Infrastructure as a shelter from inflation

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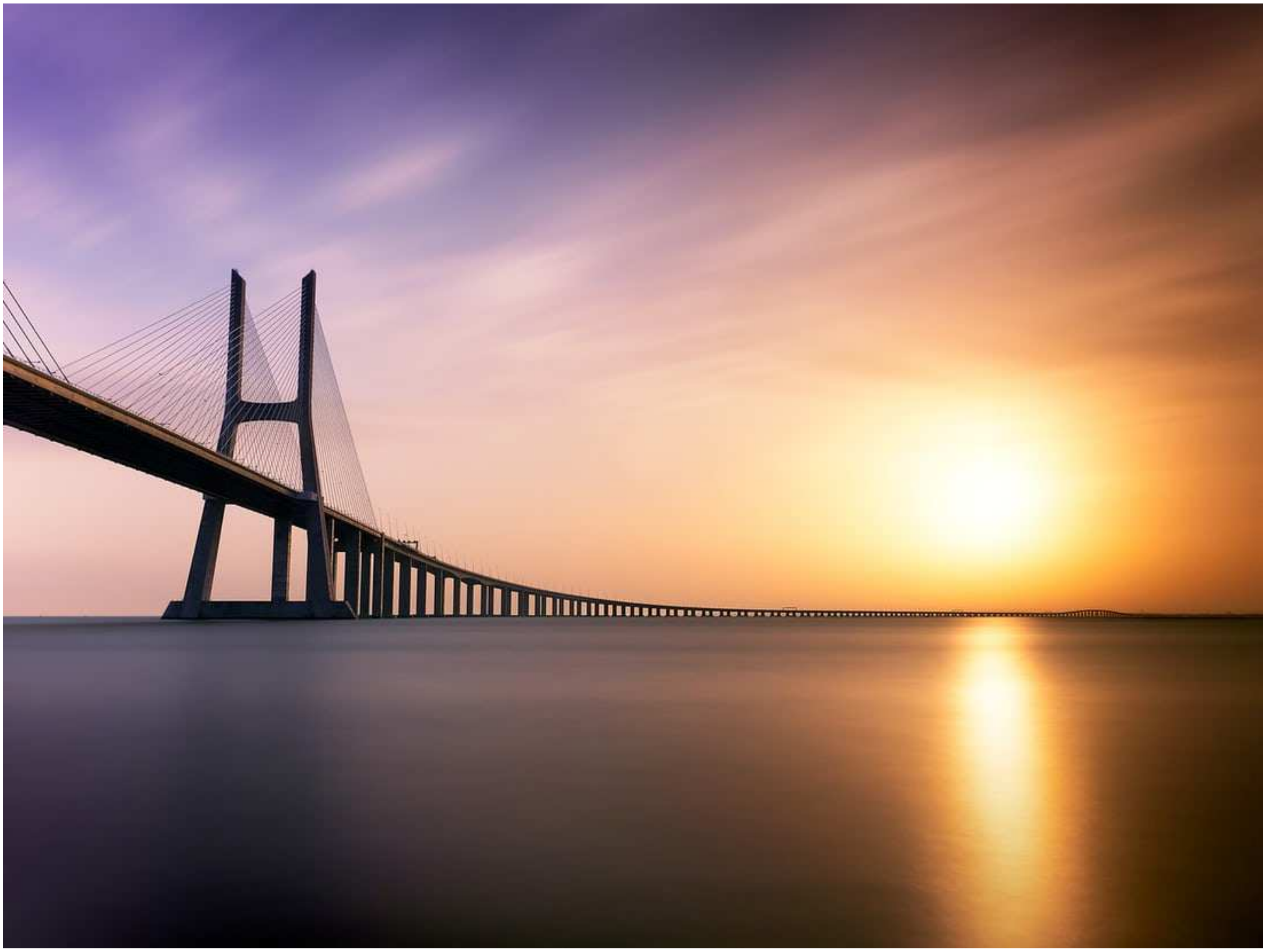
After more than two decades of non-inflationary growth in the western world, inflation made a serious comeback in the aftermath of the Covid-19 pandemic. It is now the single most important factor for investors, savers and consumers, who must be cognizant about its corrosive effects on wealth. While no investment is fully inflation-resistant, a few asset classes have the potential to offer some insulation. One of those is **infrastructure** due to the fact that revenues are often linked to inflation or the fact that companies in this space often enjoy the protection of strong entry barriers and strong pricing power. Beyond inflation-protection characteristics, infrastructure is set to receive a strong boost from the dovetailing themes of deglobalisation, decarbonisation and digitalisation.



