



**CLEAR PATH ANALYSIS**

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Determining strategies and accessing alternative  
assets in a highly competitive market

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# Now that the banks have retrenched, what growth are we seeing in private debt and infrastructure and real assets, and how can we expect funds to perform?

## Interviewer



**Zoi Fletcher,**  
Content Producer,  
Clear Path Analysis

## Interviewee



**Denis Prouteau,**  
CIO of Private Debt &  
Real Assets, Ostrum  
Asset Management

## SUMMARY

- *The three main sectors of real asset private debt; commercial real estate, aircraft and infrastructure are seen not only as liability matching products but also cashflow generating products and this is part of the motivation for investing in them*
- *There has been a continuous trend into real asset private debt market, whatever the maturity level of investors*
- *These are very low risk asset classes and these products are structured to survive or to go through several credit cycles*
- *The vast majority of transactions within the European infrastructure market are now fixed rate, banks are working more efficiently with investors*

### **Zoi Fletcher: Can you explain Ostrum Asset Management's offering on real asset private debt?**

**Denis Prouteau:** Ostrum started to be active in real asset private debt in 2012 and is now present in the three main sectors of this asset class; commercial real estate, aircraft and infrastructure.

Our offering is twofold: we have off-the-shelf products which are commingled funds in the three sectors I mentioned. They are Luxembourg based funds €-denominated for infrastructure and real estate and in US dollars for the aircraft sector. We also have a tailor-made solution, which allow us to provide ad hoc mandates through single investor funds or on balance sheet solutions in any of these asset classes or combination thereof.

We have a team of 13 portfolio managers based in Europe, Hong Kong and New York and we currently have 1.2 billion euros of assets under management. We have high ambitions as our target is to reach 6 billion AUMs by 2020.

The reason why we have such ambitious targets is because Ostrum is a major fixed income manager with the ambition of being an A-Z debt asset manager for our clients. And private debt obviously falls within this spectrum.

Moreover, Ostrum's specificity is its very strong proximity to insurance companies, which are one of the biggest investors in these asset classes. So, in working with insurance companies, it made complete sense to widen our product offering to real asset private debt.

### **Zoi: Who are real assets appealing to?**

**Denis:** Initially, we felt that given the slightly longer durations and the credit worthiness of these assets that they would be mostly appealing to institutional investors who were trying to match long dated liabilities – typically insurance companies and pension funds and some sovereign wealth funds.

Whilst this has been the case and still is, over the last few years we have seen other investors looking at these asset classes not only for matching liabilities but also considering these assets as cash flow generating products. Through the amortizing nature of these assets, specifically infrastructure and aircraft, these assets give back to the investors not only a coupon and interest rates but also part of the principle that they lend. These products are seen not only as liability matching products but also cashflow generating products and this is part of the motivation for investing in them.

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**Zoi: What do you recommend to investors who want to access these assets that don't closely match their risk profile and liabilities?**

**Denis:** Firstly, you need to go through something that many investors have done, which is effectively an asset allocation exercise. This is looking at the asset and liability profiles and how integrating real assets would improve the risk return profile of the portfolio. You need to go through this exercise in order to determine the proper level of duration, acceptance of risk, and currency risk to determine what asset class would make sense. For instance, if you have euro only liability, considering aircraft debt – which is US dollar denominated – would be more complicated than looking at euro denominated infrastructure or real estate.

Investors go through this asset allocation exercise and then they move to the investment phase into the asset class. This requires specific skills (that sometimes institutional investors have internalized) or investing with external fund managers. Regardless of whether you are new to the asset class or have been a long-time investor, there are a breadth of investments that can be considered within this asset class. Therefore, there are always pockets or areas that investors won't have knowledge in or will be underweight in that could be considered.

In the real asset private debt market, whatever the maturity level of investors, there is always a reason to look at it and continue to do so, so there is a bit of a continuous movement into this asset class. This is constantly shown by Preqin quarterly polls showing an ever-lasting intention to add further investments into these asset-classes.

**Zoi: What growth are you seeing in real assets, infrastructure and private debt?**

**Denis:** To address your question we need to look at each sector separately.

On European real estate, the market accounts for roughly €150 billion of yearly debt production shown to investors. You can consider this market as fairly mature. The way forward may be in importing into Europe what we have seen in the US for the last few years, which is a segmentation of the debt structure between senior products and junior tranches. As an asset manager, this segmentation would allow us to provide investors with different categories of risk profiles within our investment products. In a nutshell, I therefore don't expect the European real estate market to increase in total size per se, but in segmentation it will probably move to something similar to the US.

