Infrastructure investors' legitimacy challenge

Hermes head of infrastructure **Peter Hofbauer** explores how populism and protectionism could hurt private sector investment unless the infrastructure industry embraces change

Q Which sectors do you currently believe to be the most exciting in Europe?

PH: As an infrastructure investor, excitement is not the first thing we look for. We are focused on identifying opportunities that deliver our clients their desired investment outcomes. Our clients are typically looking for stable, long-duration, yielding investments that provide some inflation protection and attractive risk-adjusted returns. So, that's the opposite end of the spectrum to exciting.

In terms of where capital deployment is needed across Europe, however, clearly the decarbonisation agenda is key – so, renewable energy. It's not only decarbonisation, it's the energy security objectives of various governments. Then there is the EU 2020 strategy, improving transport networks to enhance carbon reduction and stimulate economic growth and productivity by reducing congestion as certain regions become more urbanised.

The broader reconfiguration of European energy networks to accommodate an increased level of distributed generation flowing from renewables, and the transition to a pan-European smart grid to drive efficiency in terms of usage of energy, are also important.

In addition to those policy drivers, there is still a significant amount of investment required in existing networks, such as water, to meet the needs of growing populations and to increase efficiency.

Q Which geographies do you consider to be most attractive?

> There's an old saying that pioneers get shot at

PH: Under our current client mandates, we can invest in all of the major developed markets – the UK, continental Europe, the US and selectively in other OECD countries. We tend to look at opportunities in those countries that have really high standards of governance, because when you make infrastructure investments you are investing for a very long time. Obviously, rule of law, political stability and economic stability, and the appropriate level of growth, are all important.

On top of that, we are also increasingly looking for jurisdictions that are accepting of foreign direct investment. If a region is not welcoming to foreign investors or doesn't require FDI to meet its needs, then in the medium- to long-term that could represent increased risk for an institutional financial investor, given the duration of some of our investments. So, it doesn't necessarily come down to the highest returning markets. It is about the markets that offer the best risk-adjusted returns.

Q What are your views on the emerging hybrid sectors that we are seeing, driven by advancements in tech, such as data centres, electric cars and battery storage?

PH: There's an old saying that pioneers get shot at. Those types of asset do not fall in our current definition of infrastructure. Investment in those sectors would not be mandate-compliant and would represent strategy drift and increased risk for our current mandates. That may not be true of every manager, depending on what has been agreed with clients. But we are fairly prudent and risk-averse, and these new hybrid asset classes that straddle the private equity and infrastructure industries are not our key focus.

Q How is technology impacting areas that you do focus on?

PH: Our view is that tech advancement is going to have a material impact on the infrastructure industry. In some cases that may be disruptive, in other cases it may be productivity enhancing.

There is an argument that technology is

already disrupting, with regulated utilities feeling the indirect impact of improved service standards offered by other industries post-digitisation. Consumers expect higher levels of customer service – around personalised communication and connectivity via smartphones, for example – and some utilities have found it challenging to embrace those developments.

On the flipside, there is no doubt innovation will bring huge opportunities, whether that be from a technical perspective, in terms of engineering process or simply digitisation. Because of the scale and breadth of infrastructure, how many people it touches and how it impacts you daily, the upside must be significant.

Q What are the biggest challenges facing infrastructure investors right now?

PH: I think the biggest challenge for private sector investors in infrastructure globally is the uncertainty brought about by the increasingly volatile political landscape. There is ever more protectionism and increasingly interventionist policies being introduced in response to populist public opinion. At the same time, the need for new infrastructure investment has never been greater and governments' capacity to invest remains constrained.

There has been questioning – and in some cases not unreasonable questioning – as to the legitimacy of private sector ownership of critical infrastructure. The commitment to long-term stewardship and constructive engagement with all key stakeholders is more pressing today than ever. How the industry responds to these challenges to its legitimacy will be critical to the future role for private capital.

Q What about concerns regarding overheating in the market?

PH: On the debt front, we have seen lenders become more borrower friendly in recent years, in terms of covenants and margins and more recently even leverage levels, particularly in relation to structurally subordinated debt. That is far more prominent now than it has been for many years. There is clearly mission creep in that.

On the equity side, it is more challenging to determine whether or not returns are too low and pricing too high. All asset classes have seen a significant rise in value and significant drop in returns, driven by central bank liquidity. On a relative basis, infrastructure is generating the same margins to the risk-free rate that it did say 10 years ago. But on an absolute basis, clearly returns have dropped in line with reduced risk-free rates. We are cautious about valuations and only pursue opportunities where we have significant conviction.

> "In order to positively influence other people, private sector investors must genuinely embrace responsible investment practices

Q What is your approach to dealing with challenges that come the way of assets you are invested in?

PH: We focus on preserving capital, first and foremost, through looking extremely closely at downside risk mitigation. We carry out pre-mortems rather than post-mortems and we constantly and proactively engage with portfolio companies, co-shareholders and stakeholders when managing our investments.

I think we are clearly at a point in the regulatory cycle where a combination of low interest rates, a lagging regulatory review process and some of the legitimacy and customer service questions I mentioned before, mean that some regulated companies are facing challenges associated with resetting and right-sizing their businesses to meet the requirements of those stakeholders.

We are working very closely with them to help them meet those demands. We do that firstly by looking at ensuring appropriate governance frameworks are in place. These businesses are in some cases intergenerational – change and challenge will therefore inevitably confront them at some point. By putting in place a fit-for-purpose governance framework enables them to address those challenges effectively, as and when they arrive. Secondly, ensuring those companies attract and retain best-in-class management talent within a fit for purpose governance structure is a relatively powerful formula for ensuring businesses perform in way that is responsible and delivers acceptable returns to our clients for the long term.

Q What do you think will be the most significant evolution in the infrastructure space over the next few years?

PH: I really think it will be this issue of the legitimacy of private sector capital investing in public service infrastructure. It is a debate that has to be had and it is appropriate that it does. I hope it can be done rationally. But in order to positively influence other people, private sector investors must genuinely embrace responsible investment practices and demonstrate to other stakeholders that they are trustworthy stewards of society's critical infrastructure. If those standards are adopted, then I think there will be ongoing broad acceptance of private sector investment in essential infrastructure assets. But if they are ignored, I think people could possibly look for a different model. ■

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