economic terms renegotiated. You are already seeing this with the recent cancellation of some high-profile offshore wind projects in the US.

The challenge for many projects is that these capital costs issues stemming from the historic rate increases over the past 18 months are exacerbated by inflation. We are also seeing inflationary pressures across the supply chain, and in certain areas still seeing supply-chain delays and labour issues, which have a direct cost on projects.

A lot of the underlying capital and project cost assumptions from a few years back are not applicable anymore. And frankly, I think that is an opportunity for strategies like ours that provide flexible capital solutions.

Q How are investors baking in some of those cost of capital and inflationary issues?

From an underwriting perspective, we are not going to assume the Fed will lower rates and that some of these inflationary pressures will somehow normalise. There is a strong possibility or likelihood that these types of pressures may persist for several years, and so our underwriting accounts for that.

Q In what way does infrastructure debt allow investors to diversify their portfolios while lowering risk?

Infrastructure debt typically has some type of locked-in cashflow from off-take contracts, which can provide protection from the vagaries of consumer discretionary spending. These off-take contracts often have inflation protection clauses as well as hard asset collateral. So even in more of a recessionary environment, that contracted cashflow and hard asset collateral can provide downside protection.

Also, we structure our investments with interest rate floors, so if the Fed reduces rates at some point in 2024 or 2025, investors benefit from that locked-in spread. For infrastructure debt, the correlation to a broader macro recessionary environment is defensive by virtue of those attributes.

We can provide bespoke or flexible solutions to try and address some capital cost and inflationary challenges from a structuring standpoint. For example, we can create a structure that permits a project to partially hedge the project's output or capacity, which provides the debt investor with cashflow visibility and allows the project owner to participate from increased revenues from the unhedged portion if the project output is correlated in some way to inflation or capital cost increases.

This allows the project owner to have some exposure to market pricing, potentially improving the project economics in an inflationary environment while preserving the downside protection that is critical for a debt investor by locking in a certain percentage of fixed cashflows from the project.

Q How does the prospect of rate cuts or levelling off this year change the environment?

We are seeing the chilling effects from capital cost and inflationary pressures across the infrastructure value chain, notwithstanding the tail winds from the IRA. If this environment persists, the reality is that equity investors will need to invest additional equity into projects and sustain a higher cost of debt.

That is what we are going to base our underwriting on. I think you will see a slowdown in investment activities, which is a function of the rate environment. You still have government policy like the IRA and the equivalents in Canada and Europe providing tailwinds, but certainly this rate environment is a headwind.

There will also be restructuring opportunities where bespoke flexible capital can fill the gap on some of these projects that may have assumed a different inflationary environment, cost of capital and just ultimate cost for these projects. There is a way to structure these creative solutions that may address those issues to bring these critical infrastructure projects to fruition.

Q Is there investor dry powder still waiting to be utilised?

Yes, there is both equity and debt dry powder that is available for the right opportunities, but there are several factors to consider in terms of capital availability.

First, we need to better understand the status of the current regulatory landscape as the IRA regulations are still being issued by the Treasury Department and are more complicated than was initially expected, so investors are waiting to understand how those regulations and incentives are going to apply. Second, political uncertainty is causing some investors to take a pause. And third, there is a perception that some projects may likely require incremental capital to get developed.

Regarding the political uncertainty in the US, there is a question whether the IRA will get rescinded or negated if a Republican administration is elected. The answer is more nuanced. It is less likely that the IRA would be rescinded in its entirety, as many areas in the IRA have bipartisan support. However, an administration has many different levers that it can use to affect legislation without the need to rescind it. For instance, capital availability under some of the Department of Energy loan programmes may ultimately get revised, or the focus may change.

It is also worth noting that the availability of capital is also affected by state and local policies. For instance, the recent volatility and lower prices for Low Carbon Fuel Standard credits have affected the economics for projects that rely on those credits.

It is nuanced, but questions around this will naturally cause investors to be a little more disciplined on what assumptions they make and slow down the pace of investment in areas that are reliant on credits.

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While there is significant capital available for infrastructure opportunities, we are being very selective on the types of projects, focusing on areas that we believe will be strategically important over the next decade – such as energy storage and the onshoring of the sustainable energy supply chain – to mitigate geopolitical and global trade risks.

Q What about the investment gap and what institutional investors might be doing about it?

If it is a traditional project finance opportunity, and the project has 'down the fairway' terms, those opportunities are best suited to the project finance market with lower return expectations.

If an equity investor is looking to take some market risk associated with a project, we can structure something where there is a tolling or contracted off-take for 70 or 80 percent of the capacity of a project that gives us that cashflow certainty, and amortisations that are important from a credit perspective.

Those do not necessarily fit squarely within the commercial or project financing market, so that is an opportunity for us to invest in those fundamentally attractive projects, which allows us to enhance our returns because we are allowing that flexibility. That is one area where private infrastructure debt investors can fill a gap in the market.

The other area where infrastructure debt capital can fill a void is for equity sponsors that are looking for a holistic credit solution for a portfolio at various stages of development. Project finance debt is not typically available at the portfolio level and sponsors need more flexible capital. Once the portfolio or individual projects achieve commercial operations, those projects can attract a lower cost of capital debt solution. ■

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