Infrastructure in 2020s: economics, environment, geopolitics

For investors, the challenge may not be *whether* but *how* to participate in infrastructure development in the 2020s.

By Benjamin Cole

For centuries, building and investing in infrastructure was primarily about developing the sinews of economic growth, such as the canals, railroads, highways and ports.

Founding father Benjamin Franklin's first claim to fame was in 1737 when, as postmaster general of Philadelphia, he earned admiration for improved service through better postal roads, eventually linking Philadelphia mail to New York City with a 24-hour turnaround time.

Soon after Franklin's efforts, the "canal age" began in the United States, generally considered to be from 1790 through 1855, during which many forms of financing were developed that are still used to this day, but broadly entailing debt and equity, as well as paying off backers and financiers through receipts.

After the canal age, the modern-era large-scale water and power grids appeared, as did waste disposal projects. Government and private opera-

tors owned assets but usually were largely financed through bond issuance.

In more recent decades, mounting worries about the environment and global warming have challenged infrastructure discussions, along with the need to upgrade electronic communications networks to handle ever-increasing traffic on the international marvel known as the internet.

GEOPOLITICS

With the Russian invasion of Ukraine, a new and dark topic has been rudely thrust into infrastructure conversations: energy infrastructure as a tool or target of war, and fossil fuels as instruments of blackmail, and the subsequent perceived necessity for national or regional energy self-reliance.

Most of an entire continent, that being Europe, is implementing permanent and wholesale changes in its energy infrastructure, as European Union leaders and members migrate to cleaner and self-sufficient energy infrastructure — and perhaps bar imported oil and gas from Russia or other regions.

In May 2022, the European Union announced the REPowerEU Plan, stating there is a “double urgency to transform Europe’s energy system, ending the EU’s dependence on Russian fossil fuels, which are used as an economic and political weapon and cost European taxpayers nearly €100 billion per year, and tackling the climate crisis.”

As if to underline the vulnerability of energy-importing nations and regions, in early April, OPEC announced additional production cuts of 1.66 million barrels per day, bringing the total OPEC+ (that includes Russia) cuts to 3.66 mbpd. Moscow added it would maintain its own 500,000 mbpd cut through the end of 2023.

And, of course, in the modern era, a reality (not a theory) is that oil and gas pipelines, or other infrastructure, can be targeted by overt military or covert operations, such as the September 2022 destruction of the Nordstream pipelines carrying natural gas from Russia to Western Europe, or Russia’s demolition of infrastructure assets in Ukraine.

While Europe’s energy infrastructure is on the front burner, many other challenges and opportunities are ever evolving in the infrastructure space, from water shortages and nations enduring chronic power outages, to proper waste disposal and, of course, outfitting major developed nations and emerging nations to reduce CO2 emissions.

For investors, placing bets in the infrastructure sector is especially intriguing in 2023. With central banks in North America and Europe battling inflation and thus raising interest rates, the broader equities market may be under pressure in coming seasons. The property markets are looking a little wan also.

Nations are ratifying record budgets for infrastructure spending, though returns for the sector’s investors promise to be relatively stable.

As ever on Wall Street and stock exchanges around the world, timely investment ideas garner a lot of attention and a lot of cash, and the infrastructure play is no exception. Even with a global pandemic and war in Europe, worldwide infrastructure fundraising struck a fresh record high of $152 billion in 2022, up 24 percent on year, according to the London-based investment house Roland Berger. Utilities and energy plays took the lion’s share of raised cash.

Investors are investing big and governments are spending liberally: In late 2021, the U.S. Congress passed the Infrastructure Investment and Jobs Act, also known as the Bipartisan Infrastructure Bill, which contemplates $1.2 trillion of spending over a five-year period.

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PATHWAYS TO INFRASTRUCTURE SPENDING

In general, investors can step into the infrastructure sector through publicly held and listed companies, or exchange-traded funds (ETFs), private equity funds, direct equity investment and certain debt strategies, says Orhan Sarayli, head of North America for Barings Global Infrastructure Group.

“In most regards, all these investment vehicles benefit from what I call the ‘essentiality’ of infrastructure,” comments Sarayli. “There is a strong alignment of interests among the equity investors, the debt holders and ultimate users of the asset.”

ETFS

For the risk-averse, infrastructure ETF’s are one play to consider, providing instant diversification within the sector, and providing liquidity in spades. A click of the mouse gains entry or exit.

For example, the Global X US Infrastructure Development ETF (PAVE) has net asset value topping $27.2 billion, a five-star rating from Morningstar, and an expensive ratio of less than 0.50 percent.

But the ETF pays a rather modest dividend of 0.77 percent.

For the yield-hungry, the SPDR S&P Global Infrastructure ETF (GII) pays a dividend just north of 3 percent. It invests in the largest 75 listed infrastructure stocks and is diversified across the sector, with positions in transportation, utilities, energy, etc.

Another option is the iShares U.S. Infrastructure ETF (IFRA), which pays a 2.5 percent dividend and is heavily exposed to utilities.

INFRASTRUCTURE DEBT FUNDS

Infrastructure investing through the debt side is increasingly appealing, says Sarayli of Barings.

