Hadley Peer Marshall & Eric Wittleder

Episode 237: Capturing the benefits of Infrastructure Debt

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. We've got a great podcast for you today. It's called Capturing the Benefits of Infrastructure Debt, and we're joined by Hadley Peer Marshall, managing director, co-head of Infrastructure Debt and Structured Solution Strategies, as well as CFO of Brookfield Asset Management. Hadley, that's a big title. Welcome and thanks for joining us.

Hadley: Thanks for having me.

Stewart: We're thrilled that you're here. And we're also joined by Eric Wittleder, managing director Infrastructure at Brookfield Asset Management. Eric, thanks for taking the time. Thanks for being on, man.

Eric: Thanks, Stewart.

Stewart: So let's start this one the way we always do, which is, I'll start with you, Hadley. Where did you grow up and what was your first job? Not the fancy one.

Hadley: I have an accent, so I'm curious if you can guess where I grew up.

Stewart: Oh, I don't hear the accent. I may hear a little mid-Atlantic, but I don't know, like Baltimore?

Hadley: No, I'm a big Tar Heels basketball fan. So I grew up in Charlotte, North Carolina.

Stewart: Oh, there you go. All right, cool. I wasn't terribly off. What was your first job?

Hadley: First job, actually, my first summer working, I had two jobs and I worked at a consignment store in a clothing consignment store, and then as a lifeguard.

Stewart: There you go. I was actually not a great swimmer, but I was a pool maintenance person, so I did the chlorine and when the kid-

Eric: Kept the peak levels in balance.

Stewart: Yeah, when the kid pooped on the deck and whatever, I was that guy for sure. That was my job.

Hadley: I did that part, plus I did the cleaning the showers and the poop deck and all that stuff as well.

Stewart: Oh, yeah.

Stewart: Okay, there you go. So you worked retail. I worked retail too as well as working at McDonald's. So I can relate to those. So Hadley, for you, what are some of the major trends driving the demand for infrastructure debt? I mean, this is an asset class that is gaining, it is plenty of momentum, and it seems to be gaining. Insurance companies have long-dated liabilities that they need to fund. And so I think there's a tailwind here, but in particular, can you make your answer include the impact of the global transition to net-zero carbon emissions, which seems like it's creating some new opportunities.

Hadley: Absolutely. When we think about the opportunity set that's driving infrastructure, renewables and transition, it really is around that $94 trillion of capital that's needed by 2040. And the big levers around that are what we call our three Ds. So deglobalization, decarbonization, and digitalization. So you've already referenced decarbonization, which is a major trend for us on the investing side. The need for corporates, for governments, for individuals to seek opportunities to be in a net-zero environment has really pushed the growth of renewables and transition in a material way.

But it's broader than that. Of course, we're seeing it in all of our businesses, including infrastructure, in different ways. So that's created a lot of opportunity. But then you think about the digitalization and the amount of data that we're consuming, and of course the big push around AI, that is increasing the opportunity set for us as well. Data centers, fiber to the home, big strategies, powers, et cetera. So we're seeing tremendous growth opportunities there to deploy capital.

And the deglobalization really is another avenue. We did a large deal on the equity side with Intel, $30 billion total, to build a semiconductor facility in the US. And that's all on the backs of this deglobalization theme that we're seeing as well. So we continue to see the three Ds really generate a lot of opportunities for us.

Stewart: And the 94 trillion that you mentioned, can you talk a little bit about that number? I think about the size of the insurance industry. I think about the size of the public pension industry, the size of the endowment market. I mean that number is larger than all of those by a wide margin. It creates a substantial amount of opportunity. Can we get there?

Hadley: Well, I mean that is probably one of the challenges that the industry could face, because as we continue to move closer and closer down the road, the amount of capital that's coming in is increasing, private capital coming in, to infrastructure renewables and transition is just continued to double over time. But the reality is that that is a big number. I mean, I can't even conceptualize it because it's so large. And so we are going to need all the different types of capital sources out there to be a major player.

