Leadership Perspective: European Infrastructure Investment Landscape

FPL hosted Roundtable Discussion held in London | February 2019

FPL Ferguson Partners

Ferguson Partners was delighted to host a roundtable discussion between senior infrastructure leaders, drawn from investors, funds, utilities, developers and advisers. The Global Infrastructure Investor Association (GIIA) was also represented. The discussion addressed the impact on markets and investing strategy of public opinion, current trends in fund raising and asset valuations, and also looked at new opportunities for investors. Attendees shared thoughtful perspectives.

The debate around the recent collapse of the Morandi bridge in Italy and concerns in the UK about profits being prioritised ahead of service quality, are examples of a growing trend in the news and public opinion regarding private investment in public infrastructure.

At the same time, a record amount of successful fundraising activity is taking place, with strong competition and high valuations for core assets. Attendees considered whether we should expect this to continue and, in view of potential political and regulatory risks, how investment strategies are changing?

The discussion then turned to new opportunities for infrastructure investment. There was real energy and enthusiasm as attendees shared views on new sectors, geographies and infrastructure development. It is clear that despite the challenges, there is belief that the asset class will continue to appeal to long term investors. Optimism is the prevailing mood of these highly experienced infrastructure players.

What is the impact of current public opinion on private Investment into public infrastructure?

It was generally agreed that public opinion of private investment into public infrastructure has soured in many OECD countries. This trend has been exploited politically. The collapse of the Morandi Bridge in Genoa and the failure of the UK contractor, Carillon are extreme examples of media and political reactions which place blame on private investment. In the recent budget, the Chancellor of the Exchequer announced that no PFI contracts will be signed while he is in office. Currently, there is a negative trend in public opinion of private ownership of public infrastructure in the UK and Europe. There is a belief that pursuit of profit has led to service failures and neglect of public assets.

The case for private investment in public infrastructure cannot be made only on the basis of cost and availability of capital. More attention needs to be paid to quality of service and the ultimate customer view and experience. It is important that portfolio company management considers customer service as a priority. It was pointed out that customers' view of private ownership is more positive where they have experienced the benefits of competition, such as in telecoms. Even in other sectors such as rail, while the perception in the UK is currently negative, in Italy the customer opinion of Italo, the private high speed train operator, has been generally positive and this has challenged the incumbent state operator to improve service and competitiveness.

The private sector leads the way where innovation is needed to develop new infrastructure solutions using fresh approaches and technology to achieve more adaptable, affordable, sustainable solutions. The public sector, on the other hand, typically tends to be slower and more reactive. There is optimism that the private sector can rise to this challenge.

Private investment is viewed more positively in new technology and where it brings increased efficiency, sustainability and lower environmental impact. This includes, for example, renewable energy, energy storage, electric vehicle (EV) recharge infrastructure, "behind the meter" energy efficiency, as well as developments in digital infrastructure and telecom.

The question is whether the investment community has a role in educating the media and public. Some large, global investors see their role as quite passive. Their capital is mobile. At the portfolio company level they may engage. Other investors, more wedded to specific jurisdictions, do take the view that GPs and investors need to take more responsibility to engage the public, listen to concerns, be more transparent, focus on customer service, and provide a positive story supported by actual data.

An important distinction needs to be drawn between OECD countries, where the infrastructure already exists and needs to be upgraded, and developing countries. In these emerging markets, private investment is viewed positively as the only way to develop the infrastructure needed to cope with rapid population growth, urbanisation and the demands of new middle classes.

In summary, while in certain sectors, end user opinion of private investment in public infrastructure may tend to be more negative in many developed countries, there is a positive story where it has brought innovation, competition and better service, in many cases challenging the public sector. In developing countries, where the need for the new infrastructure is more urgent and public resources can be limited, the support for private investment seems, broadly, to be more positive.

1) What are the current trends in fundraising and flow of capital? Are infrastructure assets overvalued? Will this change?

Despite risks in the political environment and talk of nationalisation of some infrastructure, there continues to be a record amount of fundraising activity in infrastructure. This has been the result of a "virtuous cycle" based on previous fund performance. High valuations show up as successful fund exits and very strong track records for established infrastructure fund managers. In contrast, it has been very hard for new fund managers, without track record, to raise funds. The virtuous cycle could easily turn into a "vicious cycle" based on economic events (such as higher interest rates,) together with lower returns, as a result of competition for assets. Investors and managers need to be alert to any warning signs.

There have been various responses to excess of investment chasing a limited number of assets. There has been a trend of consolidation in large funds by well-established global managers. Others are focusing on more specialized funds in new sectors, mid-market. While some funds are continuing to focus on core/core+ with lower returns, other investors and fund managers are looking at the opportunity to diversify their portfolio, including new geographies, taking more development risk and opportunities to extract value through more active asset management.

There are also other pressures on returns. For example, the phasing out of incentives programs in renewable energy and lower prices as a result of recent auctions are forcing these investors to look at cost reductions, take more market risk and look at other ways to generate value and returns from investments. Investors are becoming more open to different risks.

Different investment models are being developed which give greater control to public bodies and cap private sector returns. There seems to be public acceptance of higher returns to investors where risk has been taken and high value for consumers generated. Infrastructure has always been innovative in terms of ownership and financing structures and this should continue as governments respond to public concerns. This will have implications in terms of capital raising and investor expectations.

In summary, while there may be some challenges for the long established, large industrial scale, core infrastructure area of the market, the underlying fundamentals for private investment in public infrastructure and services remain strong. There is a more flexible approach adopted by some funds seeking investments which display "infrastructure" characteristics but are "non-core". There are also new opportunities emerging from changes in the supply of public infrastructure. The latter is fuelled by demands for more affordable, sustainable, flexible energy and services, made increasingly possible through use of technology and other innovations.

2) What are the new opportunities in infrastructure: energy transition, digital transformation, impact investing, new geographies?

As traditional core/core+ assets have become more expensive, some investors are starting to look into new areas such as energy transition, digital transformation and new geographies to get a first-mover advantage. An interesting example which has attracted comment recently is energy storage and hybrid renewable storage technology. So far fund raising and investment is still relatively small. Challenges include developing regulation, energy market conditions and structuring of investment in terms of dependable revenues. A comparison was made to the early days of renewable energy.

Strategic investors, such as large European Utilities, have been generally more willing to take market risk in new areas in energy transition and digital transformation. This is partly driven by their need to reinvent themselves and find synergies with their core business as the traditional utility model becomes increasingly challenged.

There was also discussion of moving infrastructure investment beyond the generally favoured OECD countries. Many investors continue to shy away from emerging markets due to perceptions of their political and regulatory risks. However, some private equity firms are seeing opportunities for investments with government support and long term contract arrangements in developing countries.

Mismatch will continue between the "wall of capital" available to invest in core infrastructure in OECD countries on the one hand and on the other the need for more flexible investment in higher risk, innovative infrastructure and emerging markets. This has been the case for many years but ever higher asset valuations and the prospect of rising interest rates may free up some of the available capital for development infrastructure opportunities. These investors would take on greater risks for greater returns. This, in turn, will also hopefully turn public perceptions of private investment in infrastructure in a more positive direction.

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