# The Investment Podcast

**Episode 9: A golden age for infrastructure?**
5 October 2021

**Alexia [00:00:32]** Hello and welcome to the Investment podcast. My name is Alexia Savva and I'm a Responsible Investment Associate at Infracapital, the private Infrastructure equity arm of M&G PLC. I'm joined here today by Stephen Nelson, Asset Management Managing Director with over 35 years of Infrastructure, commercial and board experience. Today, we'll be speaking to the global themes that are reshaping the nature of essential modern Infrastructure in Europe. Stephen, we're experiencing increasingly, fiscally constrained governments and corporates which have been exacerbated by COVID-19. At the same time, the current imbalance of supply versus demand in the European essential Infrastructure market is vast, and a sizeable investment need is driven by macro trends such as the decarbonisation agenda, the need to build back better and digitalization, to name a few. Additionally, we're experiencing greater momentum and traction from investors and society at large, across a wide range of ESG matters. This is from the climate crisis to Diversity and Inclusion and countries are regulating more heavily in this area. What are your views on how the macro environment is affecting the infrastructure space?

**Stephen [00:01:32]** Thanks, Alexia. Look, there is some really big-ticket stuff there. We're also just talking after the IPCC report, which basically says that if we're not careful as a planet, we're on the brink of a catastrophe. But the reason I just wanted to start with that was to in a way, set it aside, because I actually think we're at the cusp of a golden age in Infrastructure, which might sound a bit rich, given the point about climate but I will explain why. There have been other golden ages in Infrastructure. The Victorians had one - sewers, water, roads. Roosevelt had one in the 30s after The Depression, what with the civil works agreements that he pushed through. There was also a large post-war, Second World War reconstruction. So, why do I think that we're coming into a new era for Infrastructure? Well, let me just give you four reasons. I'm sure there are many, but I think that there are four from a high level. The first has to do with politics. The Biden Bill, which is now worth one trillion dollars - as a stimulus for Infrastructure, has just passed through the Senate. That means both the Republicans and the Democrats see why Infrastructure is important and we expect this to go through the House of Representatives later on in the year. A lot of that one trillion is going to be spent on the hard stuff - roads, bridges, electric vehicle charging stations, the electrification of school buses, broadband, power lines. It's very material and I think the first point is that when governments make fiscal expansion around Infrastructure at this level and, when the leading economy in the world does it, I think it's a signal to markets. I think the second point is both economically and politically driven. I think it relates to renewed confidence in supply-side financing, that's what lockdown in COVID, in one sense has done. We recognize now that governments have a role in expansionary fiscal policy, pumping money into the economies and actually pumping a lot of money into Infrastructure. I think the third is back to, dare I say it, the future of humanity and that's the decarbonisation agenda. Infrastructure is going to be central. It's not the only answer, but it is going to be central to solutions for this terrible problem that we face. Obviously, there is the sort of renewable side, on and offshore wind and solar but there's also a big trend towards carbon capture. So that's not reducing carbon dioxide, it is actually capturing the carbon dioxide that's already there and ready to be reduced and produced. Obviously, there is the transition from fossil fuels to more efficient energy production, transport, and telecoms. They've all got to play a role in the decarbonisation agenda. Then, I think the fourth point, from an investment perspective, is about investment risk. There's a lot of discussions right now around the rise of inflation, we've had years of remarkably, remarkably low inflation and therefore remarkably low interest rates in most advanced economies. There is, as I say, pressure and a lot of pressure, and I won't go into all the reasons why interest rates are likely to rise over the short to medium term. Part of the, I think, very interesting element here is the role of, at least in the UK, quantitative easing, which is, as I think most people now know, the way in which the government has issued or bought basically a huge volume of government bonds, as well as corporate bonds now totalling close to about nine hundred billion. What's the point of raising that in regard to investment risk? Well, interestingly, the issuance of those bonds through the asset purchase facility, so the issuance and the purchase of those bonds, leads to a shortening of the maturity of the liabilities that the government sits on relative to all gilts markets. The fact is that if interest rates start rising, then the impact of the QE purchases which the government has made, partly to finance COVID, will be felt at a more rapid rate than the interest rate pressures exerted through the non-QE gilt market. Now, that might all sound a little bit technical, but for investors what does that mean? It means that likely, with the rise of inflation, the rise of interest rates and the acceleration and impact that QE will have on interest rates, that Infrastructure is likely to become increasingly a really good and defensive asset class.