Stewart: It seems that way. And Eric, for you, what characteristics are you looking for when you're investing in infra debt, and what are some of the key attributes of an optimized portfolio within the asset class?

Eric: Look, the definition of infrastructure continues to expand, but there's definitely a few key underlying characteristics that we look for when we're looking to invest in infrastructure debt. And that really is high quality assets that provide essential services and benefit from high barriers to entry. So we think of infrastructure debt as benefiting from those underlying asset characteristics and providing material downside protection. When you look at infrastructure debt compared to non-financial corporate debt, you notice that infrastructure debt benefits from lower defaults over a period of time as well as higher recovery rates.

And these are numbers that Moody's and other rating agencies prepare over time. And that's really because the assets are non-cyclical, and they've proven that out during the global financial crisis. They've proved it out during COVID, it's actually very interesting now talking to potential investors and being able to point to the performance during COVID and during a high inflation period. People typically think of infrastructure assets as inflation hedges, but really being able to show how inflation actually improves asset quality in the infrastructure space is exciting.

And look, as a lender, particularly a fixed rate lender, you don't necessarily benefit from being able to price on pass through higher prices to rate payers, but you do benefit because your loan to value improves significantly. The EBITDA wedge on the underlying assets increase, thereby reducing your loan to value. Those are the typical characteristics that we look at, and it's been helpful in different cycles. And then when you think around risk management, we liked to build portfolios that are diversified across the different sub-sectors. Sub-sectors obviously come in and out of favor, but as long as you're looking at those underlying characteristics, you should be in a good spot.

Stewart: It's interesting when you mentioned the non-cyclical nature of the asset class, is that uniform across infrastructure? Is there pockets where you see better cyclicality or different, more cyclicality? I mean you've got a volatile economic climate to some extent. How does that play into your risk management?

Eric: Look, if you're doing it right, you should be identifying underlying assets that effectively have inelastic demand. They're providing essential critical services. And so demand should not change based off of the different economic cycles.

Stewart: It makes sense. And so Hadley, you mentioned a partnership with Intel. Can you talk a little bit about specific examples of how you've been able to partner with borrowers in the infrastructure space? I mean, you don't have to name them, obviously, those are proprietary information, but can you talk a little bit about how you've been able to do that?

Hadley: If you think about our business holistically, we've got a few pools of capital that can be quite valuable to borrowers. I mean, we can play in the structured equity side, we can play in the more kind of non-investment grade. And then we've got insurance capital that can benefit from investment grade type credits and anything else that doesn't fit into the other buckets. And we see ourselves as a low maintenance partner in circumstances where maybe the bar can't raise all the equity capital, because they don't want to bring in a competitor, or they can't write the full check size, or they see significant amount of growth but aren't able to fund that growth yet. Or they're just trying to be more competitive, and then emanate process. We can be that type of capital if you're thinking about the kind of high yield capital that we have, where we're trying to facilitate their growth and we're trying to be as value add as we possibly can be, but at the same time, we know our position, we don't control the business. And so we are there just to be a low maintenance partner.

And I think that's quite valuable because things that we can offer up are ways to grow with them as they grow, or to be a little bit more flexible so they can actually generate the growth and the value that they're trying to achieve. So that's generally our standing when we think about our partnerships with the various bars that we have out there. And then in terms of examples, I'll give you one that I thought was very interesting. There's a residential solar company that really kickstarted after Katrina, the hurricane. And they built up a great business in a concentrated way in New Orleans, and they've gone and grown from there. And their model is really around building out the residential community and especially around the low-to-moderate incomes and entering into these long-term contracts. So you get the cash flows that are contracted in nature, and we just continue to support the business. So as they've grown, we've given them more capital over time, and that's been a great partnership as they've really made in ways into a market that is really underserved.

Stewart: That's really interesting. And Eric, so if we talk about portfolio construction and how insurance companies are using infrastructure, and I think that you'd agree with me that right now, it's a lot about the structure of the investment or the vehicle itself as well as the asset class. So how can insurers gain access to the asset class, and are there capital-efficient ways to do that?

