The Investment Podcast

Episode 29: The Investment Podcast: Infrastructure – an industrial revolution?

20 March 2023

[Music]

Speaker 1: *The Investment Podcast,* brought to you by M&G.

Speaker 2: This podcast is for investment professionals only.

Romil Patel: Hello and welcome back to another episode of *The Investment Podcast*. My name is Romil Patel, and I'm delighted to be joined here today by Martin Lennon and Ed Clarke, co-founders of Infracapital. Infracapital is the infrastructure investment arm of M&G. It was founded in 2001 and today invests in more than 60 businesses across Europe. Welcome to you both, Martin and Ed. It's great to have you on today's show.

Martin Lennon: Thank you. It's good to be here.

Ed Clarke: Yes, good to be here.

Romil: Infrastructure as an asset class has come a long way with total assets under management, exceeding $1 trillion as of March 2022. Last year was a mixed bag, marked by uncertainty around rising inflation and efforts by central banks to exert some control. For infrastructure, the first six months saw the most active fundraising ever, surpassing $127 billion according to data provider, Preqin.

That slowed over the second half of the year as it became evident that the pace wasn't sustainable in terms of continued flows, but an impressive year for infrastructure nonetheless. Looking ahead, Preqin expects infrastructure to achieve a compound annual growth rate [CAGR] of 13.3% by 2027. Martin, what's been behind the rise of the asset class and where do we see the key opportunities today?

Martin Lennon: I think it's fair to say that infrastructure's come a hell of a long way since Ed and I first started plying our trade in the sector back in the early 90s. I think at its foundation is this absolute need for private capital to play an important role within the infrastructure investing asset class. Goldman Sachs predicts that something around €10 trillion of investments [are] needed in the European infrastructure asset sector by 2050.

What that's done is it's delivered a really diverse range of opportunities both by sector and geography. We focus on what we call the European mid-market space. That diverse set of opportunities has enabled us to invest in over 60 different businesses in 15 different countries, in 20 different sub-sectors over our period of investing.

On the demand side, clients have increasingly recognised the benefits of the infrastructure asset class. At its heart it's essential and resilient, which gives it the basis of which to be a strong performing asset class throughout the cycle.

Many investors see that as an important part of their diverse portfolio. Of course, it also has the ability to deliver yield and inflation, which has got a little bit more topical in recent months. Altogether we see a really broad and growing opportunity set. Some of the main themes that we've been following, which are still relevant today, are around decentralisation, obviously moving infrastructure away from the centre closer to the communities from which it serves, technology or digitalisation, and increased focus on sustainability and everything that brings.

Ed Clarke: What it feels like is the infrastructure space is going through a kind of industrial revolution at the moment. Historically when we started, what infrastructure was all about was investing in was existing, stable, secure assets like water companies, like electricity networks. What we've seen in recent years is the drive towards sustainable sources of power and energy needs – accentuated by the war in Ukraine – to have resilient local infrastructure, have driven a whole change in the way that infrastructure is provided. You layer on top of that the technological changes, and really it gives rise to a whole new set of opportunities, and we've really been working hard to play in that space.

Romil: If those are the trends, then Ed, what specifically have you been looking at?

Ed: We've had a number of key themes which really drive it. For me, one of the most interesting ones at the moment is looking at the way that big corporates are all setting themselves net zero targets, and then trying to backfill their supply chains, their processes to all deliver on that net zero promise. A great example in our portfolio at the moment is we have a business in the Benelux called Inland Terminals Group. It operates terminals inside the factories and distribution centres of major European corporates who receive goods coming up from Asia via the ports of Antwerp and Rotterdam.

What our business does is it moves them by barge to their distribution centres or to their factories, taking trucks off the road and allowing them to significantly cut their carbon emissions. On top of that, we're now working with some of those customers. Nike is an example where we're introducing hydrogen power barges to really make that leg of the supply chain carbon negative.

Romil: The barge example is rather interesting, particularly when it comes to taking road haulage emissions out. How do you see our role when it comes to plugging infrastructure gaps in order to deliver positive and measurable outcomes for our communities?

Ed: I think what we have a really crucial role in playing is delivering the capital that's needed to enable a lot of these projects and businesses to prosper. What we see is, as the world goes through this kind of industrial revolution, we see in some of the major corporates that used to be the traditional bellwethers of the infrastructure space – the big utility groups, the big telecoms groups – they often have small business units that are trying to develop and do things, but they find it difficult to access capital because it's not part of the core business.

A great example – we recently entered into a partnership with Fortum, one of the big Nordics utilities where we took a 70% stake in their electric vehicle charging business across the Nordic region. This business – probably the leading one in the region – had developed so far, but actually, the need to keep developing it required a lot of capital, which Fortum wanted to share the burden of.

We came in, took a 70% stake, and we've now actually taken 100% control of that business and are really reinvigorating the management and accelerating that growth, which is obviously a key part of the transition to electric vehicles in that region. I see our role as working with businesses, working with entrepreneurs, working with the major corporates to help the visions that they have about the development of infrastructure become a reality.

Martin: I think Ed makes a really good point here. Our role is not just to sign cheques, it's not just to give money to companies. We are valued because of our experience, whether that's entrepreneurial companies, as Ed mentioned, whether it's large corporates, whether it's start-ups. It's our experience and knowledge to actually be intelligent providers of capital that can actually add additional values around governance, strategy, new markets, you name it. That is a really valued commodity [and] I think part of the reason that we've enjoyed such longevity in the sector, frankly.

Romil: It's quite interesting that we look at some of the leading companies and not necessarily improving the performance of ESG laggards. What are some of the challenges in ensuring that the innovative companies that we are investing in continue to do so in order to help plot that path forward, operating within a sustainable window?

