Institutional Investing in Infrastructure
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Infrastructure on the defensive: Industry experts see coronavirus as a moment-in-time disruptor

By Kali Persall

The current COVID-19 crisis has proven the defensiveness of certain asset classes within the infrastructure space, while shining a spotlight on the vulnerability of others — even those previously thought to be resilient.

Over the past several months, traditional core assets that ranked low-to-medium on the risk spectrum took a noticeable hit, as shelter-in-place orders brought travel to a standstill, leaving many to wonder, just how defensive is infrastructure, really?

Not all infrastructure is created equal

GDP-correlated assets, such as ports, airports, and toll roads, have taken the biggest hit from the pandemic, as they are based on user traffic. As of May, the airport index fell 40 percent year-to-date, ports dropped 32 percent, toll roads were at –28 percent and rail was down –18 percent, according to a report from Whitehelm Advisors, entitled Infrastructure's Resilience in Uncertain Times. In comparison, within the availability-based regulated assets category, midstream and storage were –25 percent, regulated utilities were at –8 percent, and tower companies were actually up 16 percent.

Experts estimate that revenues of publicly listed infrastructure companies have seen an 8 percent downward revision so far in 2020, according to a June report by Nuveen. However, experts note infrastructure is inherently defensive, and even the assets that have been impacted the most will see a strong rebound once lockdown measures ease up.

"Given the nature of infrastructure assets' long-term revenue streams, the asset class has historically proven to be stable and resilient to short-term volatility," says Dave Noakes, co-founder and senior managing director at Prostar Capital. "Whether due to their underlying defensiveness or low correlation to traditional asset classes and market cycles, we've historically seen infrastructure assets emerge from previous downturns in relatively good shape."

One defensive characteristic of infrastructure is that it provides relatively high total returns with low correlations to traditional asset classes, such as equities, fixed income and real estate, according to a 2017 study by JPMorgan. In addition, unlike other asset classes, core and core-plus private infrastructure investments offer long-term exposure to durable, economically insensitive cash flows that are protected against inflation. These cash flows are often underpinned by long-term contractual agreements, such as public-private partnerships (P3s) with creditworthy counterparties that are immune to fluctuations in the market, including utility companies or government entities. This makes this asset class uniquely poised to weather downturns.

But just how defensive is infrastructure when faced with a major exogenous shock as dicey as coronavirus? The global standstill caused by the pandemic is expected to unleash what has been called the largest drop in global energy investment in history, the International Energy Agency (IEA) said in a May report. At the beginning of the year, global energy investment was on track to grow around 2 percent. However, now spending is expected to plunge by 20 percent in every major sector, representing a loss of $400 billion. In addition, global investment in oil and gas is expected to fall by almost one-third, and investment in shale is anticipated to fall by 50 percent in 2020.

This comes as global GDP prepares to see the worst contraction since the Great Depression. According to a study published by Harvard Business School in July, prior to the outbreak, the global GDP growth rate for 2020 was expected to be close to 2.3 percent. As of April 2020, experts forecasted that it will instead contract by 3 percent, diving far below the 0.1 percent contraction of 2009. Furthermore, U.K. steelmaking company Tata Steel noted that, on a global scale, this is the first time since the Great Depression that both advanced and developing economies are in recession together.

Just a moment in time?

Despite the shakeup, many asset managers investing in infrastructure believe this environment will be nothing more than a moment in time. In fact, many assert that infrastructure has been relatively shielded compared with other asset classes, due to inherent defensive characteristics that make it immune to broader economic volatility.

“I do believe COVID will be a moment-in-time event,” says Ben Vaughan, a managing partner and COO of Brookfield’s infrastructure group. “How long that moment is, I think still remains to be seen but I do think it is sort of a moment in time, and it will end and the world will revert to normal.”

Infrastructure assets are typically long dated in nature due to the structure of their contracts, giving them the characteristics to withstand short-term volatility. For example, airport and toll-road concession can be up to 99 years in length, according to Whitehelm Advisors. The report also notes that, while recovery to pre-COVID-19 levels of demand may take several years, the firm believes the essential nature of infrastructure assets will return to trend, as it has done with exogenous shocks in the past.

“While COVID has tested the resilience of transport-related assets, such as airports, car parks, ferries and toll roads the impact has been asymmetric,” says Anish Butani, senior director of private markets at bfinance, in an interview with i3. “For instance, on a relative basis, toll roads are likely to bounce back quicker than other transport sectors as economic activity rebounds.”

Butani notes that, if nothing else, the pandemic could bring about a new wave of thinking about these types of investments.

“COVID has highlighted the need to consider strategies and sectors on an asset-by-asset basis rather than by labels such as core and core-plus — the distinction will be between contractual and non-contractual,” he adds.