Eric: Look, infrastructure debt I think is still a growing asset class for investors, but one that we've seen a lot of growth over the past five to seven years. And so people are getting more familiar with the underlying characteristics, people are getting more familiar with how to allocate investments within their own book. And they're also realizing that, look, it's difficult to get exposure to infrastructure debt in the public markets. There's not too many opportunities. When you look at opportunities on the private side, historically, that's largely been investment grade opportunities. And so with the drive to find higher yield, we are seeing more investment products targeting institutional investors that provide exposure to high yield infrastructure debt.

Investors, they like the duration that infrastructure debt provides, matching their liabilities, as we talked about the underlying asset characteristics, they like the resilient countercyclical nature with low correlation to public markets. And so they've been looking to find how to allocate more to private infrastructure debt, particularly higher yielding strategies. And one product that has been successful is through rated note structures for investors to make the investment more capital efficient than it may have been historically.

Hadley: And actually I have to give the insurance community a lot of credit for this asset class building up. I mean, when we started this business nine years ago, there weren't many players out there, and the asset class, very little was known about it. But the insurance companies actually had pretty good experience doing a few direct deals. Even some of them have a large group that can focus on direct deals. So they were pretty well versed in the asset class and became big backers of it as it's grown into more fulsome mainstream asset class, broadly speaking.

Stewart: And so Hadley, when we think about, there's been a fair amount of focus on regulatory changes that have been coming up and we've done a number of webinars and so forth and trying to keep our community informed as to where regulators are headed. Have any of these recent regulatory changes affected the infrastructure debt market? And has it created any adjustments that you've made to your strategies?

Hadley: Generally, regulation has created opportunity for us. When we take a step back and think about starting up this strategy nine years ago, that was on the backs of the credit crisis and the regulations that came in and impacted the banks, the leverage lending guidelines, etc. And so from there, you saw where equity was having to fill a void, and you really could not get the same kind of leverage you could prior to the credit crisis, hence why mezzanine debt developed eventually within the infrastructure platform. And now if you fast-forward, we've seen additional regulations being put in place and just market disruption.

So the regional banks is a good example of that. And that did create a pullback more broadly because of the impact of potential regulation and regulations coming through, as well as what we've been seeing on the real estate side. Because data centers, as an example, would be an asset class that could look at finding capital from the real estate market. And when things shut down, especially in 2023, you saw a pivot towards the infrastructure market and an opportunity set for us from that perspective. So generally, we find when the regulation has come in, it's been advantageous for our business because there's more scarcity of capital allowing us to deploy.

Stewart: That's super helpful. And Eric, I mean, you know this market and there's nobody in my mind that's gotten more skin in the game on climate change than the insurance industry, but at the same time, those folks are held to a prudent expert standard, meaning that they need to be able to get competitive rates of return on capital that they're deploying. And so can you talk a little bit about how Brookfield aligns its infrastructure investments with sustainability development goals and examples of projects that contribute to environmental sustainability while still offering competitive rates of return?

Eric: Yeah, look, ESG and sustainability is part of our DNA here at Brookfield. We're one of the largest owner-operators of renewable assets in the world, and that holds true in our debt investing strategy as well. It probably counts for close to a third of our investments to date and a big chunk of our pipeline. And when we're looking to make these investments, we're not looking to do so by discounting our returns. We're looking to maintain our return targets when providing financing in that space.

One example in particular is one that Hadley actually mentioned earlier because it touches upon a lot of the ESG attributes, it's a company that provides residential solar in a previously underserved LMI customer base. And so it's providing the customers the opportunity to source renewable green power at their house at a discount to local utility rates. So the value proposition is huge from an environmental standpoint. It's huge from a serving underserved customers and providing value proposition, and it's an attractive investment opportunity as well, and one that meets our target return thresholds.

