March 23, 2023

Capitalizing on infrastructure opportunities

A deep understanding of the underlying businesses in question remains critical, in terms of underlying revenue, cost and value generation levers, as well as risks.

- Recent experiences in Germany are reminders of how essential infrastructure is, and how policies can help, instead of hinder energy supply diversification.
- If risks are properly managed, well-diversified portfolios of infrastructure projects have the potential to offer comparatively safe and predictable return streams.
- For retail investors seeking to enter an unfamiliar asset class, taking a cautious and selective approach makes sense.

Two megatrends continue to reshape infrastructure investing. As previously pointed out, Vladimir Putin's latest war on Ukraine and the resulting global cost of living crisis have boosted a variety of infrastructure investments, notably in renewable energy.[1] All over the world, investors and policymakers are trying to speed up the energy transition, as well as enhancing quantities and security of energy supplies. In turn, the need for accelerating private infrastructure investments is making it easier for traditionally less active groups, including retail investors, to gain better access to the asset class. These policy responses deserve to be welcomed, but only cautiously.

Winter has been extremely challenging in Europe, despite significant progress in preparations throughout 2022. These have been surprisingly speedy, especially in Germany. To assess what has changed, and what else will be required, projects aimed at security of supply are a good place to start. Specifically, take the North Sea port of Wilhelmshaven, about an hour's drive away from Bremen. After years of bickering over terminals for liquified natural gas (LNG), a new one was recently completed there in record time. The decision was taken in February 2022. All project steps (approval and construction) were done by November 2022. LNG has been arriving in Wilhelmshaven since December 2022, playing a crucial role in getting Germany through the winter.

So far so good and already, we see similar tendencies in the field of wind energy and solar energy, in terms of significantly shortening previously notoriously long administrative approval processes.[2] The reason to be only cautiously optimistic is that Germany's system of decentralized administration makes it very hard to know whether and how to extrapolate from the success in Wilhelmshaven. Will support for speedy decisions be equally energetic when the project in question is not national headline news at a time of crisis? What if instead, we are talking an urgently needed stretch of high voltage transmission line, widely opposed at the level of federate states? Or, a potentially extremely productive windfarm an excellent, windy location that has long been held up by vocal, local opponents, including elected decision makers at level of municipalities or rural districts? Anyone familiar with developing energy projects

[1] More than just a potential inflation hedge (dws.com)
[2] See, in particular: Mehr Energie aus erneuerbaren Quellen | Bundesregierung

in Germany will have come across plenty of such examples. Despite encouraging moves at the federal level since February 2022, it remains to be seen how this will actually translate into practical changes at the local level in 2023, especially once the immediate sense of crisis passes. Even the governing coalition in Berlin has recently appeared rather hesitant and fractured on the topic.[3]

This points to a broader paradox in thinking about the asset class. Infrastructure has always been essential to the proper functioning of society, the economy and the well-being of citizens. However, it sometimes takes a crisis, such as a nearby war or a pandemic, to bring home just how costly previous policy errors have proven to be. In Germany and beyond, the previous reliance on gas supplies from a single supplier created dangers, not just in geopolitical and security terms, but even when it comes to addressing the basic needs of citizens. At least for a while, that should lead to better policies, while at the same time creating scope for new pitfalls.

