How Covid could benefit infra

PANEL

MARK CHLADEK
Head of brownfield transactions, Infracapital

TANIA TSONEVA
Senior director – global infrastructure research, CBRE Investment Management

ANITA LYSE
Group sector head – real assets, Alter Domus

MODERATOR: Nick Fitzpatrick, group editor, Funds Europe

GOVERNMENT SPENDING AT A TIME OF ECONOMIC CRISIS, AS WELL AS THE HEIGHTENED SENSE OF 'GREEN' INVESTING, ARE BOTH DRIVERS FOR NON-LISTED INFRASTRUCTURE INVESTING. ANOTHER IS THE RETURN OF INFLATION.

Funds Europe – What are Europe's infrastructure needs, to what extent is there government support for infrastructure development, and how would infrastructure investment make our societies better?

Tania Tsoneva, CBRE Investment Management – We have relatively high-quality infrastructure in the UK as well as in Europe. However, infrastructure investment has diminished over time, probably due to sovereign balance sheets being under pressure. We went through the financial crisis, then the sovereign debt crisis, so we saw a declining trend and there is going to be a need for catch-up.

The drivers of infrastructure investments going forward are going to be decarbonisation and digitalisation. Europe is the role model when it comes to the energy transition and the greening of the power generation fleet. The UK has the National Infrastructure Plan until 2050, Europe has the

CONNECTIVITY – Laying fibre optics to households is a key infrastructure theme.

EU Recovery funds, the 'Fit-for-55' initiative, and the European Green Deal. From an investor's point of view, there are ambitious targets and a lot of plans, but we also see diminishing returns on capital in some of the sectors, especially in UK-regulated networks.

I expect to see the most investment in the power sector. In the UK, if you look at what National Grid has set for the next five years, about £8 billion (€9.3 billion) of investment, it's all going into the reinforcement of the grid to accommodate the accelerated growth of renewables and electrification of transport. But how do we attract so much private investment when regulators are reducing equity returns?

Mark Chladek, Infracapital – A few years ago, the European Investment Bank (EIB) identified that there is a requirement for €335 billion per annum to be invested in European infrastructure. Across all sectors, there is a massive demand for new investment. We are seeing this as an opportunity across the entire infrastructure spectrum including sustainability and security of energy supply, digital services and connectivity, cleaner transport and logistics solutions… it's a long list.

As an infrastructure investor, we have been very active investing in businesses where there is significant growth through new capital investment, for example smart meters, fibre to the home and electric vehicle charging infrastructure.

Anita Lyse, Alter Domus – When we speak with our clients and prospects, the theme that comes back again and again is anything with the word 'green' in it. People are increasingly investing in wind farms, solar, recycling – the environmental component of the new fund projects that our clients have is very much present.

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Tania Tsoneva, CBRE Investment Management

Then you have digitalisation, as well as data centres, which have become quite popular among both infrastructure and real estate investors – it's an asset class that sits well across both.

So, I really agree with the two themes that Tania brought up – the energy transition, so decarbonisation, and digitalisation, that's what we see from our clients. There are, of course, new funds being launched that invest in more traditional core infrastructure, but yes, green is very much a key word out there.

Funds Europe – What are some of the most interesting investment opportunities linked to the needs that you've mentioned already, and what is it that makes them so appealing?

Chladek – We've touched on connectivity and digital services. Infracapital has been an early-stage investor in several fibre businesses across Europe. Typically, we are identifying the opportunities where there is a need for private infrastructure investment to fund the fibre rollout. In some European countries the fibre rollout has been more advanced through accelerated programmes and the high fibre penetration has led to limited new opportunity. We have established platform businesses in the UK, Germany and Poland where we identified that there was a requirement for significant investment in the fibre rollout in rural areas.

Typically, to make the investment economically viable, rollout programmes receive government support to enable such private investment. This support can be through either direct contributions towards capital expenditure or sometimes voucher schemes, where the general public or companies are given vouchers by the government to subsidise the cost of their fibre installation.

With the impact of Covid, the lockdowns and the move to flexible working, this investment has been even more critical in those communities and demand has been significantly higher. This really is developing much-needed new infrastructure to provide essentially connectivity to these communities.