Silver linings

While the COVID-19 outbreak has proven disastrous for some infrastructure assets, it has posed unexpected opportunities for others. Availability-based or regulated assets, such as water, utilities, renewables and digital infrastructure, have performed notably well in the face of short-term volatility, due to the fact they have no volume risk associated with them.

In the midstream energy sector, Steve Bickerton, senior managing director and co-founder of Prostar Capital, says the market conditions caused by the pandemic could actually be a blessing in disguise. Oversupply, combined with a fall in demand, has caused excess inventory in the sector. Given current market conditions, commodity prices are low and customers are scrambling to lock in medium- to long-term contracts, equipping firms such as Prostar with a defensive portfolio of assets.

“Regardless of what’s going on in the world economy, we still continue to use energy,” said Bickerton in a May video interview with IREI. “We still need to generate electricity; we still need to heat our houses, drive air conditioning. What we’re seeing at the moment really in the energy midstream space, especially around storage, is really a perfect storm in a positive way.”

For other asset classes, COVID-19 has failed to sound the alarm altogether. In the case of water infrastructure, one of the oldest asset classes, other challenges such as climate change pose a much more dire threat than the virus.

“I believe water is one of the most resilient types of infrastructure,” notes Matt Diserio, president and co-founder of Water Asset Management. “The reason is because the demand doesn’t change that much depending upon economic volatility ... the amount of water that an individual uses doesn’t really change that much depending upon whether GDP is up 3 percent or down 3 percent.”

Not only is water infrastructure emerging relatively unscathed by the pandemic, Diserio explains, COVID-19 has actually helped to accelerate recognition of water — which is often overshadowed by its renewable counterparts — as a bonafide asset class.

Other sectors that are emerging stronger than ever seem to follow larger trends taking place in the economy, such as the shift toward 5G and cloud-based computing or ecommerce, according to Dylan Foo, senior partner, co-lead of infrastructure at Apollo Global Management. Similarly, he notes, advancements in technology related to battery storage, energy efficiency and electric vehicles are driving a lot of activity in the transportation sector.

Data centers, in particular, are booming as distance learning, working from home, and socialization through video calls have become the “new normal.” The defensiveness of digital infrastructure has become increasingly evident in the current economic cycle, as many facets of our lives — financial and healthcare information and consumer retail activity — move online. All of these things depend on the internet, which in turn depends on data center infrastructure.

There are several reasons why data centers are so defensive, according to Sam Bendix and Darob Malek-Madani of National Real Estate Advisors, who participated in a joint interview with IREI. The essential nature of data centers is highlighted by the diverse variety of tenants, regardless of their business or industry, that rely on data centers to support their operations, says Bendix. Malek-Madani adds that state-of-the-art data centers are structurally designed to weather extreme events in the world and are designed to stay online 99.999 percent of the time, regardless of earthquakes, extreme weather, or maintenance issues.

Post-pandemic opportunities

While it may still be too early to judge what performance will look like in the post-COVID-19 era or how quickly assets bounce back, on a relative basis infrastructure is primed to outperform, Butani points out. At present, all signs point to a robust post-pandemic environment rich with opportunities. For one, the pandemic, as a result of the deficits that are being run, may open up some new privatization opportunities for assets that are owned by governments, according to Vaughan. President Donald Trump’s administration is considering a $1 trillion infrastructure stimulus plan designed to reinvigorate the United States economy. The funds would go to roads and bridges, as well as 5G wireless and broadband infrastructure. This comes on the heels of a $500 billion transportation bill that was introduced by House Democrats earlier in June, focused on transit and railroads.

Experts also expect competition to be high, as a number of investors gear up to capitalize on market dislocation. In a report entitled Navigating New Opportunities, bfinance warns that new funds will face a lot of competition from existing vehicles as there remains plenty of dry powder in the market, even before the new funds that are being raised in 2020.

“When we additionally consider the turn-around private equity managers, who have the capacity to shift enormous firepower towards distressed debt in order to gain control of issuing entities, it becomes clear that there could be a bidding war for the ‘best’ opportunities,” states the report. It adds that with higher competition comes reduced returns for prospective investors, as well as trade-offs between deployment speed and risk/reward dynamics.

Noakes says Prostar is seeing a general shift away from risk by most managers, with greenfield opportunities generally stalling in most markets. They are also noticing a contraction in large-cap deals, as well, which is partially driven by the capital markets, but also by certain managers who have been focusing more on shoring up their portfolios than looking to put more equity to work. Bickerton adds the sectors exposed to travel will face the longest road back post-COVID-19.

While many question marks about the state of infrastructure still remain, experts all agree that the asset class is strong enough to take on COVID-19. What happens next remains to be seen, but poses a plethora of opportunities for investors.