“We believe the private infrastructure debt market provides attractive attributes, namely (a) all of the positive attributes associated with infrastructure investing; (b) a continuous flow of opportunities, that is debt is being issued steadily; (c) generally secured positions in the capital structure that are senior to equity; and (d) relatively attractive returns that, in many cases, provides a better cash yield to investors than might be expected within a given time frame.

In August of 2022, Barings closed its Inaugural Target Yield Infrastructure Debt Strategy Fund with a $630 million capital raise, which expanded Barings’ global infrastructure platform to more than $14.3 billion in assets under management. The fund will invest in below-investment-grade debt in Europe and North America, and will largely serve institutional clients such as pension funds and insurance companies. As might be expected with government-backed enterprises, default rates on infrastructure debt are relatively low, especially in developed nations.

“Default rates indicate infrastructure debt performs better than non-infrastructure debt, especially in high-income countries,” Global Infrastructure Hub recently reported, citing Moody’s Investors Service data.

Based on a sample of infrastructure debt originated from 1983 to 2019, the average cumulative default rate of infrastructure debt was 5.4 percent over a 20-year period, lower than the rate of 8.2 percent for non-infrastructure debt. Moreover, infrastructure debt defaults are not total loses because creditors can often seize assets with substantial operational value.

> *“Even with a global pandemic and war in Europe, worldwide infrastructure fundraising struck a record high of $152 billion in 2022, up 24 percent.”*

“This makes expected losses on infrastructure debt in high-income countries very low at 0.5 percent of the debt value — lower than 1.1 percent for an A-rated investment-grade security,” wrote Global Infrastructure Hub.

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Of course, all debt, including infrastructure debt, is subject to inflation and interest-rate risks. Predicting interest rates is always dicey, but as of mid-2023 central banks have already done a lot of rate hiking, and inflation globally may be cooling. The timing for infrastructure debt investing may be propitious.

EUROPE ENERGY INFRASTRUCTURE

With the Ukraine-Russia war grinding on, other battle lines are hardening as well, such as Europe’s determination to decrease reliance on Russia, or other aligned exporters.

The Luxembourg-based Energy Infrastructure Partners is among several groups investing in energy-related infrastructure in Europe, with a focus on investment-grade plays with an eye toward long-term cashflow, although its offerings are primarily geared toward institutional investors.

Not to be outdone, the Germany-based financial giant DWS in late 2021 launched an open-ended European infrastructure investment fund, open to retail investors who want to invest in infrastructure projects across Europe. In part, DWS was responding to a new German law allowing retail investors to participate in infrastructure project investments, intended to help finance Europe’s progress to cleaner energy through unlisted (not publicly traded) renewable-energy projects.

After a long run sideways covering more than a decade, listed infrastructure stocks in Europe appear to be building up some steam, even while facing higher interest rates, regional war and a possible global economic slowdown. The Dow Jones Brookfield Europe Infrastructure Index is up 13.81 percent year-to-date, as of early April, nearly double the rise of the Stoxx 600 Europe Index, which is a broad measure of European stock markets.

INFRASTRUCTURE INVESTING: RECESSION PROOF?

With recession forecasts populating the financial headlines and airwaves, and central banks in Europe and North America hiking interest rates, investors may be looking for refuges in coming quarters. Infrastructure, of course, has a “low beta,” in that movements in the economy or interest rates do not affect infrastructure values as much as, say, real estate or tech industries.

“I do not know if anything is 100 percent recession-proof, but there is certainly a good track record with infrastructure lending proving its resilience through various business and economic cycles,” says Sarayli.

Consumers and businesses tend to pay water and power bills and keep the internet and phone services plugged in. Necessities are the last expenditures to be cut.

“If the asset is essential, its performance should still hold up even in a recession,” explains Sarayli.

Some infrastructure assets, such as solar- or wind-power plants, have near steady demand for their product and often have signed long-term contracts. In addition, investors in debt issued by power generators will have first claim on operating income, before equity holders.

For investors seeking safety and yield in 2023, infrastructure debt is certainly worth a long look.

IN THE FINAL ANALYSIS

While investors can move in and out of infrastructure stocks and ETFs with the click of a mouse, most sector experts advise a five-to-seven-year horizon for investments in private equity and debt, or related funds.

Yields on infrastructure debt have risen in the 2020s, along with yields on all debt instruments. That has pressured values for extant holders of debt, but of course likely presents a better entry point for new investors.

Europe and the United States have embarked on ambitious large-scale programs to enlarge and even reinvent infrastructure, in particular regarding Europe’s energy future.

Even beyond energy, the economic leaders of the developed world are reassessing risks and vulnerabilities attendant to globalization and the ability of hostile exporters to curtail shipments of vital components or commodities.

In just one example, without integrated circuits, also known as computer chips, production or repair of any number of essential products, including airplanes, automobiles, computers, smartphones, high-end industrial machines and military equipment, can grind to a halt. The developed nations are reviewing if traditional infrastructure, as well as industrial infrastructure, is resilient in a world where trade can be impeded, whether by geopolitics, pandemics or even stateless saboteurs.

For investors, the expanding infrastructure sector can offer solid yields with low risk. It may be time to build an infrastructure portfolio. ■

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