Lyse – Anything that touches renewable energy, whether it's wind, solar or others, is very much in fashion. We have also seen projects among some of our clients around other energy sources. For example, in the shipping industry, there appears to be a shift towards alternative fuel types such as methanol or green methanol, produced off biomass.

Everybody wants to go green and all that has been accelerated by the pandemic, where people have become a bit more conscious of these issues. We're just out of the COP26 in Glasgow. Some saw that as a failure, others as an okay-ish deal. Regardless, the clients that we have – fund managers and asset owners – want to have the green certifications or good ESG scores, because that's what their investors want to have. We see more capital being allocated to these low-carbon or decarbonised investment strategies.

Tsoneva – One thing on my mind is renewables: I think there is a lot more coming in offshore wind. What I particularly like in the UK is the 'contract for differences' mechanism – of course, everyone has their own view whether you get the right return, but what we've seen on the offshore wind side is quite spectacular in terms of its early adoption, as well as the pots of money that are available for new technologies, like floating windfarms, for instance. So, I'd emphasise that there are still interesting opportunities in the renewable sector.

Funds Europe – How does the current economic climate impact the outlook for infrastructure investing and for private assets in general? Are corporates in this sector particularly affected by the pandemic or by the macro backdrop of low interest rates?

Tsoneva – I think that the economic environment is supportive for infrastructure investing and overall for real assets. The economic rebound is relatively strong, many of the economies in Europe are reaching pre-pandemic size, and we expect that this growth will continue in 2022. Hopefully the spike in inflation is transitory, but even if it isn't, the hedge that infrastructure provides for high inflation is there. In a high inflationary environment, infrastructure is probably one of the obvious choices. The key risks that we monitor are monetary policy, that is when interest rates will start creeping up, and the supply-chain bottlenecks that we continue to see.

Chladek – We believe infrastructure investment is an attractive asset class as it resilient to the economic cycle and the current economic climate has supported this thesis. When considering infrastructure investments, we really focus on the essentiality of the underlying assets and the likely resilience of the businesses.

In infrastructure sectors where performance has been more correlated with GDP, we have seen some negative impact of Covid and the economic climate; however, overall we have been pleased with their resilience and subsequent recovery.

That said, across many infrastructure sectors we are invested in – such as sustainable energy generation and storage, utilities and fibre – the current economic climate has had limited impact and, given the critical nature of both existing assets and new investment, we believe the outlook is very good.

Lyse – What we hear from the market is that the outlook for infrastructure

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investment is strong due to the Covid-19 stimulus packages. Traditionally, infra is a way for governments to spend themselves out of a crisis, create jobs and help get the economy back on track. Even though this session has a European focus, we're all aware of the $1.2 trillion (€1.1 trillion) in the Biden package that will invest in a lot of different types of assets, including the energy transition and broadband that we've talked about.

I think it's true also for the other types of private assets that we see in general. Real estate, which struggled a bit through the pandemic, is coming back very strong now. Also, private debt and private equity are doing really well, so there are lots of opportunities out there for different types of managers, and infrastructure is certainly not an exception.

Chladek – A key attraction of infrastructure investment is it should provide a strong degree of inflation protection. In a higher inflationary environment, investors will look for their infrastructure investments to be resilient to this, whether through regulated returns, contractual arrangements where revenues are index-linked, or just a natural ability of these essential businesses to recover inflationary impacts through their pricing and revenues.

Tsoneva – Exactly. With most of the infrastructure assets, you have very high barriers to entry and even monopoly or monopolistic position. In regulated sectors the link with inflation is often explicit, and the same under many toll road concessions. But even if there is no explicit link, infrastructure companies should be able to recover inflation because of their market power.

Funds Europe – Survey after survey over the past two years has signalled the growing appetite and allocation to private assets from the institutional investment sector. Can the private-assets funds industry absorb these flows, and what are the operational challenges?

Lyse – That is a very good question. I've seen the same surveys as you have, and over the last few years and probably the decade, they show that investor target allocations are constantly above current allocations.

