UK infrastructure market review:

Resilience through the economic cycle

Against a backdrop of slow UK economic growth, a strong appetite for the infrastructure market prevails. In this piece we examine the UK private infrastructure market more closely and identify where the risks and opportunities lie for institutional investors.

Marija Simpraga,
Infrastructure Strategist,
LGIM Real Assets

SUMMARY

- 2018 saw a record number of European infrastructure deals and capital inflows
- Strong appetite for the asset class persists as 92% of institutional investors surveyed globally aim to increase or maintain their exposure to infrastructure*
- UK infrastructure presents a more mixed picture, with political uncertainty weighing on investment volumes and sentiment in 2018
- The uncertainty will likely carry over in 2019 and weigh on transaction volumes
- Against a backdrop of slow UK economic growth and low business confidence, we favour defensive infrastructure assets. Examples of these can include assets with long-term contracted or regulated cash-flows such as some types of renewables and utility networks; but also non-contracted assets such as ports and airports with strong market position, quality of revenues, appropriate levels of gearing and a track record of resilience through the economic cycle.

* Preqin Investor Interviews, June 2016 - June 2018 in "Preqin Investor Update: Alternative Assets H2 2018"

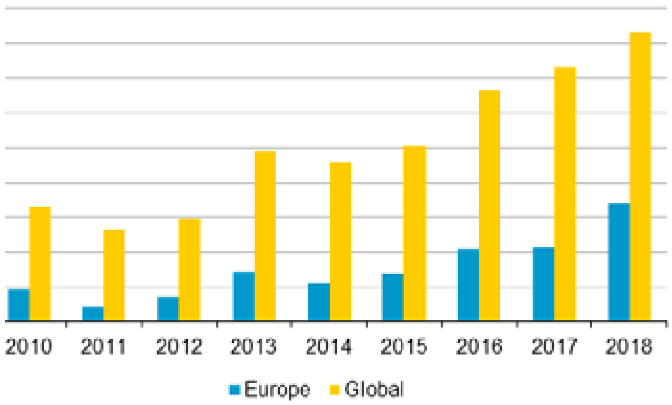
Legal & General
INVESTMENT MANAGEMENT

MARKET BACKGROUND AND DEAL VOLUMES

The global private infrastructure market has had a record year in 2018. Fundraising continued to increase, led by North American and European funds across debt and equity and reached a five-year high in 2018. Meanwhile, dry powder – capital committed but not invested – continued to climb. This implies that the appetite for infrastructure grew faster than the size of the available pipeline of investments.

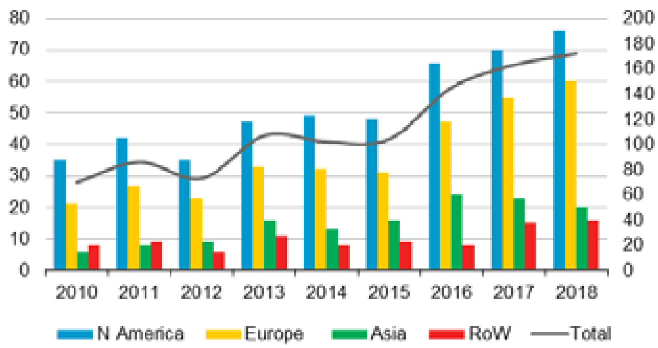
According to Preqin, a total of 30 infrastructure funds reached final close during 2018 – 28 equity and two debt funds. The number of funds closed has declined slightly from 2017 which saw 31 final closes, however the average size of the funds has increased considerably. This reflects the trend for concentration of capital at the hands of large investors with extensive infrastructure experience. According to Preqin data, 10 largest infrastructure investors accounted for around 44% of infrastructure funds raised in 2018 – up from 34% in 2013. It also highlights the concentration of capital in funds that are likely to deploy into large-ticket deals, which could exacerbate the existing trend of elevated valuations of flagship assets.