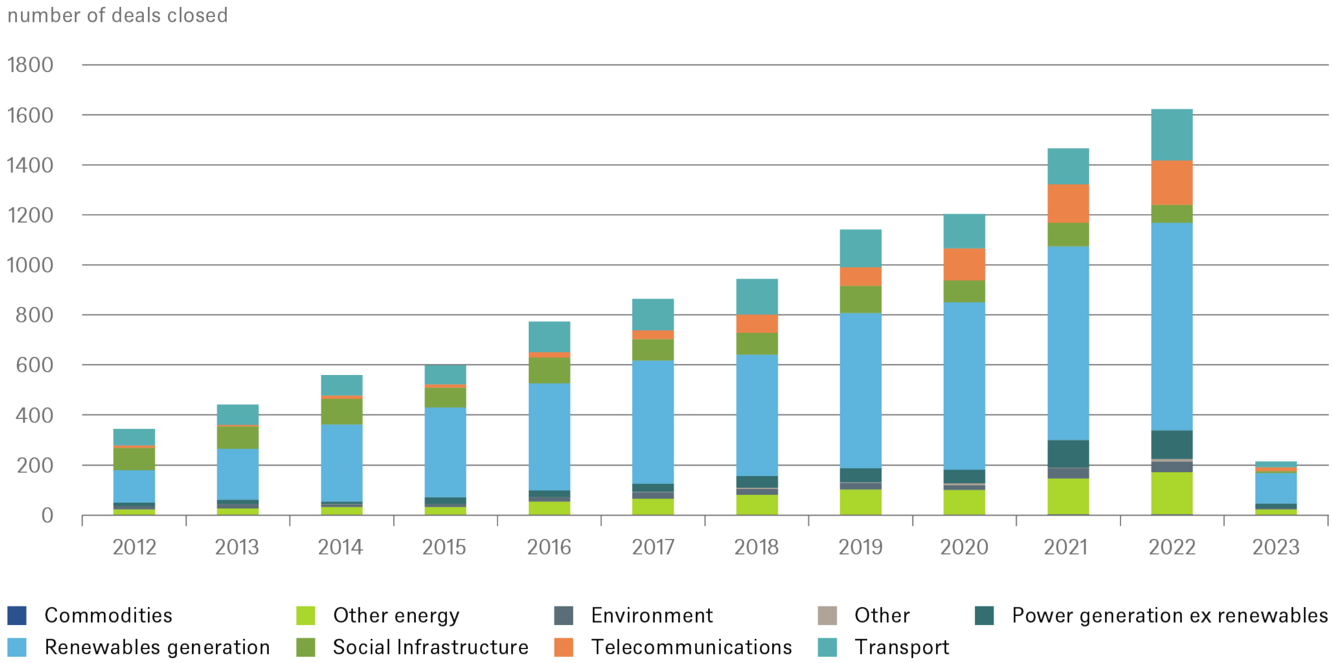
Such thinking also underpins the second trend: making infrastructure investment more accessible. The basic motivation behind this has long been clear, including at the European Union (EU) level. As we have argued, large amounts of capital are needed to cover the investment needs in the area of energy supply, but also in the area of infrastructure overall to facilitate Europe's energy and digital transformations decision makers are aiming for.[4] If Europeans wish to secure their current high standard of living and lay the foundation for future prosperity, significant investments will be required in the coming decades to transform European economies, reduce external dependencies and build a sustainable industrial landscape.

Current sources of capital (governments, banks, institutional investors) will not suffice to close the existing financing gap. At the same time, private investors have so far been hindered in investing in this asset class, with some vehicles requiring high minimum investment amounts or onerous reporting requirements. All over Europe, this is beginning to change. To once again take Germany as an example, the new Fondsstandortgesetz ("German Fund Jurisdiction Act") passed in 2021 implements EU rules in harmonizing the playing field for green infrastructure investments; moves supervision towards digital information exchanges; and creates new opportunities for fund products specifically aimed at a retail audience.[5]

This too is to be cautiously welcomed. For good reasons, infrastructure has long been favored by many institutional investors. For centuries after the initial industrial revolution, traditional transport infrastructure projects, such as railways and toll road projects, have often wholly or partially relied on private funding; indeed, the very idea that in modern industrialized countries, these should be provided by state entities rather than private enterprises is largely a comparatively recent development of the 20th century.[6] Electricity generation, notably from onshore wind, offshore wind and solar have risen in prominence in recent decades and represent the lion's share of completed transactions over the past decade, as shown in the chart below. Most probably, this will not change in the coming decade, either, since the move away from fossil fuels is an irreversible process that gradually penetrates all areas of private and corporate activity. Together with well-functioning grids and backup facilities for when intermittent renewable electricity is not available, renewables are seen as essential as Europe tries to wean itself from fossil fuels.

[3] Germany is at last tackling its long-standing economic weaknesses | The Economist
[4] https://www.dws.com/en-gb/insights/global-research-institute/a-framework-for-european-transformation/
[5] Deutscher Bundestag - Bundestag beschließt Stärkung des Fondsstandorts Deutschland
[6] For revealing examples on privately funded infrastructure booms gone wrong in mid-19th century North America, see Surowiecki, J. (2004), The Wisdom Of Crowds: Why the Many are Smarter than the Few and How Collective Wisdom Shapes Business, Economics, Society and Nations, Little, Brown, esp. p. 50-68.