If you're an asset manager looking to raise funds, this makes things easier in theory. But then you have to deploy the committed capital and actually generate return on it. That has become challenging, in particular because of the scarcity of suitable assets to invest in and also because prices have been climbing in many sectors.

Managers have had to adopt a much more disciplined approach towards investing and focus more on their longer-term strategy to add value to the assets and portfolios, and ultimately to the investors in a sound and sustainable way. This is probably one of the lessons learnt from the previous global financial crisis, where in the years leading up to it, people were buying assets a bit too hastily with, let's call it limited due diligence, and often being too leveraged. Inevitably, some got their fingers burnt.

Chladek – We've seen this over a number of years in the infrastructure space with increasing allocations and demand for the asset class. The market has demonstrated its ability to scale up to meet this demand historically and I'm sure it will do the same going forwards. The infrastructure investment management market has scaled up and we continually see new funds and also managers raising larger funds.

However, we are lucky that, as mentioned earlier, it is a sector where there is a massive opportunity for new investment in the underlying asset class to accommodate this demand.

Tsoneva – Looking at the market, I completely agree fundraising has scaled up so much in the last few years – there is an exponential growth and a lot of this capital has been deployed. I agree as well that there are going to be more opportunities, from power to electric vehicles. When it comes to the deployment of funds, a couple of the issues that are still out there relate to what type of business models will apply to the emerging technologies. I think Mark mentioned smart meters as well as electric vehicle charging. There are very diverse business models out there, different economic returns will be made under different scenarios. In order to be able to deploy capital, we really need to see something that is more infra-like, that produces longer-term returns so that it's attractive to infrastructure investors.

Lyse – Picking up on Tania's last point there, we have also clearly seen increased interest for investment strategies around social or affordable housing among our infrastructure and real estate clients, and it seems the pandemic has accelerated that trend.

There is another concept that is seeing growing interest as well beyond the ESG/sustainability concept. It's impact investing or impact financing – so, managers who are, at least in theory, willing to give up a portion of the return to invest in projects that will have a real impact on societies, on people and people's lives. It's still a niche in our world, but we do see an increased interest towards these types of investment strategies.

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Mark Chladek, Infracapital

Funds Europe – The Association of Investment Companies (AIC) in the UK recently urged the government to deny access to the general public to its proposed LTAF, that is to say the government's LTAF. That's a fund structure designed to make long-term, illiquid assets more widely available. The AIC said private assets should remain the preserve of professional investors. Do you agree?

Chladek – Our view is that it is important the design of any such fund has the customers' needs at heart. We believe there is demand for a product that is more widely, but appropriately, accessible to certain types of retail investors. Most institutional investors already access long-term assets via existing funds available to them. Obviously there needs to be appropriate liquidity terms to reflect the illiquid, long-term nature of underlying investments, but we believe it is crucial to ensure that such products can be offered to retail investors on appropriately advised basis and we shouldn't automatically exclude anyone who's not a 'professional'.

Lyse – In a way, whether we agree or disagree is to some extent irrelevant. It's a fact that there is a clear interest from high-net-worth individuals to invest in