Figure 1: Aggregate infrastructure fundraising ($bn)



Data source: Preqin, 21 Jan 2019

Figure 2: Infrastructure dry powder ($bn)



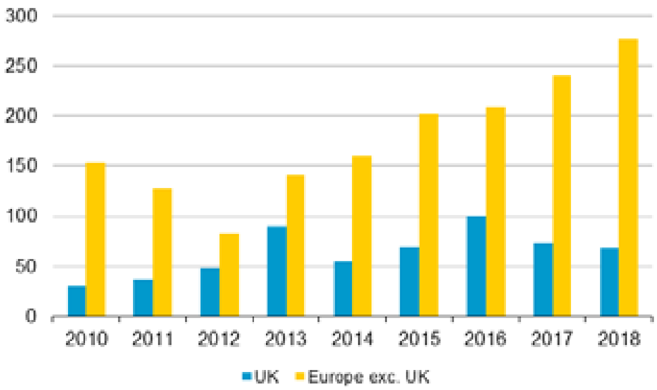
Data source: Preqin, 21 Jan 2019

Figure 3: Largest infrastructure equity and debt funds closed in 2018

Fund	Manager	Final size (mm USD)	Strategy
Copenhagen Infrastructure III	Copenhagen Infrastructure Partners	4,318	Equity
Fondi Italiani Per Le Infrastrutture III	F2i SGR	4,082	Equity
Macquarie Super Core Infrastructure Fund	Macquarie Infrastructure and Real Assets (MIRA)	2,935	Equity
Partners Group Direct Infrastructure 2016	Partners Group	2,707	Equity
Infracapital Partners III	Infracapital	2,510	Equity
PIP Multi-Strategy Infrastructure Fund	Pensions Infrastructure Platform	860	Deb/Mezzanine
PREDIREC EnR 2030	ACOFI Gestion	204	Deb/Mezzanine

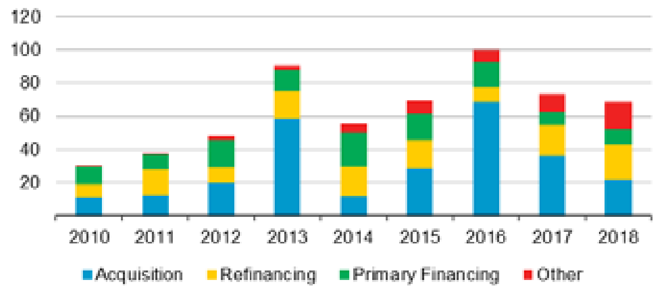
Data source: Preqin, 21 Jan 2019

Figure 4: Value of infrastructure deals closed ($bn)



Data source: IJGlobal, 21 Jan 2019

Figure 5: UK deal volume breakdown ($ bln)



Data source: IJGlobal, 21 Jan 2019

UK CONTEXT

The value of deals closed in 2018 in Europe grew to more than $250 billion. Total value of deals in the UK declined however, to $68 billion in 2018, down 7% from the year before.

The year-on-year drop was largely caused by the decline in merger and acquisition activity. This may in part be due to the heightened volatility in financial markets, as well as elevated political uncertainty owing to speculation over the Brexit process, alongside the sector implications of a potential Labour government. Greenfield financing volumes have recovered somewhat in 2018. On the other hand, refinancing activity continued to grow strongly, climbing 18% from the year before. This may well be due to borrowers locking in lower borrowing costs ahead of the potential Bank of England base rate hikes.

Figure 6: Largest infrastructure transactions completed during 2018

Transaction	Total value ($ million)	Equity investors
Hornsea 1 Offshore Wind Farm (50% stake acquisition)	5,812	Global Infrastructure Partners
Moray East Offshore Wind Farm Financing	3,304	EDP, Engie, Mitsubishi, Kansai Electric Power, Mitsubishi UFJ, China Three Gorges
Triton Knoll Offshore Wind Farm Financing	2,733	Innogy, J-Power, Kansai Electric Power
Galloper Offshore Wind Farm Refinancing	1,835	Electricity Supply Board, Sumitomo Corporation, Siemens Financial Services, Innogy, Macquarie
Dudgeon Offshore Wind Farm Refinancing	1,774	Equinor, Masdar, China Resources Group
Race Bank Offshore Wind Farm (573MW) Refinancing	1,719	Orsted, Sumitomo Corp, Macquarie
M25 Widening (102KM) PPP Refinancing	1,676	Dalmore, Equitix, GCM Grosvenor, Balfour Beatty, Egis, DIF
CityFibre Additional Facility*	1,414	West Street (Goldman Sachs), Antin
Cory Riverside Energy Refinancing**	730	Dalmore, Fiera Infrastructure, Semperian, Swiss Life
Wales and Borders Rolling Stock (CAF Financing)	692	Sumitomo Mitsui Banking Corporation, Equitix