**Alexia [00:06:53]** Thanks, Stephen. I think that there are some interesting topics there to unpack. You touched upon the decarbonisation agenda, clearly it being mission critical, and some of the new and nascent sectors that are coming out to play there, coupled with investors and their hunt for steady yields in the back of the macroeconomic outlook. How would you define the risk and return profile for new Infrastructure and some of the sectors that you touched upon, but also existing Infrastructure? And how is this being shaped by that macroeconomic outlook?

**Stephen [00:07:24]** Yeah, it's really interesting, isn't it? I mean, look, this is just my personal view, but I think that one way of thinking about it as an Infrastructure investor is for different classes of risk. So just putting this kind of basically, there is a set of risks associated with technology and innovation, which investors have to take a very specific view on, primarily through technical advice and due diligence. What I mean by that is, if you're investing as we do at Infracapital and M&G in, for example, battery technology (firms which are developing battery technology) what you are having to weigh up is OK, lithium batteries versus solid-state batteries versus hydrogen. These are actually very important to your 5, 10 and 15-year investment horizons because it's such a dynamic market. I think a second way of looking at risk is that those markets where you've already got networked opportunities, and where the demand is much more easy to, if you like, assess, but where a land grab and rolling out of those networks is the name of the game, and carries a different kind of risk. What kind of markets? Broadband. We know that people are demanding much more broadband width with the increased video usage, on and on. So, it's not so much that we can't see the demand, but how are you going to roll out and at what pace and at what cost? And are you going to get the sites that are going to be more, rather than less valuable? Another market which I happen to be involved in is electric vehicle charging. For example, we invest in EV [electric vehicle] charging in the Nordics, a really dynamic market. So again, with no doubt, you can see government policies really moving consumers towards electric vehicles by 2030, 2035 and 2040. But how do you get the best sites? How do you get them at the right price? How do you get the right returns? Finally, I also think about the class of risk but what I think is really relevant, is planning and regulation. We shouldn't underestimate as investors the challenges of looking forward both on investment subsidies, which governments like to put forward in various jurisdictions for wind and solar, but also emerging technologies such as tidal. You have to take a long-term view. You have to weigh up and make investment judgements around not only subsidy but also, on occasion, the risk of retrospective changes in regulation. We as investors suffered that in the solar market in Spain. So, innovation technology, the networking of new assets, new investment assets and planning regulation, I think are kind of new classes of risk, well not new, but very dynamic classes of risk, which need to be thought about.

**Alexia [00:10:24]** Yes, clearly there's an abundance of opportunities for experienced Infrastructure managers that new risks that are emerging with macro trends as they develop. How are we also seeing capital markets support and drive some of these key themes?

**Stephen [00:10:42]** Yes, so how is this all getting paid for? Good question. Look, I think we have really good grounds to be optimistic. Again, taking the high ground on the way in which capital and capital markets can direct huge flows of money towards good outcomes, both in Infrastructure and more specifically in the ESG space, which I'll talk about. I've mentioned QE, which is the U.K. central bank's approach to pumping money in and a lot of that will be going into Infrastructure. But we've got this ESG agenda, and I think many of us have started to hear about the green bond market. Actually, the green bond market is a subset of the wider market called the sustainable bond market. Within that wider market, you've got social bonds, which is about affordable housing and microfinance, and you've got sustainability linked bonds, which are a combination of green and social, but green bonds, are specifically bonds that are issued to purchasers that relate to environmental outcomes. Let's just start with the numbers around this bond market. By the end of 2019 into 2020, over a trillion dollars of sustainable bonds had already been issued, which I think is a very telling statistic and a massive recent acceleration. Within the last 12 months, the estimate for the sustainable bond issuance is around 650 billion of which thereabouts 50% (375 billion dollars or so) is green. This is already a developed and significant market. Roughly speaking, this is 5% of the total 130 trillion bond market. So, 5%, there is still some way to go, but it's growing and growing rapidly. Just let me clarify, a green bond is a bond which in structure is very similar to a standard bond, but it comes with a non-binding commitment from the issuer that they will deliver environmental outcomes. This is what makes it quite exciting, and we can talk about what those outcomes might be.

**Alexia [00:13:08]** Yes. It's encouraging to see the growing levels of capital that are flowing into this space, to put money into important environmental but also social issues to the wider sustainable financing. How do we avoid greenwashing this space? So, you spoke to the non-binding nature of them. Clearly, in the private space, there are challenges in providing tangible evidence and data that prove the sustainability of business operations. What are you seeing here?

