Igneo Infrastructure Partners

Long-term patient capital at work to build a sustainable future through infrastructure

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Marcus Ayre,** partner and head of Igneo Infrastructure Partners, Europe. The following is an excerpt of that conversation.

You have been an active investor in Europe for more than 15 years now. What are the significant changes you have observed in that time?

Infrastructure has become established as a key institutional asset class. It has proven itself as incredibly resilient throughout economic cycles and shock events. In the past 15 years, we've been through a global financial crisis, a banking crisis and the COVID-19 pandemic. The war in Ukraine has been on our doorstep here in Europe. We've had political events, such as Brexit. Through incredible amounts of turmoil in the macro market, we've seen infrastructure's ability to continue to deliver predictable, stable returns throughout that period, which is proof of the thesis that infrastructure has matured into a critical part of every institutional investor's asset portfolio.

With that maturation of the market has come increasing specialization. When I first joined Igneo Infrastructure 16 years ago, the sector was full of generalist global funds, with a handful of regional funds. Today, we're seeing increasing specialization and strategies differentiated by geography, by sector, by risk level, with multiple products from managers to address individual parts of the spectrum.

How would you characterize the level of activity in infrastructure transactions in Europe so far this year?

After a very busy first half of 2022, we began to observe some softening of the level of activity by the end of the year, which has continued into the first quarter of 2023. There is definitely still activity, but it's not at the frenetic pace of 18 months ago. That is partially due to the rising interest-rate environment, with the higher cost of debt and lower availability of debt slowing down activity. We also saw a softening of the amount of capital being raised in the infrastructure marketplace, driven by what was going on in institutional investors' own portfolios. The denominator effect has caused them to effectively be a little overweight in infrastructure, so they're having to get new allocation approvals from their respective trustee boards or investment committees.

We have seen high inflation rates persist during the past 12 months in Europe. What effect has this had on the infrastructure market, and what challenges has this presented to the businesses in your portfolio?

One of the benefits of infrastructure is that it does have an element of pass-through inflation protection. We typically categorize our infrastructure businesses as either regulated, contracted or volume businesses. In that regulated space, there is a very explicit pass through of inflation, typically through the regulatory formula. In contracted businesses, often there is also an element of indexation or inflation pass through set out in the contracts. And then in the volume-related businesses, where you are reliant on traffic, typically from transport businesses, you have more power to set your own prices. In that case, again, you are often able to pass through some of that inflation cost.

I will note, though, even where you do have a right to pass on inflation, either through a regulatory model or a contracted agreement, that doesn't always mean you should. Your license to operate implies you absolutely have to be doing the right thing for the end user. In Europe, we are grappling with an energy crisis where the cost of energy is incredibly high, and that's leading to a cost-of-living crisis. The end consumers are having to spend a significant portion of their take-home pay on heating and lighting their homes. While you ultimately have a responsibility to deliver returns to your underlying investors, it's also important to demonstrate to consumers that you are being as efficient as possible in your operations and that you're not in any way looking to take advantage of the situation.

In terms of the challenges, a high-inflation environment leads to central banks looking to raise interest rates. Higher interest rates flowing through into the debt capital markets means you can borrow less against the same level of cash flow. Infrastructure is typically a project-financed asset class or cash flow–based lending asset class. Where you haven't put long-term debt in place in your portfolio of businesses, you are either having to pay more of your cash flow to lenders or you're just borrowing less. At Igneo, particularly in our European portfolio, we refinanced our portfolio business over the past three years with long-dated debt because we thought the debt was particularly attractive, and we decided at that time to put as much of it as possible into long-dated, fixed-rate debt. As we look to acquire new businesses and refinance those businesses in the future, that will be at higher cost of debt, which will have a direct impact on the portfolio businesses.

Has the recent increase in risk-free rates had much of an impact on asset valuations?

On the debt side, the increase in risk-free rates hasn't caused a huge increase in margins, but we've certainly seen an increase in underlying rates. That means there is less debt to put against assets and infrastructure businesses when you're buying them, which is having an impact on enterprise values.

On the equity portion, we've seen a much more muted impact. For managers who do regular independent valuations, businesses are typically valued using a capital asset pricing model [CAPM], and the risk-free rates are embedded in the CAPM model; however, during quantitative easing, independent valuers often effectively put in a buffer. Quantitative easing created an artificially low risk-free rate environment, and valuers typically put in some form of additional premium on top of the risk-free rates to allow for a more normalized long-term average.