* Prior to raising the additional facility, West Street and Antin acquired CityFibre for £538 million in a separate transaction
** Dalmore-led consortium acquired Cory Riverside in an earlier £1,492 million transaction
Data source: IJGlobal, 21 Jan 2019

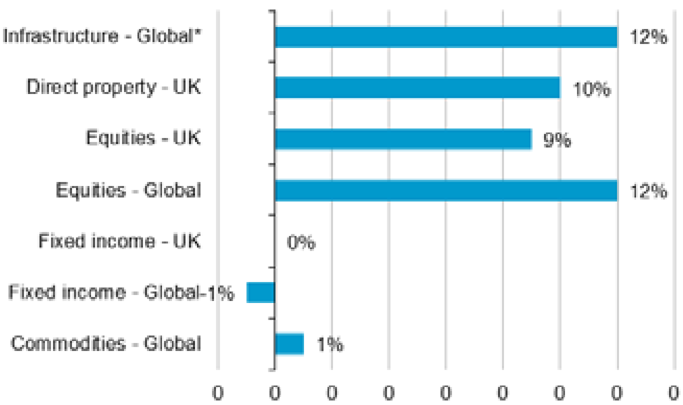
Returns for global private infrastructure, as represented by the MSCI Global Quarterly Private Infrastructure Index, were 12% for 12 months ending September 30th 2018. This is below the five-year average of 15% and reflects the trend of rising infrastructure asset valuation amid increased investor demand.

Going forward, investors are targeting returns of around 7-9%, highlighting the continued pressure on asset valuations from high investor demand. The 7-9% average target reflects the majority investor preference for lower-risk core infrastructure. Super-core asset are likely to deliver sub-6% returns, while value-add strategies can return in excess of 10%.

In our view, this was nevertheless a strong performance when compared to the returns in other asset classes.

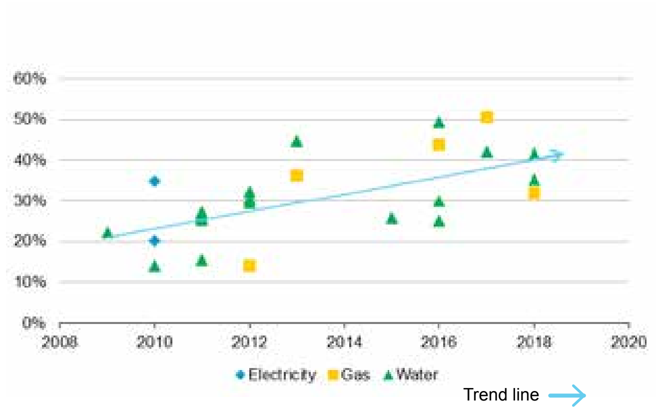
"Returns for global private infrastructure were 12% for 12 months ending September 30th 2018"

Figure 7: Total return in 12 months to Sep 2018 (local currency)



