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Infrastructure: predictable yield or secular opportunity?

What to do in a negative-yield world? Declan O'Brien, Head of Infrastructure Research and Strategy and Perry Offutt, Head of Infrastructure Americas, give a deep-dive into the evolving and emerging infrastructure sector and the role it can play in investors' portfolios.

Declan O'Brien, Head of Infrastructure Research & Strategy

When investors think about infrastructure they often think about large, monopolistic often somewhat boring assets, but actually as the sector has matured it has evolved and it is well placed to capitalize on many of the most important secular trends in the economy.

When we think about infrastructure, what are we talking about? Really it is essential assets and services for the functioning of a modern economy. These assets produce stable cash flows and are less correlated with the economic cycle.

What we're trying to achieve from an investment outcome is a premium over listed markets - the so-called illiquidity premium - so for debt it is over public fixed income and for equities over listed equities.

We are looking also for low correlation against those same benchmarks, and finally, inflation protection. A lot of infrastructure assets do have inflation protection, and some of them don't and we will touch on that a little bit later.

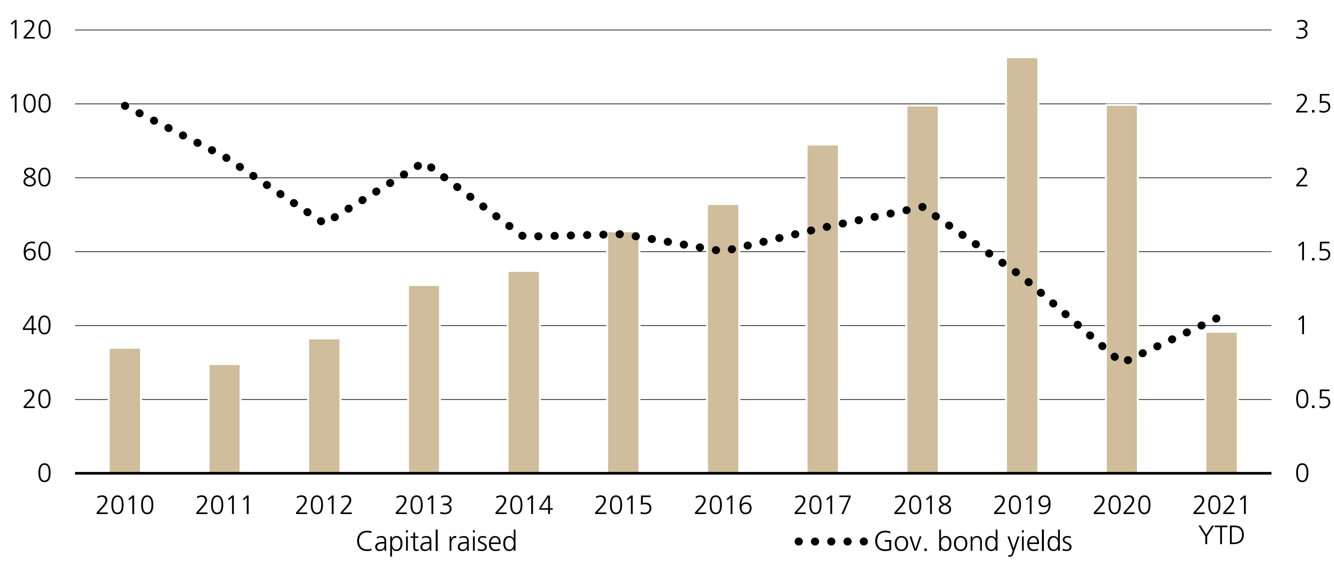
Finally, I think very relevant to this topic in terms of the broader array of sectors, it's a combination of the traditional assets that you might recognize as infrastructure, e.g., toll roads, airports, utilities and bridges, but it's also some of these more secular trends as we discussed around energy transition, digital infrastructure, and also demographic change.

When we look at the growth of the infrastructure sector you can see really strong growth over the past decade. Even in 2020 we saw really strong fundraising, the main reason for that is the strong performance of the asset class.

Since the Great Financial Crisis, the asset class has returned between 10% to 12% growth, which is obviously very strong performance. It showed itself to be very resilient to the credit crisis and, more recently during the COVID-19 pandemic, relative to other alternative asset classes like real estate and private equity.

