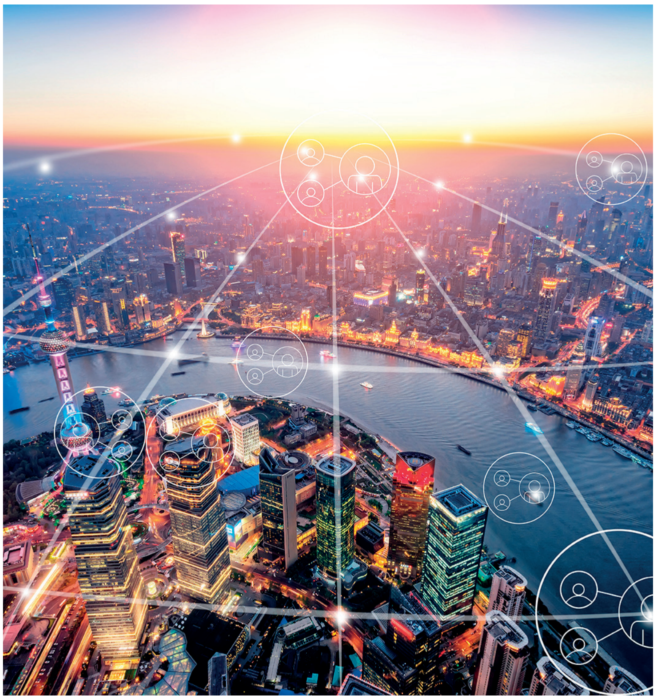
Sustaining strong performance in an evolving infrastructure landscape



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The outlook for infrastructure remains positive, and high-quality businesses should deliver sustained performance through the ups and downs of the economic cycle.

By *Andrew Morris*

As large investors' allocations to infrastructure have matured, they are thinking about how to complement their existing decisions for portfolio construction. Typically, they want more control over where capital is deployed by choosing the risk profile and specific markets, sectors, or even individual asset selection. For example, there has been a proliferation of single-asset continuation funds, where seed assets give investors the chance to appraise the assets in which they will invest. Large investors are looking for a more tailored approach through mandates where they can design and implement a bespoke investment strategy.

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Opportunities in an increasingly competitive market

Opportunities can be found in sectors that have strong tailwinds and strong regulatory and supportive legal regimes. Value can be created by deploying capex to expand or build new infrastructure. For example, new data centres and tower assets, expanding and densifying fibre networks, and new wind and solar power plants. Another strategy is to look for different entry points into an asset, an example being the re-powering of a wind farm portfolio by increasing its efficiency and thus extending its useful economic life. By staying in the mid-market space, where there is less competition and valuations appear to be more reasonable, one can support the growth and make a material difference to these SMEs.

The promise of digital infrastructure

The move to a full-fibre world will provide a long tailwind of growth opportunity. However, not all digital-infrastructure businesses will benefit equally, as different subsectors mature. There are common trends impacting future performance that investors should be thinking about.

First, can these businesses, over an extended period, increase prices to their customers? In the United Kingdom, we've seen double-digit increases to retail prices, which is not sustainable. While that might provide short-term benefits to investors, there may be longer-term negative effects as customers look to save money.

Second, with significant growth pipelines and capex planned, does cost inflation impact projected returns on growth investment? Investors take full capex-cost risk in many digital businesses, and the historically benign inflation and interest-rate environment have masked this underlying risk.

Finally, with all the projected build, there is risk of overcapacity and infrastructure competition leading to price erosion or lack of usage. There is evidence of these issues affecting digital businesses across different markets, a clear example being the challenges in the altnet sector (smaller, alternative broadband providers) in both the United Kingdom and Germany.

Addressing the energy transition

The clean energy landscape is evolving rapidly with unprecedented policy support (for instance, the US Inflation Reduction Act). Identifying the right entry point is a challenge though, and we recommend investors to look for opportunities that are economically competitive, provide market solutions and are not overly reliant on subsidies.

Strategies should therefore be research-led and dedicated research teams should continuously assess different clean-energy technologies and solutions such as hydrogen, renewable natural gas and carbon capture, utilisation, and storage (CCUS) to help identify which emerging business models will be sustainable and successful in the longer term.

Similarly, the decarbonisation of transport could be the next big opportunity in energy transition, as emissions from transport account for 23% of global emission and are still rising.

We are still at the very beginning of what needs to be done to decarbonize our economy and the sources of power and energy. There is a long way to go, and this sector will continue to present interesting opportunities for investors going forward.

Diluted inflation protection

Infrastructure's key premise is to provide long-term, stable returns with inflation protection. But as the definition of infrastructure has expanded, the direct inflation link in underlying businesses has - to some extent - been diluted. Investors are digging in to understand how inflation is affecting revenues, costs and capex.

In core infrastructure, assets typically have contractual revenue streams that allow investors to pass on inflation. But when inflation is high for a prolonged period, sensitivity is needed to the impact on customers and other key stakeholders, which is likely to mean some 'give and take' in any pricing decision.

In the core-plus market, businesses typically have more flexibility to set their own prices, but in a more competitive market with higher prices, the elasticity of demand consequences.

Inflation is well understood in the energy markets, and merchant exposure has benefited business during this period of higher inflation.

In digital, inflation is less understood, and the sector is going to be tested through a period of slower growth and higher inflation. It appears that certain types of digital businesses and markets are likely to provide better inflation protection.

Changed cost of capital environment

The rise in rates impacts investors' portfolios and has led to a slowdown in decision making. This has taken momentum out of the market. The fundraising environment is harder, and transactions are taking longer to close, as bid-ask spreads are emerging between buyers and sellers, indicating the cost of capital is resetting.

Infrastructure has benefited during the past low-rate decade as a yield-replacement strategy, and that dynamic has now flipped. Infrastructure still offers diversification benefits, but it is likely investors will start to expect higher returns from infrastructure. We've seen valuations reset in public markets, and relative-return institutional investors typically move first to adjust their cost of capital to changing economic fundamentals. In the meantime, the dry powder raised the past few years may support valuations as that capital gets deployed. The rising cost of debt, however, will reduce the leverage available and may put downward pressure on valuations. ■

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SUMMARY

Digital infrastructure will provide a long tailwind of growth opportunity.

The clean energy landscape is evolving rapidly and presents interesting opportunities.

The effects of inflation on infrastructure still aren't completely understood and vary by sector.

The rise in rates impacts investors' portfolios and has led to a harder fundraising environment and a longer lasting process for transactions to close, indicating the cost of capital is resetting.

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