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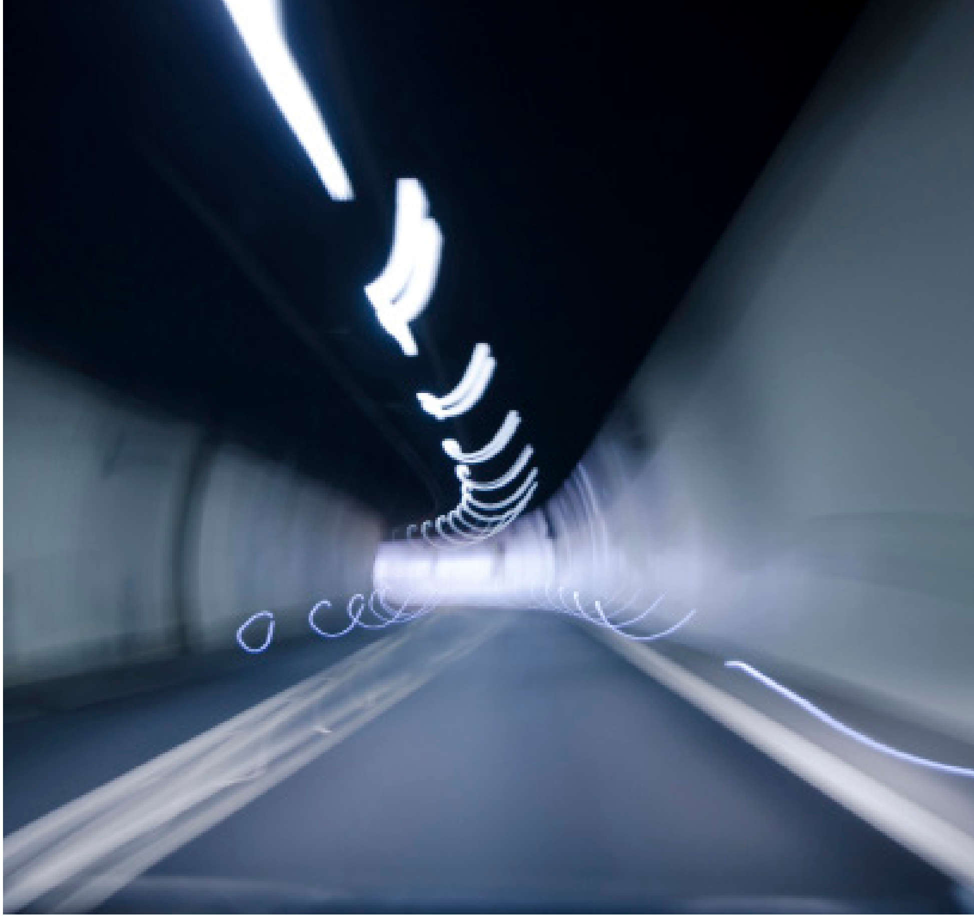

alternative assets, and there is equally a strong interest from the PE type of firms to access this source of capital. This concept of retailisation of private equity has already come and I think it's here to stay and that we're going to see more and more of it. It's kind of like a convergence of the AIF world and the Ucits world in some respects.

Within Alter Domus, we have started to see it with what I guess is the European equivalent to the UK-proposed LTAF fund, namely the Eltif. We also see a lot of feeder funds, whereby specialist managers draw capital from a large number of high-net-worth individuals or what is now referred to as HENRYs – High-Earning, Not-Rich-Yet people. The feeder fund then invests into one single investment: a private equity fund, an infrastructure fund, or a real estate fund. The combined ticket is often between €50 and €100 million, so quite sizeable, and therefore attractive to fund managers.

From an administrator's perspective, managing these funds with a high volume of investors does come with its lot of challenges in terms of both the KYC process as well as the transactional aspects, distributions and calls, etc. Firms like us are looking at how to do that more efficiently, inevitably via the use of better technology.

Should they be allowed? I don't see why not, as long as it can be properly ensured they are investing on a well-informed basis. You can also take the position of, 'Well, if they are allowed to invest in all sorts of complex instruments in the liquid world, why shouldn't they be allowed to invest in these types of assets which are a lot more tangible and maybe easier to understand, conceptually speaking?' These assets are long-term and you're not facing the same challenges you would in the sometimes very irrationally fluctuating public markets, where it's easy to get your fingers burnt. That's another way to look at it, I suppose.

Funds Europe – Before we wrap up, then, how would you sum up the final case for infrastructure or the main takeaways from this conversation?

Tsoneva – In my opinion, it's a unique moment to invest in infrastructure. Although the situation could change, there are converging factors to support this: the commitments to net-zero economies and then 'green recovery' coming out of the pandemic.

Chladek – I agree, It's a very exciting time to be investing in infrastructure – the sector continues to make significant and essential improvements for our society, whether that be the transition to sustainable energy, connectivity for people and businesses, more environmentally friendly transport and logistics. It's a sector that touches on everyone's lives on a daily basis, and it really is an opportunity for us to make a positive impact. **f**e