Capital raising in the infrastructure sector

(LHS-USD billion, RHS-bond yield(%)) 2010-2021 YTD



Source: Preqin; Bloomberg May 2021
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That has given institutional investors some confidence as they become more and more familiar with the asset class. Saying that, allocations are still very low to infrastructure, around 1.1% to 3% of allocations for large pension and insurance companies.

Compare that to closer to 10% for real estate allocations, then there is still some runway for the infrastructure asset class.

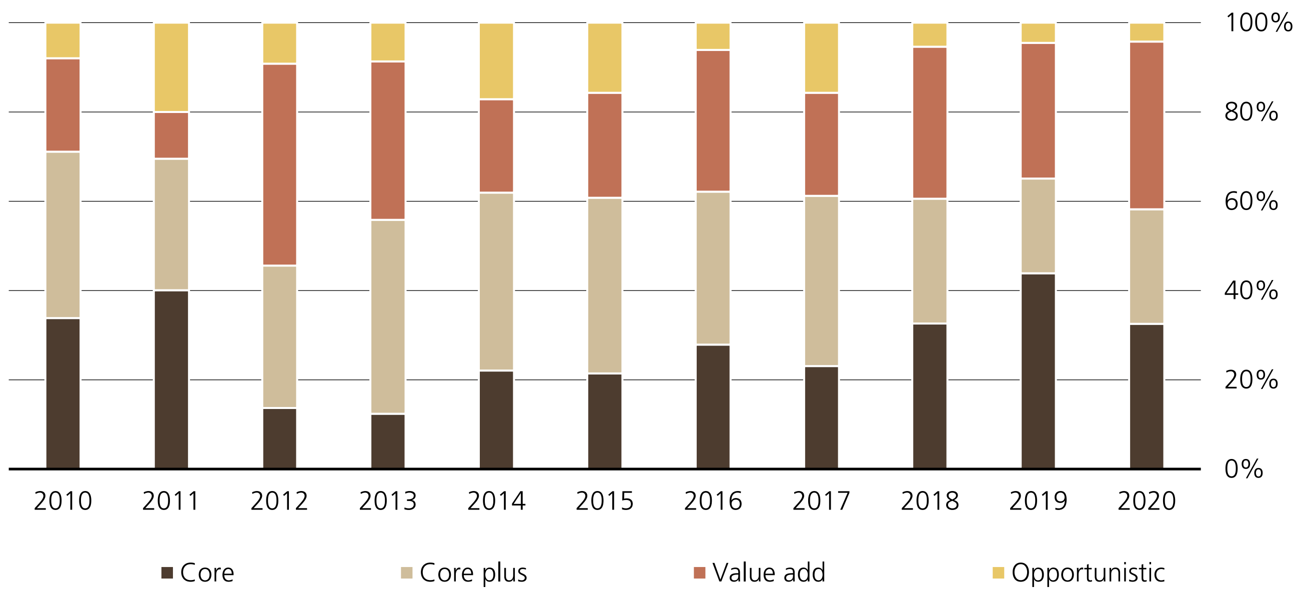
Part of the reason for this very strong performance in growth has been falling real rates. This has been true across private markets but probably more so for infrastructure because it is a levered asset class and, as a result, if rates are falling you can refinance and really boost performance, so that has been a strong point.

Bond rates have started to pick up due to concerns around rising inflation. I think if this persists we could see an impact on the attractiveness of certain infrastructure asset classes & sectors that do not have a linkage to inflation.

As inflows have grown there's also been a bifurcation in the market. Core and value-add strategies are making up an increased share of the total market, and I think this is partly to reflect some of those more secular trends that I mentioned already. It's also partly because GPs are taking on more risk to match the very strong performance achieved in some prior vintages.