As we come into a more normalized rate environment, valuers have been able to remove some of the buffer from their CAPM calculation, so we aren't seeing a one-for-one adjustment to the cost of equity as risk-free rates go up.

The second point has more to do with what we as fund managers tell underlying institutional investors about the nature of the return. We're not talking to investors saying we promise to deliver U.S. Treasuries–plus; rather, as managers we are normally marketing funds with absolute returns. What we promise to deliver depends on the strategy — a 10 percent return, a 12 percent return, a 15 percent return, depending on the risk strategy of the underlying fund. In effect, this makes a fund's cost of equity less reliant on risk-free rate movements.

Are you still seeing much investor appetite for the asset class against this backdrop of rising interest rates?

The short answer is yes. Investors want to be invested in infrastructure, but the reason has changed a little. Whereas three or four years ago, infrastructure was one of the few places where investors could find yield, today it's relatively easy to find yield in other asset classes. What is more challenging is to find something that is both yielding and provides you with an element of capital appreciation or inflation protection. And I'm seeing infrastructure continue to deliver that blend of yield plus inflation protection in a way other sectors are not.

Against this demand, there is the denominator effect that will take a few more quarters to work through so institutional investors can rebalance their portfolios and reallocate to infrastructure in a more meaningful way.

What are the main challenges you see in the years ahead?

Challenges are always opportunities. Those I see in the years ahead include energy transition and the security of the supply chain. Particularly here in Europe, one of the things the invasion of Ukraine has done is throw these issues into very sharp focus for governments. Specifically, how do we wean ourselves off Russian oil and gas, and how do we make sure we are achieving decarbonization across the energy and the overall industrial space?

There is now real impetus from politicians and from governments to make progress on decarbonization. The challenge is how to take that impetus and make it tangible and investable for investors such as ourselves. We all know we need to gain energy security and move to net zero, but we don't know how we're actually going to get there. What are the practical steps to get us there — that is the real challenge. Still, it's exciting to see the opportunities for infrastructure investors because it is going to require significant levels of investment, and that is a huge opportunity for institutional investors who want access to the asset class and for funds like us, who want to deploy capital in good infrastructure assets and grow those businesses.

And I think one of the things we saw prior to the invasion of Ukraine was a number of the European institutional investors, particularly the northern European institutional investors, had become quite focused on trying to move away from any fossil-fuel exposure at all. The invasion of Ukraine has put into sharp focus that it is not enough just to exclude investments from your portfolio. That doesn't fix the bigger problem. You have to engage and be part of the solution. Just walking away from the problem from fossil-fuel investments effectively just pushes them into vulture funds, which are happy to own "dirty" assets and run them for as long as possible, for as dirty as possible, and get great returns off those assets. But that is not helping us ecologically move to a decarbonized future.

There is a lot of talk about opportunities arising from the energy transition and the move to net zero. How do you view these developments at Igneo?

We have a philosophy around using our existing businesses and assets to drive that energy transition. And that, to me, is the way forward. We have to create the right environment, the right economic models, to make those big projects work. We work on energy transition in every one of our portfolio businesses already, but there will continue to be an evolution in this space. Is there a space for carbon capture and storage? Absolutely. There are very hard-to-abate industries that will require carbon capture and storage as part of the solution. At the moment, the economic models for carbon capture and storage are very challenging, unless you're using carbon capture and storage to extract oil and gas, and you make enough money out of the oil and gas to pay for the carbon capture and storage. That's slightly defeating the purpose if we're going to go down that route. We will see an evolution in terms of the economic models both around the cost of carbon, but also the cost and economic models around carbon capture and storage. Will they be the regulated utilities of the future? Potentially. And I think that's potentially true also of hydrogen.

We are long-term investors in infrastructure. We are patient with our capital. We want to invest in businesses that will survive for the long term, so through the short-term spikes in inflation, COVID-19, Brexit, the war in Ukraine, energy crisis and cost-of-living crisis, we want to make sure we have businesses that continue to deliver predictable cash flows throughout whatever gets thrown at them. It's about this long-term patient capital working to build a sustainable future.

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CORPORATE OVERVIEW

Igneo Infrastructure Partners is the direct infrastructure team of First Sentier Investors Group. Operating since 1994, the team works closely with portfolio companies to create long-term value through innovation and proactive asset management. Igneo manages $17.8 billion (as of March 31, 2023), on behalf of more than 200 institutional investors around the world.

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