Hadley: I mean, probably one of the interesting things that is worth noting is that the foundation of our investing in renewables and transition is the fact that renewables is the cheapest source of power out there. So it's actually a very good investment thesis from that perspective. On the dispatch curve, they're going to get dispatched. And so from that perspective, we do like the asset class a lot for the attributes that it can bring to the downside protection in our deals.

Eric: And Hadley, building upon that, when you talked about the three Ds earlier and decarbonization, you mentioned net-zero targets, and they're not just governmental targets. Right now, most of the investment opportunity that we're seeing in the renewable and decarbonization space is actually being driven by private sector investment, right? Customers continue to demand net-zero solutions from the corporates that they're looking to buy products from, and the corporations are hearing that, they're taking that into account, and they all have their own net-zero targets that more often than not actually exceed and outpace the government regulations. And so most of our investments that we're seeing and that we're providing financing for are private sector driven.

Stewart: That's super helpful. So Hadley, what are some of the most significant changes you're facing today in the infrastructure debt market and how are you innovating to overcome them?

Hadley: Obviously just the amount of capital that's going to need to come in at some point, and that's a longer term challenge that the industry is going to have to overcome. But when we think about some of the other things that we grapple with, they're minor in the grand scheme of your podcast, making sure we have the appropriate step-in rights when we're subordinated debt. So structural features around that, making sure that the industry risk. So as example, a spike in inflation like we saw during COVID, supply chain issues, labor issues, things like that that were well protected, because Eric outlined the definition of infrastructure. So you should be insulated, but you can only be so insulated from macro dynamics.

So making sure that we're well-prepared and have the right amount of cushion. And really what we mean by that is the equity cushion that's behind us can absorb those types of risks in any meaningful way, so that our structures are well protected from that standpoint. So those are the types of challenges that we make sure that we're well protected against and that, as credit people, we do worry a lot. So we can find reasons to, but that does alleviate some of it.

Stewart: And you mentioned the term step-in rights, and I'm not familiar with what that means. So can you unpack what that... I just think about people who listened sometimes that aren't necessarily steeped in the T, and it sounds like, I think I know what it means, but if you could help me.

Hadley: Sure. I think it's something that's underrated, undervalued, but it is binary risk. So in the structures where you're subordinated debt, and we usually structure our deals at the old co-level, we need to make sure that we can step in and fix the problem. Our investors invest with us because we are an owner and operator of these assets, we have strong asset knowledge. But if we have to just stand still and wait for things to work out on their own or maybe by someone else, then that eliminates the value that we can bring on the asset management side if we ever had to step in.

And so it means that, structurally, that we can do that, and that our debt would trigger in a way, a covenant trigger, before any other debt in the system. And so that's critical because the only other avenue you have is you can just buy off all the senior debt, and these structures, I think you're well versed to appreciate that generally, the largest piece of the capital structures is the senior piece, the investor grade piece. So that's a lot of money that you'd have to come out pocket.

Stewart: Makes total sense. So I've gotten a great education in the asset class and I've got some kind of a little bit of a shift here on some career stuff, and I'll go with you, Eric. What advice would you give to young professionals who are aspiring to work in infrastructure, finance and investment? And I'll take you back to a time when a little earlier in your career when you were a newbie at a big place like a Brookfield, and I'm sure you've had days, I know I have, where you weren't exactly sure what you were doing and you're eager to learn, but not sure where to look. And what advice would you give folks who are new to the space?

Hadley: And maybe old to the space as well.

Eric: Exactly. Yeah, I like to think that I wasn't in that position too long ago, but the team reminds me frequently that it was a long time ago. Look, if I were to find myself in that position, one of the things when I see people who have been successful, it's really seeking out mentors. It's making sure you are actively expanding your network, talking to as many people as you can, even if it's not an immediate opportunity, for informational purposes, to learn more, for more people out there to be able to speak on your behalf when they're talking with colleagues and peers in the industry. And then when there is someone out there who is open to being a mentor, really taking advantage of that. I mean, people want to help and they want to see other people succeed. I think we sometimes don't fully appreciate that, but I've benefited from having multiple mentors over my career, and without them, I think it would be much more challenging.