**Stephen [00:13:37]** Yeah, well, look, we should recognise that a lot of these bonds are actually quite regulatory lite or covenant light. As you say, it is a non-binding commitment. So that means that the emphasis put on verification by purchasers is really high, and that, again, puts a real emphasis or pressure on the importance of how the proceeds are being used, does the issuer actually fall under something? It is a clunky word, but do they fall under the taxonomy of a green company or a company or issuer with green credentials. Then, there is tracking, monitoring, and reporting. We as M&G and Infracapital are getting deeply involved in the importance of that. That's If you like, at a working level. Right up at the governmental level we know, particularly in the EU, that there is a lot going on in terms of EU directives around task forces on climate-related disclosure and non-financial disclosure. So, perhaps boring as this sounds, this whole standardisation is massively important to the proper functioning of a new bond market, because what we don't want, nobody wants, frankly, as an investor, as a purchaser and indeed as an issuer, a market which is compromised by, as you say, greenwash.

**Alexia [00:15:13]** Yes, definitely. As you speak to the increasing regulation, the traction from investors in this space is requiring greater disclosure on data, which will provide greater transparency on ESG matters and how we begin to document those.

**Stephen [00:15:32]** Sorry to interrupt but I may have a slightly wild thought. I think that in, let's say, 10 years' time, not five, data such as carbon dioxide generation will be second in importance in reporting terms, in sustainability statements and investment decisions as P&L data. It will become almost as standardised, if not as standardised as that because of the climate challenge that we have. I think it's that important.

**Alexia [00:16:03]** Yes, definitely. If anything, the IPCC report has brought that further to light. We've spoken about the macro trends at play and what this means for the infrastructure industry. How does all of this play out on a real kind of day-to-day basis in the management of infrastructure concepts?

**Stephen [00:16:19]** Well, I have the great and fun job of working with companies in this space. These are the assets that we invest in on behalf of pension funds principally, and our limited partners. I think this is where it really gets real. You have to, as an asset manager, you have first to say and clarify with the management teams who run these assets, "Okay, what's the mission here? What is at stake and what are the standards we require?" That's quite a nuanced debate, because if you just took every aspect of, let's call it ESG, that you could and you issued a 150 if not a 250-page questionnaire and say we want to be market leading in all of those elements, you'd be in la-la land. You have to make choices and how you make those choices, smart choices, how you scale those choices relative to the size of the business is actually a part of the skill. I mean let me take, and this is a social one rather than environmental, diversity. I'm associated with Gigaclear which is the leading rural alt-net broadband provider in the U.K., which I chair. It's got about 450 people and growing very rapidly. The diversity debates, targets, and aspirations that we will have at that board are going to be very different from a solar business, which we also invest in, or several, where there's a handful of people managing the solar panels. So, I think you've got to make some decisions there around what is the mission and what are the standards. I think the second thing you have to really pay attention to is soft skills, inspiring busy people to get with this agenda. That's not because people are resistant, but people have very busy lives. We're all very busy. There is an element of leadership and one way to do that is commercial. It is to actually show the data that ESG businesses, when they're run on solid ESG credentials, are better run businesses. And guess what? Better run businesses tend to be more valuable. So, there is an economic outcome from this, and I also think there's a financing one. There is emerging data around the credit worthiness of a company's assets where they have high ESG credentials relative to those where the ESG credentials are lower. I think the last thing, Alexia, is as an asset manager, we provide support. For example, and I know you've been involved in this, we think, okay, standardisation is really important. Let's get a third-party provider to help gather CO2 data on a standardised basis across all the assets. We then take away that quite onerous task of collating the data and we get it importantly on a like for like basis. All of that nitty-gritty stuff is really important when the rubber hits the road, so to speak.

**Alexia [00:19:31]** Yeah, definitely. I think that as we're transitioning from a rhetoric of very ambitious commitments to now being followed up and supported by action and data, setting that materiality of ESG factors is important. Well, thank you, Stephen, for sharing your insights on what was an interesting discussion and one that I guess we could speak about at length. Thank you also to the listeners of the investment podcast and please do get in touch with Infracapital and M&G PLC as we are keen to carry on the discussion on this important topic.

**Stephen [00:20:06]** Thank you very much.

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