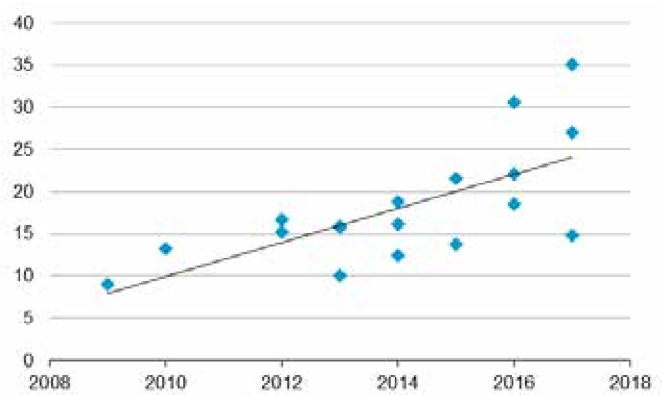
*Target return. Infrastructure – global = MSCI Global Quarterly Private Infrastructure Index . Direct property = MSCI All UK Property Index. Commodities = Bloomberg Commodities Index. Fixed income (UK) = Bloomberg Barclays Sterling Corporate unhedged total return. Fixed income (Global) = Bloomberg Barclays Global – Aggregate Total Return Index Unhedged. Equities (UK) = FTSE 100. Equities (Global) = MSCI World Index.
Source: Bloomberg, data covers the period of 12 months to Sep 2018; data retrieved 21 Jan

Figure 8: Regulated UK utility valuation multiples (premium to regulated asset value for M&A transactions)*



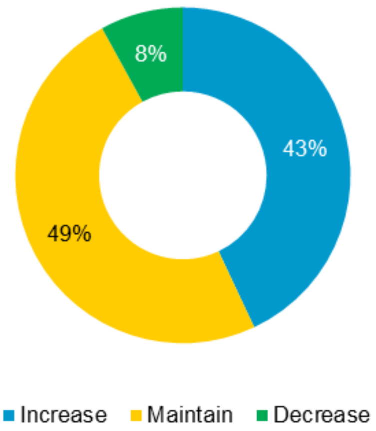
*Regulated utilities include water, gas and power distribution networks. Regulated asset value is the value of assets used by the regulator to set utility network returns. This value is also used by the market participants as basis for company valuation.
Source: Company filings, Bloomberg, LGIM Real Assets Research, 21 Jan 2019

Figure 9: Global airport transactions valuation multiples (EV/EBITDA)*



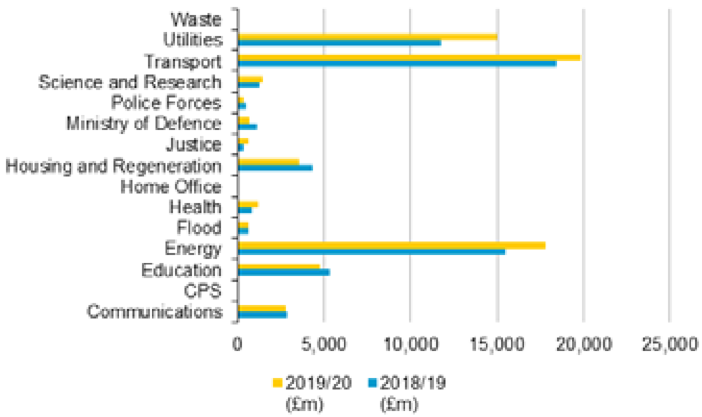
*Historical valuation multiples at acquisition of majority stakes in global airports.
Source: Company filings, Bloomberg, LGIMRA Research, 21 Jan 2019

Figure 10: Institutional investor plans regarding exposure to infrastructure (June 2018)



Source: Preqin, 30 June 2018

Figure 11: National infrastructure pipeline



Source: National Infrastructure Commission, 26 November 2018

"According to the National Infrastructure Commission's Infrastructure Pipeline, infrastructure build-out is set to increase by 11%"

The continued appeal of infrastructure assets is reflected in investor surveys. Globally, institutional investor demand for infrastructure remains strong, with 92% of investors surveyed by Preqin aiming to either maintain or increase exposure to infrastructure asset class.

In the UK, the situation could be slightly different, with investor sentiment influenced by the outcome of the Brexit negotiation process and the possibility of a Labour government. Foreign investors form a large share of UK infrastructure investor base, and may be particularly cautious during this period of heightened political uncertainty.