WHAT IS INFRASTRUCTURE?

Infrastructure refers to the basic physical and organisational structures and facilities (e.g. buildings, roads, power supplies) needed for the operation of a society. In investing, infrastructure is a real, tangible asset class, normally constituting a combination of land and structures. As such, it will usually always retain some residual value – something which is comforting in an economic downturn. On top of that, because infrastructure is usually essential for the smooth functioning of our daily lives, demand tends to be relatively inelastic. Infrastructure assets tend to have inherently long lives and relatively reliable cash flow.

Investors have two main routes to invest in infrastructure – by buying the securities of listed infrastructure companies, or, via unlisted investments, often accessible via private equity funds. Despite the difference in investment wrapper, the underlying assets have similar characteristics which are worth taking note of in the current context…

INFRASTRUCTURE AS A SHELTER FROM INFLATION

Broadly speaking, infrastructure investments might offer investors a degree of protection from inflation.

On one hand, a lot of infrastructure assets have their **revenue streams linked to inflation through regulation, concession agreements or contracts**. A recent example of this comes from the airline industry. As part of the regulatory model for Heathrow Airport, the charges it levies on consumers and airlines are index-linked to UK Retail Price Index (RPI), meaning that as RPI increases, so do Heathrow's returns. The UK RPI hit 11.1% in April 2022 and the Civil Aviation Authority has granted the airport permission to raise its passenger fees by more than 56%, demonstrating the airport's ability to pass-through the impacts of inflation. Most regulatory frameworks allow regulated assets to use inflation-indexed user tariffs (for example, the recent rise you most likely seen in your electricity bill), while inflation-linked toll increases can be common features of concessions for various types of surface transport such as roads, bridges, and tunnels.

On the other hand, infrastructure assets that do not have an explicit link to inflation often boast **pricing power** given their strong strategic position. Often, entry barriers in the sector are high whether it be through stringent regulation, available space, or zoning laws which often make it difficult to replicate existing assets or provide a substitute.

With that said, certain sectors do see a degree of competition and have to consider the consequences of price increases. For example, if increased charges make flying from Heathrow less affordable, more passengers could be swayed to fly from City, Stansted or Gatwick instead.

In a recent assessment of Channel Link Enterprises Finance Plc's (CLEF), the company that runs the Eurotunnel, Fitch Ratings noted, "the critical nature of the asset managed by Eurotunnel, the long-term maturity of the concession terminating in 2086 and the historical resilience of passenger volumes on the high-speed trains and car shuttle business", citing these factors to support their view that CLEF will navigate recovery following the impact of the Covid-19 pandemic and Brexit-related uncertainties. Nonetheless, Fitch did also note competition from ferry operators and exposure to discretionary demand.

These examples highlight an important point: infrastructure assets are not homogenous and investors must assess their sensitivity to inflation on a case-by-case basis. On the following page, we group infrastructure assets into three broad categories: **cycle-linked assets**, **regulated assets** and **public-private partnership** (PPP) assets. Each provides investors with a different level of protection from rising prices.

3 categories of infrastructure and their behaviour during inflation

CYCLE-LINKED ASSETS

Revenue is linked to the health of the economy.