So I'd really encourage people to expand their network, seek out mentors, and then finally be open to opportunities. A lot of people think that there's necessary steps that need to be taken in order to get to the position they want to be. And sometimes, becoming narrowly focused on that leads them to pass up other opportunities that are presented to them that could lead them on a new and exciting path. I mean, I'm sure if we talk to Hadley, I don't know if she looks back if she would think that she's now the CFO of BAM.

Hadley: Yeah, no, I still think I'm the junior person in the room.

Stewart: I would just add, I'm a big fan of thank you notes, and when you're earlier in your career and someone takes the time to mentor you or offer advice or whatever, I think it's always a nice touch to say thank you, because that's how we all learn. Hadley, you've had an extensive background in finance and infrastructure. Were there some pivotal moments in your career that influenced your current role at Brookfield?

Hadley: I would actually say there was a deal I worked on back in the day. It is Transelec. It was a portfolio company of Brookfield. It's a transmission company in Chile. We don't own it anymore. But what's interesting about that deal is how influential it was to my career, because I worked on that deal when Brookfield was in the position of acquiring it. And I was a young VP and I worked hard and I got noticed by Brookfield, which got my boss, at the time, to notice me even further and led to me joining Goldman, and then actually eventually Brookfield. So I credit that deal and my performance on that deal, luckily, I didn't slack off, in giving me doors that opened to institutions I really enjoyed working at.

Stewart: That's really helpful. I mean, I just think that it's interesting over time how there's moments in your career and moments throughout your life that are pivotal and they change things. I mean, I remember distinctly when I accepted a job as a full-time finance prof, and I was like, "This is going to change things." And it really did, and the decision to come back into industry. But it's interesting how you remember those moments and how important they are. So I've got a fun one for the two of you out the door, if you'll engage me in it, which is we've got a lunch with the two of you, and you can each invite one guest for a total of four. So if you could have lunch with anyone, alive or dead, who would it be? Eric, I'll start with you.

Hadley: Eric's going to have a really interesting answer. I'm sure of it.

Eric: I'll kick it off. I don't know how interesting it is, how you might be able to even guess, but I would probably say Teddy Roosevelt.

Stewart: Wow.

Eric: I feel like that would be a fun lunch. I mean, he is the man in the arena, and I think the stories that we would leave with from that lunch and the folksy quotes that we could apply to our life going forward would be quite memorable.

Stewart: You are not the first person to mention Teddy Roosevelt, and I think that I can completely see that. And I love the man in the arena, and I don't mean to make it gendered, it's the person in the arena as opposed to the critic on the sidelines. I really appreciate that, particularly as an entrepreneur. And Hadley, how about you?

Hadley: I would pick Katharine Graham, and I think she could hold with Teddy given her political background, because I read her biography and she was incredibly famous for her connections, her parties in Washington DC on behalf of her husband, where she got both sides of the aisle and anyone and everyone to have a dinner that would be memorable in everyone's eyes. And then to turn around upon the death of her husband and take over the Washington Post and run it in a very critical period of time, including Watergate. And so she was instrumental in that. So having to learn the business and being taught by Warren Buffett how to look at a financial statement, I mean, that must've been incredible. So I think she'd be fun.

Stewart: That would be a great lunch table. I really learned a lot today. I really appreciate you both being on. Thank you so much for taking the time. And thank you for the education as well.

Eric: Thank you Stewart.

Hadley: Thank you.

Stewart: We've been joined today by Hadley Peer Marshall, managing director, co-head of Infrastructure Debt and Structured Solutions Strategies, as well as CFO at Brookfield Asset Management, and Eric Wittleder, managing director of Infrastructure at Brookfield Asset Management. Thanks for being on. Thanks for listening. If you have ideas for a podcast, please shoot me a note at Stewart@InsuranceAUM.com. Please rate us, like us and review us on Apple Podcast, Spotify, Google Play, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast. We'll see you next time.