Changing investment styles in infrastructure

(Share of investment styles as a % of industry), 2010-2020



Source: Preqin; Bloomberg May 2021
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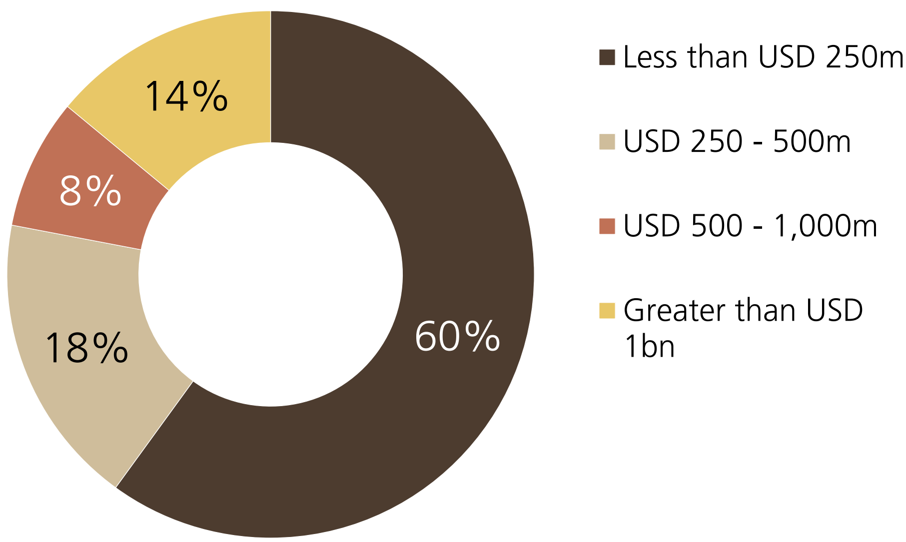
We're seeing growth in the so-called 'megafund' which is really funds, particularly closed-ended funds, of more than USD 3 billion. Actually the average size of infrastructure funds has more than doubled over the past 10 years.

What's interesting about that trend is that is creates dislocation in the market. The majority of deal flow is actually for transactions of less than USD 250 million, whereas the bulk of the funds being raised have been for funds greater than USD 2 billion.

So that clearly creates a disconnect. If you have a USD 5 billion fund, you can't afford to do tickets of less than USD 250 million and deploy in an efficient and timely manner.

Transaction & enterprise value (USD)

% transaction count split by size, August 2014-August 2019



Source: UBS Asset Management, Real Estate & Private Markets (REPM); Preqin, Average size August 2014 to August 2019

That really creates an opportunity I think for mid-market funds and, anecdotally, we are seeing more of the mega funds looking at specialized mid-market offerings.

I think that reflects the competition for those larger assets and the fact that there are less of them. And this probably also contributes to more take-privates as well in the sector, which has been a growing trend.

Finally, looking at the future outlook it is quite an exciting time for infrastructure as it is exposed to a lot of the important secular trends.

The three most important for infrastructure are probably what we call the 3Ds: decarbonization, digitalization, and demographic changes.

Starting with decarbonization, there are clearly very positive tailwinds: 60% of countries globally have signed up to some sort of a net zero target, 20% of the largest 2,000 corporates globally have also signed up, and asset managers and investors accounting for USD 37 trillion of assets under management also have net zero pledges.

We are also seeing falling costs in renewable energy transition technologies and the so-called 'experience curve.' We saw that in renewables, specifically with solar, we are seeing it for battery storage, and now finally we're seeing it also for electrolyzers, where we talk about green hydrogen and power-to-X.

The idea of building back green post-pandemic is also a theme that we're following very closely. Looking at the EU Green Deal and the US Green Deal and everything really having a green tinge to it.

Finally, we see more demand from end consumers for sustainable products and we are also seeing the regulators starting to interfere in markets and promote sustainability, like in Europe with The Sustainable Finance Disclosure Regulation (SFDR).

And when you look at all of this, this is a core part of the infrastructure market with around 50% of transactions over the past decade being in the energy and energy transition space.

And it hasn’t been just renewables, we're starting to move to distributed renewables, storage, bioenergy, green hydrogen, circular economy and that's all part of the market that infrastructure investors are looking at.

Digitalization trends are fairly obvious in terms of the growth of data and the internet of things, and it is another secular trend that has being accelerated by the pandemic. Clearly the increased requirements to work from home create the need for a more distributed fiber network.

We're seeing also more cloud software which needs more data centers close to end users in order for the speed of those applications to work effectively.