Examples

Airports **Toll Roads/Bridges** **Ports**

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Normally when the economy is expanding, more people go on holiday, more goods are shipped, and more vehicles are on the road.

These types of businesses can often lift their prices to factor in inflation e.g. French motorway operators have concession agreements providing for annual toll increases of CPI x 70%.

Some have escalation factors built into their agreements (e.g., airports with airlines), that provide for annual price increases. While price adjustments are not always directly linked to inflation, they tend to reflect inflation expectations, meaning they offer protection against rising prices and can even help drive returns when actual inflation undershoots.

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Operating expenses often rise in tandem with rising input prices which can dent margins. Debt servicing costs can rise on the back of higher interest rates as central banks act upon inflation.

REGULATED ASSETS

Associated with the infrastructure necessary to deliver essential services.

Examples

Water / Electricity / Gas Providers

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Demand for essential services is relatively inelastic and resilient to the economic cycle.

In most countries, utilities are monopolies. Consequently, a government-appointed regulator usually controls the pricing framework, bringing more predictability to revenues.

Revenues are often tied to inflation.

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Operating expenses tend to rise in an inflationary environment which can affect earnings.

Debt servicing costs can also rise on the back of higher interest rates as central banks act upon inflation.

PUBLIC-PRIVATE PARTNERSHIPS

Built and owned by the private sector, provided for use by the public sector.

Examples

Schools **Hospitals** **Retirement Homes**

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These types of assets usually have fixed revenues - as long as the asset is available for use, the operator gets paid, irrespective of how many people actually use it.

This provides predictability and consistency around cash flows.

These types of assets often benefit from the ability to pass on costs, sheltering the operator from input price rises.

Revenues are often directly linked to inflation.

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Less scope to increase revenues or prices.

AN INFRASTRUCTURE BOOM

Beyond inflation-protection benefits, infrastructure in itself is an attractive investment theme given that we appear to be standing on the brink of an infrastructure boom. There are three major tailwinds driving this: **Deglobalisation**, **Digitalisation** and **Decarbonisation**.

Deglobalisation was gaining momentum before the pandemic. The health crisis then shone a light on the fragility of global supply chains whether it be through empty supermarket shelves or long wait times for certain goods. Now, the conflict in Ukraine is again leading to shortages of critical hard and soft commodities, causing western nations to re-think their energy supply in particular. Moving forward we expect nearshoring and reshoring to become prominent themes in order to secure supplies of critical materials – some are even discussing the re-industrialisation of Europe. Deglobalisation will demand significant investment in national infrastructure, especially in the transport and logistics sectors.

Digitalisation was fast-forwarded during the pandemic with many facets of our lives migrated online through necessity. The fourth industrial revolution is upon us and big data, distributed ledger technology, cloud-based infrastructures and the Internet of Things will bring many benefits to human lives, *IF* the appropriate infrastructure is put in place. We expect growing investment in fibre optics, connectivity, the cloud and smart cities. Linking back to the theme of deglobalisation, digitalisation and technological supremacy are also being pursued with haste as a source of national competitive advantage.

Decarbonisation has moved to the top of government agendas as the window for us to act on climate change becomes smaller. If governments are to achieve the goals set out in the Paris Agreement, it will require an overhaul of almost every sector. Many of the stimulus packages announced in response to the pandemic had green strings attached and moving forward, we expect a further wave of investment in green infrastructure, whether it be the electrification of transport, alternative energy, better home insulation, urban heating and much more…

Various countries are already actively pursuing infrastructure upgrades. In the UK, for example, the government has set aside billions of pounds for the construction sector. The Prime Minister, Boris Johnson, has outlined a range of funding commitments, including £4.8bn for infrastructure investment in towns across the country and £26bn for public capital investment to hit emissions targets, as part of a "levelling up" drive. On top of that, the transport secretary also announced an "enormous fund" to expand the country's infrastructure for charging electric vehicles. The Department for Transport has outlined its plans for 300,000 public chargers for electric vehicles by 2030, up from 30,000 today.