On infrastructure debt, if you look at it from a global perspective, which is what the majority of investors do, there is a USD 250-billion production of financing need every year and the way forward here is very much to do with regionalisation, both in terms of countries and currencies to invest into. Effectively, there are pockets of investment needs which have emerged and are now going to grow, particularly in the Asia Pacific region. So, this is why we support this trend and we have just set up a dedicated team who look at APAC infrastructure investments from our Hong Kong office.

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Aircraft is another area where the market is global, although it is far less mature than the others because it is still very much in the hands of banks. Yet the product is appealing as on top of diversification, aircraft debt also benefits from strong creditworthiness thanks to high historical recovery rate. In this market, although investors may not yet hold aircraft debt portfolios, at least within private debt, they are starting to consider it. And it will probably become the fastest growing asset class in terms of market penetration with investors but from a very low starting base.

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**Zoi: Given the economic and market cycle that we are coming into, how are projections for returns going forward for these asset classes?**

**Denis:** Effectively there seem to be more and more investors who are looking at these markets because these are very low risk asset classes and these products, given that they are pledged to real assets, are supposed to be much less exposed to credit or economic cycles. They are structured to survive or to go through several credit cycles.

In terms of whether we are worried about the expected returns in a downturn cycle, so long as we continue to apply the same stringent selection criteria that we have always done, then there is no reason to be less or more worried about the asset class. The only element we consider for the credit cycle is overvaluation. For instance, for real estate in Europe, the next generation of funds are probably going to set lower loan to value criteria in their guidelines in order to take into account the fact that asset prices have actually increased in the last few years. This is how we integrate the credit cycle. It is the same selection process, but we would lower the loan to value in our portfolio so that we can take a downturn in the valuation of the assets themselves.

With regards to the impact on yields in these assets, given the loan nature and the fact that they are illiquid products, the volatility of these assets is very low. Investors actually like the low volatility feature of real asset private debt; again, these products are meant to produce cash flow, not generate capital gains. That being said, an unusual consequence of the credit cycles is that when all debt products, be they liquid or illiquid, were in high demand, the only way to have access to this market was through the primary market. With a little bit of downturn in the credit cycle in general, we now notice, on top of primary deals, where pricing is sometimes slightly affected by wider liquid credit spreads, that some secondary offers are coming to the market, mostly from banks. The reason for this has nothing to do with the asset class but something more to do with the capacity of the banks to refinance themselves on capital markets. As their visibility and conditions for refinancing worsen because of the credit cycle downturn, some banks are effectively lightening up their portfolios, starting with the jewels of the crown i.e. the best assets in their books that can be easily sold, which are the real assets private debt products. This example shows how the credit market downturn affects the real asset debt markets. This is good news for investors because it provides us with more investing opportunities, away from pure primary transactions.

In a nutshell, whilst we don't expect much of an impact on real asset private debt yields, the downturn in credit cycles means we will have more choice and will be able to effectively be choosier.

**Zoi: On the private debt side, will funds be able to run as effectively when we are on a down cycle and there's a more challenging environment with more write-offs and defaults, restructurings?**

**Denis:** It remains to be seen as to whether there are more write-offs and defaults, as we haven't seen this within our own portfolios.

These products are structured to resist these credit cycles. Investors invest in them for the right reason i.e. very long investments. It is clear from the start that these investments are held-to-maturity investments and so investors do not expect any liquidity provided by the asset managers or the market itself. This means that you avoid what you see on public markets, which is the high volatility that is sometimes triggered by forced sales or everyone moving the same way at the same time. This kind of effect does not occur with real asset private debt. And more importantly, we are confident about the creditworthiness of these assets in general because they are structured and secured properly.

When you invest in a 25-year final infrastructure, you know from the start that over the span of 25 years you will go through several credit cycles. So, the structuring of the assets and the access to the security package are going to be the way to secure your investment.

**Zoi: The biggest challenge in infrastructure is finding the deals since there is a lot of money including from banks, is this set to change?**

**Denis:** In general banks have understood that given the duration of these assets, a bank's balance sheet is not meant to be used to hold a 25-year asset. Banks have made a lot of progress working together with investors and listening to them to structure deals so that they aren't kept on the bank's balance sheet but on an asset manager's investment vehicle for the benefit of an insurance company or a pension fund.

One striking element is that 10 years ago, there were hardly any European transactions that were fixed rate transactions, because most of these assets were floating rates. This was the way banks were holding these assets on their balance sheets. For banks financing themselves in floating rate currencies, it simply made sense to hold floating rate assets. Now, banks are structuring more transactions on a fixed rate, which proves that they are not meant to be kept on the bank's balance sheet. And now around 70-75% of transactions, in terms of volume, within the European infrastructure market are now fixed rate. This demonstrates how much the market has transitioned from the banking monopoly into a chain which is efficiently working between banks and investors such as ourselves.

**Zoi: Thank you for sharing your thoughts on this topic.**



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