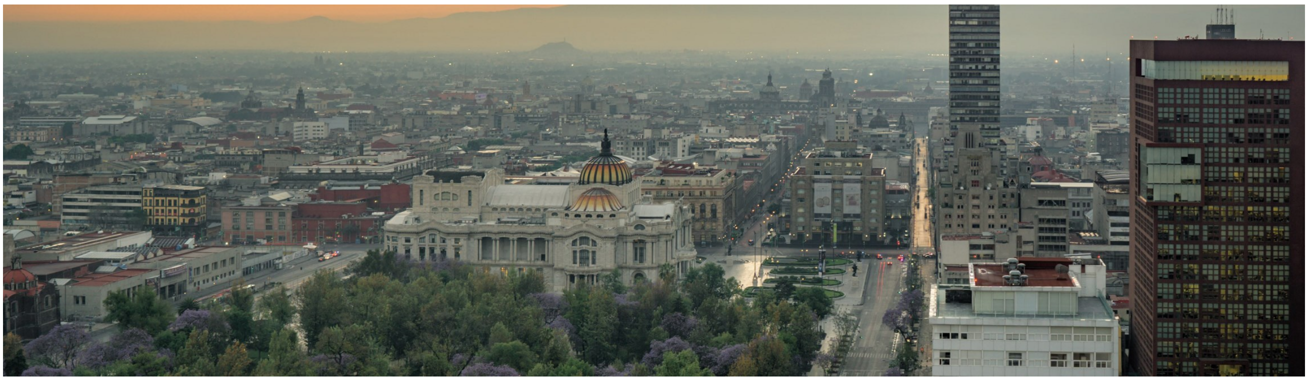
Selectivity may pay off in Latin American infrastructure debt

by Paul David | 07/12/2018



Summary

Infrastructure-debt investments in Latin America are often considered to be risky – and, as a result, more suitable for a portfolio's "core plus" fixed-income allocation. But carefully choosing countries and projects can turn this asset class into a core holding with attractive yield potential and a solid risk profile.

Key takeaways

- Investors are increasingly looking to infrastructure investments as a way to balance their portfolios – and actively selecting among Latin American infrastructure-debt projects can be particularly attractive
- Focusing on essential infrastructure projects in investment-grade countries may help minimise the market, currency and political risk associated with this asset class
- With careful portfolio construction, Latin American infrastructure debt can sit within a traditional core allocation even as it offers enhanced return potential

Many investors consider investments in Latin America as relatively risky parts of their "core plus" allocations – the traditional home for investments with higher risk profiles. That would be understandable for countries such as Argentina, whose sovereign debt is rated B plus, or Brazil, with its BB minus credit rating.

However, we believe that tarring an entire region with the same brush isn't the right approach – particularly when it comes to infrastructure-debt investments. Actively selecting among projects and countries in Latin America may provide enhanced return potential at levels of risk that are comparable to similarly rated US issues – which can help Latin American infrastructure investments fit within a portfolio's core allocation.

Being selective can help reduce a range of risks

The first step to mitigating risk in this asset class involves focusing exclusively on the six countries in the region that have investment-grade credit ratings: Mexico, Chile, Peru, Colombia, Uruguay and Panama. These countries have all demonstrated strong track records for developing their infrastructure with foreign capital. And crucially, they all also will require significant inflows of foreign investment in the coming years.

Latin America's investment-grade countries have a BBB+ weighted average credit rating

	Mexico	Peru	Chile	Colombia	Uruguay	Panama	Weighted average/ total
Credit rating	BBB+	BBB+	A+	BBB	BBB	BBB	**BBB+**
2017 GDP growth	2.00%	2.50%	1.50%	1.80%	2.70%	5.40%	**2.10%**
Population (millions)	127	31.9	18	48.2	3.4	4	**232**
Infrastructure index	4.3	3.8	4.8	3.8	4.7	4.9	**4.3**

Sources: Credit rating based on average long-term foreign currency ratings provided by S&P, Moody's or Fitch, where available. Ratings are adjusted to the Standard & Poor's rating tiers shown above. GDP growth from Bloomberg Economic Forecast Function, as at 29/11/2018. Infrastructure index from The Global Competitiveness Index 2017-2018 (World Economic Forum) as at 29/11/2018; scale is from 1 (worst) to 7 (best). Weighted average calculation is based on infrastructure-debt activity over the last five years, as at 31/12/2017. The above chart is illustrative in nature and should not be considered a recommendation to purchase or sell a specific security, strategy or investment product.

Risk in this region can be further mitigated by selecting a mix of infrastructure-debt investments across various sectors – particularly in critical areas that have what we believe to be minimal market risk, such as electricity distribution and transmission; water pipelines and desalination systems; renewable energy; and established transportation projects such as airports and toll roads. Moreover, focusing a greater share of investment on the large economies of Mexico, Chile and Peru – with smaller allocations to Colombia, Uruguay and Panama – could help manage market risk even more.

Careful selection may be able to help mitigate other types of risk as well:

- The currency risk associated with this asset class can be managed particularly for US investors. Many projects – especially in the energy and power sectors – have US dollar cash flows and prefer to borrow in dollars. The same doesn't apply across all sectors, however, underscoring the need for careful asset selection.
- Political risk can be managed by investing in the highest-profile infrastructure projects – such as regulated companies and projects – where the winning bids are chosen through an open-procurement process.

Improved yield potential and favourable ESG profiles

Infrastructure-debt assets in Latin America also offer a host of other potential benefits:

- They typically have credit ratings close to the sovereign-debt credit ratings in their relevant countries, but with a pick-up in spread. For example, Mexico and Peru have sovereign credit ratings of BBB plus and Chile is rated A plus – and infrastructure deals in those three countries are typically close behind, with ratings of BBB or BBB minus.
- They currently offer long-term yields that we believe can persist through the economic cycle. While every infrastructure-debt deal is unique, our analysis shows that infrastructure debt in Latin America offers about 100 basis points of additional yield potential compared with similarly rated US public corporate debt.
- Since a significant proportion of the investment opportunities in this area are in renewables (such as hydro, wind and solar power) or in lower-carbon natural gas, this asset class can also be attractive from an environmental, social and governance (ESG) perspective.

Latin American infrastructure debt can be a core holding

For years, investors have increasingly looked to infrastructure investments as a way to balance their portfolios. In fact, the total amount of infrastructure assets under management has more than quadrupled in the last decade, according to Preqin.

Of course, infrastructure investing is not without its risks, but we believe being active and selective in this space may provide attractive return potential. By focusing on essential infrastructure projects in strategic countries in Latin America, investors can help ease some of the concerns that are associated with investments in the region – including market, currency and political risk. This can help Latin American infrastructure debt sit within a traditional core allocation even as it offers significantly enhanced return potential.

About the author/s

Paul David
Director, Portfolio Manager, Head of Americas, Infrastructure Debt

Mr. David is a portfolio manager, a director and Head of Americas, Infrastructure Debt, with Allianz Global Investors, which he joined in 2012. As one of the original members of the firm's Infrastructure Debt team, which began in 2012, he is responsible for leading its development and activities in the Americas, as well as building its presence in the US.

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