Looking east, Chinese President Xi Jinping announced an "all out" infrastructure spending package following Covid lockdowns which have weighed on the economy. According to Bloomberg, state-owned banks have been asked to provide 800 billion yuan ($120 billion) in funding for infrastructure projects. The state-run Xinhua News Agency has reported that the nation's infrastructure is deemed "incompatible" with the needs of national development and security and more projects are anticipated, especially in transportation, energy and water conservancy, as well as new facilities for supercomputing, cloud computing and artificial intelligence. The Made in China 2025, a national strategic plan, outlines key industries that are to be prioritised and developed. Many of these are concerned with infrastructure, such as railway equipment, power equipment, ocean engineering, green energy and green vehicles…

Across the Atlantic in the US, the Bipartisan Infrastructure Law will see $1.2 trillion invested in infrastructure over the next 8 years. The plan is far-reaching and will see billions of dollars injected into an array of infrastructure sectors including roads & bridges, the power grid, freight rail, broadband networks, water supplies and airports. The Biden administration also recently announced new steps to build out the first-ever national network of 500,000 electric vehicle chargers along America's highways and in communities using funds from the Infrastructure Bill: $7.5 billion is proposed for EV charging infrastructure and more than $7 billion for the critical minerals supply chains necessary for batteries, components, materials, and recycling.

Here in Europe, geopolitics are compelling governments to reassess energy security. As such, it is likely that new investments will be needed for us to source energy from different sources (such as renewables) or/and to source from different places (e.g. new port infrastructure, new pipelines…). At the same time, the EU is striving to become the first climate neutral continent. As part of the European Green Deal, with the European Climate Law, the EU has set itself a binding target of cutting emissions by **at least 55% by 2030** and **achieving climate neutrality by 2050**. This requires current greenhouse gas emission levels to drop substantially in the next decades and will be near-impossible without substantial infrastructure upgrades, particularly in the fields of transport, building and industry. Beyond that, the European Parliament has voted to end the sale of petrol and diesel cars by 2035. Without a rapid roll-out of recharging infrastructure across the continent the transition to electric vehicles could be hampered.

Complimenting the pan-Eurozone infrastructure drive, individual countries have also launched their own programs, for example, the "France Relance" recovery plan. This is a massive €100 billion investment plan representing the equivalent of one third of the annual state budget, with €40 billion provided by the European Union in order to support businesses, rethink production models and transform infrastructure.

CONCLUSION

With inflation at levels unseen for decades (making cash holdings undesirable), equities exhibiting fierce volatility and bonds in the midst of a historic rout, it is difficult for investors to find a place to put their capital. Out-of-the-box thinking, beyond the traditional asset classes is becoming increasingly necessary.

One answer to the current investment dilemma might be offered by infrastructure assets. This asset class is tangible, usually with strong intrinsic value, and cash flows tend to be somewhat predictable. Beyond that, this is one of the few asset classes that can offer a degree of protection from inflation, stemming from the fact that operators often have their revenues linked to inflation, or, because they exhibit strong pricing power. This is especially true in sectors where operating costs are limited.

On top of protection from inflation, infrastructure is poised to benefit from three powerful, overlapping themes: Deglobalisation, digitalisation and decarbonisation. Already, various governments have announced ambitious spending plans to revitalise national infrastructure.

However, a wide variety of infrastructure assets exist and each has its own nuances and risk/return drivers. Investors must assess sensitivity to inflation and the economic cycle on a case-by-case basis. One other thing to watch out for is pricing risk: with many projects priced using a discounted steady cash flow, when interest rates rise, the rate at which future cash flows are discounted becomes higher meaning the fair value would decrease. Unless of course future cashflows grow quicker than the discounting rate…

Beyond that, strong diversification across sectors, business models, investment vehicles and maturities is important for any would-be investors.

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