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First-Lien (Bond-like) Infrastructure Investments

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Last year, I made a presentation to MOI Global members on fundamental alternative investments. This year's presentation is a follow-on to that subject, examining additional alternative segments like infrastructure and pipelines. To recap, one of the features of alternative assets is little or negative correlation with most investors' growth engines—equities.

One asset class that provides negative correlations to stocks are bonds. Bonds represent first-lien claims on corporate cash flows associated with corporate assets versus the more subordinated claims of equities. There are certain equity securities that have first-lien claims that provide similar cash flow characteristics as bonds but have upside potential from increasing cash flows or distributions, modest levels of leverage, or higher yields than similarly positioned bonds.

One of the key drivers in bond-like infrastructure securities is the outlook for interest rates. In looking at the historical rates of returns for bonds, some economists have noted that interest rates have a secular decline rate[1] driven by low inflation and an ever increasing amount of capital which is the result of economic growth and competition for capital from sources worldwide. Capital is typically destroyed in war, famines and epidemics[2]. When a capital shortage occurs (typically after one of the three capital destroying events) it leads to inflation which leads to higher interest rates. When the opposite occurs (peace and worldwide participation in growth), inflation and interest rates go down.

Our current situation with lower interest rates is the result of more capital from economic growth and competition from firms and governments on a worldwide basis. We are also in the aftermath of a capital destroying event (WW II) which created shortages and inflation in the 1960's to the 1980's. Given that most of the current generation of investors have experienced inflation during this period, there is an inherent bias towards more normalized or higher rates of this period. With this lower interest rate tailwind, many first-lien investments should do well.

Some of these infrastructure firms provide the financing of assets to firms who can deploy their equity capital to better uses elsewhere in their operations. Examples include triple-net (NNN) leasing of properties for distribution, restaurant, or retail firms and leasing of aircraft to airlines, ships to shipping firms or pipelines to integrated oil or refinery firms. In some cases, there are firms that lease equipment that is shared amongst many users or is used by a specific credit-worthy user. Examples include equipment leasing and midstream pipeline leasing firms. These types of firms have functional but not necessarily contractual customer lock-in. Some of these firms also have geographic clumping, economies of scale, and the use of technology to efficiently share the assets. A common characteristic amongst winning firms across all three of the categories of firms is functional lock-in and financial stable customers. Good underwriting ensures the stability of the customer base.

The first example is in the NNN lease real estate space. NNN lease REITs have a cost advantage over other REITs because the property upkeep and maintenance are provided by the tenants. These REITs also have long-term inflation adjusted rent contracts with lessors. Broadstone Net Lease (BNL)a private company with plans to have an IPO in Q1 2020, provides NNN lease real estate to firms across a large geographic area in the United States and across health care, industrial and many retail sectors. This diversity effectively provides the investor with a diverse group of secured bonds that have increasing coupons over time. In each of these property types, these firms provide first-lien financing to the business they finance by owning and leasing the mission-critical real estate that these firms use in operations. Since the value of the lease is typically greater than the underlying property value, the key to analyzing these investments is the credit analysis of the lessor. BNL (after its announced internalization) has amongst the lowest cost structures amongst NNN lease firms.

The second example is investing in infrastructure firms who provide necessary products and services. This includes power, energy, communications and transportation infrastructure. An example is an infrastructure investment company called Brookfield Infrastructure Partners (NYSE: BIP). BIP provides infrastructure assets to clients worldwide including data infrastructure (towers, data transmission and distribution and data centers), transportation (ports, toll roads and railroads) and energy (pipelines) and utilities (regulated electricity and gas transmission and distribution). BIP are value investors and invest in the same projects that Brookfield invests in for its institutional clients. About 95% of BIP's revenues are from either contractual or regulated sources. BIP also has the lowest fees amongst other infrastructure firms in part due its larger size. They also have a proprietary deal flow and take advantage of synergies from assets BIP already owns.

The third example is long-term leases of transportation infrastructure. Lease financing is a cost-effective way of sharing or financing capital equipment so the customer can spend their resources on their core business. Some of these businesses can also share equipment amongst various locations and thus more effectively share the asset amongst customers. An example here is MPLX (NYSE:MPLX), a midstream pipeline company. MPLX owns the core collecting, transportation and storage assets of Marathon Petroleum. The valuation of MPLX is an example of the current valuation in this space. MPLX has a long term lease with Marathon Petroleum for the infrastructure it owns. This lease is similar to an unsecured obligation (debt) of Marathon but the yield associated with MPLX and it lease is 7% higher than Marathon debt.

[1] Paul Schmelzing, "Eight centuries of global interest rates, R-G, and the 'suprasecular' decline, 1311-2018", Harvard, November 8, 2019.
[2] David Fischer, The Great Wave – Price Revolutions and Rhythm of History, Oxford University Press, 1996.