Against this backdrop, we would expect the merger and acquisition activity to remain subdued over the next year. If the recent financial market volatility persists while interest rates gradually increase, we would also expect less refinancing activity. On the other hand, greenfield (primary) financing activity may see an increase from the previous year as capital is deployed into projects approved prior to the period of market turbulence. According to the National Infrastructure Commission's Infrastructure Pipeline, infrastructure build-out is set to increase by 11%, mainly driven by increased project volumes in renewables and utility networks.

> "In the investment grade space, institutional investors have gained market share over the last decade at the expense of banks"

DEBT FINANCING

Debt financing of infrastructure projects continues to be dominated by commercial banks. However, in the investment grade space, institutional investors have gained market share over the last decade at the expense of banks, which have pared back their long-term financing activities due to more stringent capital requirement rules. More restrictive rules on longer duration or higher risk exposures have led the banks to focus on recycling capital and on shorter maturities (3-7 years). The longer dated exposure (10-30+ years) has typically been provided in the form of fixed-rate institutional debt. Inflation-linked debt is deployed where appropriate based on the underlying cash flows.

UK REGULATORY UPDATES

- UK water network regulator Ofwat published draft proposals on water sector returns during the 2020-25 regulatory period. The proposed measures will effectively reduce returns on regulatory asset base for water companies, leading to decreased returns for shareholders

- The energy networks regulator Ofgem followed the same tone. It issued draft regulation which proposed utility returns which were significantly below investor expectations. The tone of communications from the regulators suggests regulated utilities are set for a substantial decline in returns in the period up to 2025-26

- EU commission issued aviation guidance notes detailing the future of UK-EU air connectivity. Addressing the possibility of a no-deal Brexit, the notes outline the EU's intention to maintain the current level of air connectivity between the UK and the EU in the event of a no-deal Brexit. This adds a great deal of regulatory clarity and suggests that a shock to UK-EU air travel volumes is unlikely in the case of a no-deal Brexit

CONCLUSION

Global infrastructure is set for further capital inflows over 2019, as institutional investors look to increase exposure to the asset class. In the UK, foreign investor retrenchment and volatile macro economic environment could pressure investment volumes. However, this could leave domestic institutions in a better bidding position for those assets that do come to the market.

With respect to asset returns, core infrastructure appears best positioned relative to other segments of the infrastructure market against the backdrop of subdued growth and macroeconomic uncertainty. This includes assets with contracted revenues indexed to inflation and low commodity price exposure such as some types of renewables and utility networks. Non-contracted assets such as ports and airports can also present a strong investment proposition, where they feature strong market position, quality of revenues, appropriate levels of gearing and a track record of cash-flow resilience. We continue rigorous stress-testing of all potential investments to determine appropriate level of gearing that delivers returns resilient through the economic cycle.

In 2019, we expect greenfield financing pipeline to continue to be dominated by offshore wind. Around 1GW of new projects is scheduled for commissioning during 2019. The subsidy auction in April will enable up to 6GW of projects to go ahead. Electricity transmission transaction volumes will likely remain strong. This is due to the regulation which requires offshore wind developers to sell the transmission assets (substations and cables) that transport power generated by newly built wind farms. Increased activity is likely in digital infrastructure due to UK government support via the Local Full Fibre Network programme. Interconnector transaction volumes could receive a boost in case of a favourable Brexit outcome. Transport transactions activity may decline over the next year as 2018 saw significant financing activity, most notably in rolling stock procurement and airport refinancing and M&A.

> "Core infrastructure appears best positioned relative to other segments of the infrastructure market against the backdrop of subdued growth and macroeconomic uncertainty"

We would expect equity valuations to remain elevated as the growth in investor appetite continues to outpace the growth in available investment pipeline. This could be amplified in core and super-core assets by investor flight to safety amid heightened financial market volatility as these assets exhibit strong defensive characteristics. Increased aversion to risk could further support the divergence between A-rated and BBB-rated spreads for debt transactions in the private market – continuing the trend seen in late 2018.

Increased investor focus on higher-rated transactions will likely to lead to a very competitive pricing environment in 2019.

CONTACT US

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020 3124 2803 **contactrealassets@lgim.com** **lgim.com/realassets**