THERE IS MORE TO INFRASTRUCTURE THAN JUST RENEWABLE ELECTRICITY GENERATION



Sources: Infralogic, DWS Investment GmbH as of 3/16/23

Two other types of infrastructure also need to be mentioned. Over the past 20 years, digital infrastructure projects, such as data centers, cell towers powering mobile telephony, and fiber optic networks have grown in prominence, as the growth in internet usage boosted the need for physical communications infrastructure. Increasingly, facilities to provide health and education, such as hospitals, universities and schools and other social infrastructure projects are also seen as important parts of the asset class, even if the number of deals in these areas remains modest for now.

What all these segments have in common is that one way or the other, they underpin citizens well-being, as well as economic activity and thus prosperity. At the same time, judging their attractiveness as investments requires careful analyses, not just segment by segment but asset by asset, to thoroughly understand the underlying revenue, cost and value generation levers available to the business in question.

To be sure, the quasi-monopolistic nature of many infrastructure assets means that final customer demand often tends to be inelastic. In general, they are therefore usually able to push through higher costs to customers through increased fees or tariffs. To put it bluntly: Most people would rather not go to a restaurant or order a pricey bottle of wine during a cost-of-living crises, if that means being unable to afford heating their homes.

Inelastic demand, however, will only deliver decent returns if risks are properly understood and managed on an asset-by-asset basis. To continue with the above example, most people would rate having a home as more essential than eating out. In itself, though, the inelasticity in demand for housing and shelter has not always made investments in residential real-estate a winning proposition everywhere. Indeed, the rules governing new open infrastructure funds aimed at enabling German retail investors to finance infrastructure project companies are partly based on those of German open real estate funds. The later have repeatedly run into troubles, most spectacularly following the global financial crisis of 2008.[7] Rules have since changed to avoid those specific problems for real estate, but it remains to be seen how well they work in infrastructure. Most probably, there will be some learning by doing, for asset managers, investors and regulators alike, with some potential problems and risks only becoming obvious with the benefit of hindsight.

Policy responses can be unpredictable. To take just a few topical examples, last summer's very threat of many European households facing a cold, costly winter, brought affordability concerns to the top of the agenda for many regulators and other policymakers. The former often have the ability to limit regulated assets' capacity to react to changing economic conditions under existing regulatory regimes. The later are frequently tempted to interfere with existing economic arrangements, imposing, for example, windfall taxes on assets following periods of outperformance. All this have impacted how quickly infrastructure assets have been able to adjust revenue streams to boost or at least maintain residual cash flows. For some infrastructure assets, higher costs of capital and material inputs also pose earnings risks. And of course, with interest rates rising and likely to remain higher than they have been for many years, the impact on discount rates and infrastructure valuations continues to be increasingly felt across the asset class.

If risks are properly managed, returns from a well-diversified portfolio of infrastructure assets have the potential to offer comparatively safe and rather predictable return streams for investors, while at the same time contingently contributing to societal well-being. And for newly launched retail products, we believe there should be no shortage of projects to choose from in coming years. In Germany and elsewhere, government plans see plenty of new green generating electricity coming online until 2030. Beyond that, related projects such as upgrades to power grids, will also need to be financed. A practical example are power grids in Germany from north to south, which bring the electricity generated by offshore wind farms in the north to the areas in southern Germany where many large, energy intensive industrial areas are. Then there are projects geared toward the energy transition, from electricity storage in the form of batteries, to hydrogen and innovative smart grid projects that balance supply and demand responses. But for retail investors seeking to secure attractive returns in an asset class they might have limited familiarity with, taking a cautious and selective approach makes sense. Not least in terms of who to entrust their hard-earned money.

[7] Immobilienfonds als Milliardengräber (faz.net)

GLOSSARY

In business administration, the cost of capital is the cost incurred by a company in using equity capital for investments or in obtaining debt capital for them.

The discount rate is the interest rate charged to commercial banks and other depository institutions for loans received from the country's central bank's discount window.

The European Union (EU) is a political and economic union of 27 member states located primarily in Europe.

Liquefied natural gas is the name given to liquefied processed natural gas cooled to -161 to -164 °C.

A monopoly is a market with only one supplier.

Open-end funds are funds whose shares can be issued and redeemed at any time.

Price elasticity describes the relationship between a change in a good's demanded quantity and a change in its price.

Important Information

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