Infrastructure investors have been really active, particularly in fibre-to-the-home but also in datacenters. There has been a recycling of assets from telecommunications companies who are trying to free up capital for 5G investments and infrastructure.

Finally, demographic change. Unfortunately, we are all getting older and as a society you look at the rich world where one in three people by 2050 will be pensioners, and one in 10 over 80.

That will clearly create a huge need for investment around retirement living, care homes, private hospitals, and also public-private partnerships.

Clearly, the pandemic highlights some deficiencies there as well, fiscal policies have been very much focused on health spending but, at the same time, government finances are stretched. We think this creates a real opportunity.

All of that makes it quite an exciting time for infrastructure. Combined with the fact that infrastructure broadly did what it said on the tin in the most recent pandemic and the one before it makes it quite attractive asset class.

When you look at building a portfolio you can have the traditional infrastructure that provides defensive stable cash flows and yield, but the ideal portfolio probably has to also take up some of those secular opportunities around those growth sectors as well.

Perry Offutt,
Head of Infrastructure Americas

Two of the '3Ds' are taking up a lot of our time: decarbonization, focused on renewables across wind, solar, and battery storage; and also digitalization, in terms of cell towers, fiber in general, then of course data centers. We have made investments in those areas and we continue to focus on new opportunities, especially across Europe and North America.

In order to achieve predictable returns as well as cash yield, infrastructure is very well positioned. However, one really needs to think about portfolio construction and creating diversification not only across a variety of industries but also across geographies to achieve the goal of predictability.

The pandemic clearly has benefited some areas of infrastructure but it has definitely challenged some others. While creating a diversified portfolio, we focus on relative value and add assets like transportation that are truly essential to the community, as well as unregulated utilities that also provide essential services when they offer attractive risk-returns.

Therefore, while we definitely focus on the two key macro themes that I just mentioned, adding in a variety of other infrastructure sectors can support the very predictable cash flow which obviously is important to our investors.

1 Inflation looks to be rising, how does this change the investment case for infrastructure?

Declan O'Brien (DB): Many infrastructure assets do benefit from inflation. The key driver for infrastructure valuations is interest rates.

The way I look at inflation is if it looks to be persisting and that results in higher rates, then that will have an impact on valuations for certain infrastructure assets.

The infrastructure assets that it will affect are those that don't have an explicit or implicit link to inflation, and maybe assets connected to secular themes around technology are less well protected.

On the flip side, for some of the assets that have a direct link, e.g. utilities, contracted renewables, power and utilities, as well as some transportation and social assets, I think valuations will increase if the main reason for that interest rate increase is solely inflation.

2 Valuations are at a peak, or near to a peak – how do you think about opportunities around valuations, and do some sectors offer better value than others?

Perry Offutt (PO): As base rates have declined around the world, valuations across all asset classes have generally gone up and infrastructure is not immune to that.

Having said that, there are opportunities within infrastructure where we do see value.

Note that it is difficult to assess overall values across the industry in aggregate because the mix has changed. Digitalization, for example, has become a larger percentage of total infrastructure investments, and those tend to trade at higher multiples, but also offer more growth potential.

The one area where we see the most value really has more to do with the size of the opportunities, specifically the small- to middle-size end of the market. There are lots of transactions of this size and there tends to be less capital that has been raised for that part of the market. As a result, there are less auctions and therefore valuations tend to be slightly more reasonable than they would be if you were focusing where everyone else is.

When we spend time talking to developers and companies that are looking for capital and are very interested in having long-term strategic capital, valuation is an important factor but not the only factor in that partnership.

In summary, we still see value in the market, however, not at the same valuations that we saw years ago as some of these areas have become more popular.

3 What have you been spending time on in some of those racier, more emerging segments?

PO: It's really important to focus on the future and do the research now.

If it is battery storage or hydrogen, or some of the areas mentioned earlier, it's important to focus on those now from a research perspective so that you understand the risks of each, but obviously not deploying capital until it fits the risk profile for an infrastructure investor.

We find that if you do the work too late and the idea becomes too mainstream, then the returns are substantially less and you missed the opportunity. So in my view, as it relates to the frontier markets, do all of your homework now to be prepared to move quickly when it becomes the right risk-return.

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