Ed: One of the real challenges of our time is the whole transition to net zero. I think a lot of people get the impression that that's going to be quite an easy and relatively quick process. I think the reality is that we are so heavily dependent on fossil fuels, that that transition is going to take a long time, it's going to take a lot of effort, and it's going to take very consistent political and government support to enable that change to happen.

I think what's interesting about the position funds like us have in the market is that we can really be an important part of that change and help those people. We've seen the demand for ESG from our underlying client base has led to us introducing at the company levels a whole raft of reporting strategies, initiatives to help deliver on those goals because we have the pressure, if you like, from our end clients. It's a virtuous circle and clear evidence that the power of investors is making a big difference in these important areas.

Martin: Beyond environmental impact, which is much talked about, the “S” and the “G” of ESG are equally important. One of the challenges that we and many of our portfolio companies face is around diversity. It's traditionally a very male-dominated set of industries and we really have to make long-term decisions to try and shift that diversity balance and put in initiatives such as training initiatives or thinking about recruiting from adjacent industries etc.

One of the things we do which really supports that is we have the benefit of having quite a large diverse portfolio of businesses. Whilst they might be in the same sectors, they might be in different countries or they might be in different sectors. We can bring that experience and knowledge together as we do periodically to really get a sharing of best knowledge and ideas and try and make sure that we act as more than a bunch of individual investments, but a collective infrastructure community, if I can put it that way. I think that's the best way forward to address some of these quite challenging systemic issues that we face.

Romil: Speaking of challenging issues, today that is inflation. Infrastructure is traditionally associated with a degree of inflation protection. What's the relationship between the two and how does the asset class offer protective benefits when it comes to inflation? As investors, what else can we do to de-risk and make our assets resilient?

Martin: I'm glad you made the point. I'm smiling slightly because those of us who have been around in infrastructure for a long time will remember that one of the core characteristics of the asset class is that it's a real asset class and therefore it does provide protection to inflation. We've all been a bit spoiled because inflation's been low and it's been stable for such a long time that we've lost sight of it. Of course, the last 12 to 18 months have put that back into prominence.

Actually, I think it's been a great learning experience for people that aren't that familiar with infrastructure and the inflation protection qualities that the asset class brings. Let's remind ourselves why infrastructure does provide inflation protection, and it comes in a variety of different forms. Regulated industries such as utilities very often have a regulated pricing model, which is reviewed periodically by the regulator of that particular sector. That normally provides for quite a significant degree of inflation passed through, so it's baked in to that regulatory model.

Equally infrastructure businesses that operate through long-term contracts, again, very often have inflation protection mechanisms embedded within those contracts, so another form of inflation protection. Even those infrastructure businesses that don't have those two qualities, if they have a strong market position, going back to that essential characteristic, then again, they're very well placed to be able to pass on inflation to their customers, be they business or otherwise.

Whilst I wouldn't say inflation is 100% perfectly hedged within the infrastructure space, I think if you look across different asset classes, infrastructure stands out as being one of the very best in times of high inflation. We still need to be mindful of the broader stakeholders. I think spikes in inflation can have very significant impacts on businesses and customers as we know.

We can't be complacent. We still need, as infrastructure business owners and managers, to make sure that we do everything we can ourselves to mitigate the impact of inflation rather than just relying on passing it through to the end customer. I think that way we continue to maintain our license to operate, if I can put it in that way, given the importance of the sectors that we invest in.

Ed: I agree with that and I think the watchword when we are looking for new investments to make is that essentiality is really the key component and that's what justifies the infrastructure tag. Essentiality, high barriers to entry and sustainability more and more at the moment. With those characteristics, then, the customer needs the service that you are providing, whatever the economic environment and that really gives you security and safety, which is why investors have invested so heavily in the infrastructure asset class of late.

Romil: Well, unfortunately, time eludes us. Before we wrap up, I'd like to come to you both for your final thoughts on what you are keeping an eye on amid the ever-changing conditions, and what do you ensure that you're not losing sight of with so much going on?

Martin: There's probably a couple of things I would say before Ed adds his comments, but I think we've had a long sustained period of supportive macro tailwinds for the infrastructure space really since the back of the global financial crisis. That's changed in the last 12-18 months. Whilst obviously there's potential threats around that, I think there's also yet a great degree of opportunity for the asset class [that] perhaps we haven't seen for some years.

I think one of those opportunities is around sustainability. As Ed said, there's been an amazing amount of requirement from investors and clients and so forth about data collection and understanding, for example, the carbon footprint of their businesses. Going back to the example of the barge that Ed made, we're starting to see, which is really quite exciting, the opportunity for sustainability factors themselves to be value drivers within our businesses, within our operations, if you know what I mean.

I think we're just scratching the surface of that and the whole world of sustainability will not just be about data collection, but actually using it as a force for good that not only benefits society, but actually should deliver greater performance and returns for our clients.

Ed: I think it's a really exciting period that lies ahead of us. The challenge as an investor is keeping on top of those type of changes. We've got a great track record of doing that, but you have to keep forcing yourself to keep refreshing what you're doing, keep looking ahead in different ways. So an exciting period, but definitely with some challenges to keep on top of.

Romil: Well, unfortunately, that's all we have time for in today's instalment of *The Investment Podcast*. We hope you enjoyed today's show. It's been a real pleasure to speak to you both Martin and Ed, and thanks indeed for sharing your insights.

Martin: Thank you.

Ed: A pleasure. Thank you.

Romil Patel: Thanks to you, our audience as ever for tuning in. We look forward to seeing you next time.

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice or forecast.

[00:16:15] [END OF AUDIO]