Infrastructure Strategic Outlook 2024

H2 2024 Market Update

IN A NUTSHELL

- The infrastructure asset class has seen its performance continue to weather the higher rate environment. Data from a range of private market benchmarks now point to another strong year of equity returns in 2023, although conditions in 2024 for businesses will remain challenging from a macroeconomic perspective.
- Sectors with a high reliance on capital expenditure have been under the greatest scrutiny from the prevailing rate environment and have thus seen pressure on valuations. Elevated construction and labour costs compounded the pressures from an increase in the cost of capital.
- As interest rates fall, we expect the transaction market to gather pace, which should address the liquidity constraints in the fundraising market. The delay in cutting rates and resultant reticence to bring assets to market has replaced the denominator effect as the key factor impacting fundraising.
- Elections continue to be front-of-mind for infrastructure investors, and appetite for data centres continues to grow. Although the additional AI-driven demand has bolstered an already bullish pipeline, cloud storage, data sovereignty and capacity constraints are all factors that are expected to drive additional data centre requirements.

Infrastructure Strategic Outlook 2024 – Market Update

Infrastructure's resilience continues to be tested

At the beginning of 2024, optimism with regards to rate cuts led to expectations that the infrastructure market would begin its recovery. However, as expectations for early rate cuts swiftly shifted to cuts coming later in the year, the infrastructure market remained in defensive mode, with a lack of transaction activity leading to a restriction of funds flowing into the market. Even in this environment, the performance of the infrastructure asset class has remained robust. Looking forwards, with inflation having fallen and economic growth expected to be unremarkable, infrastructure's defensive characteristics will again be front and centre of investor minds.

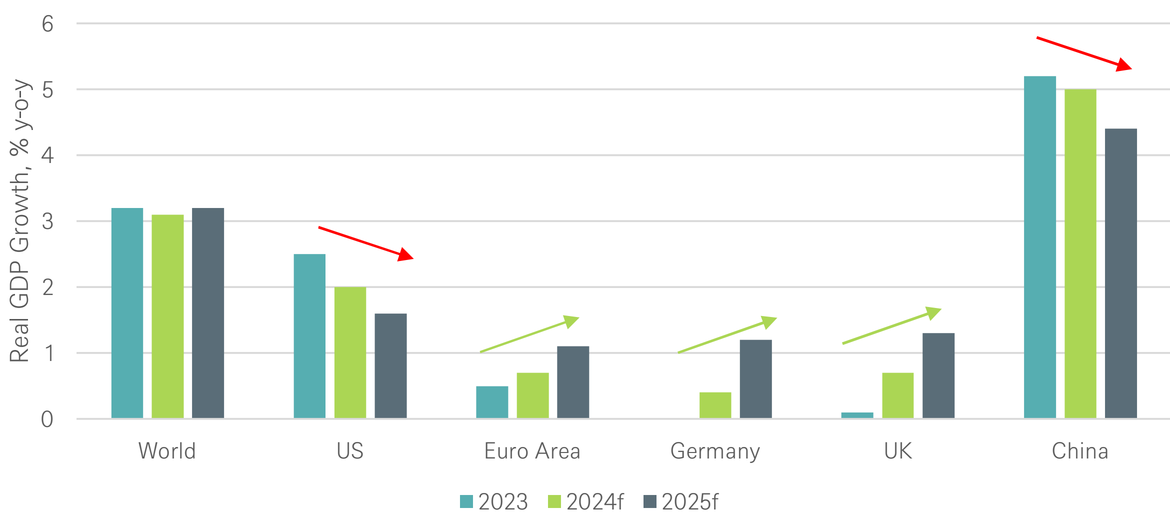
1 / Macro Update

Inflation and interest rates are expected to fall, which should provide some relief to infrastructure from a costs perspective, but at the same time there is likely to be less of a lift to earnings from higher inflation.

1.1 Interest Rate Cutting Cycle Begins

Interest rates have remained higher than expected in Europe and the United States, but the inflationary spike that central banks have been aiming to tame has now largely passed; the European Central Bank (ECB) began its cutting cycle in June and the Bank of England (BoE) and Federal Reserve are set to follow suit over the remainder of the year. The short-term impact of this macro picture is significant for the infrastructure market given the lift to earnings the inflationary environment has given to some assets, while higher interest rates have increased debt-servicing and capital expenditure (capex) costs. Significantly, a rate environment which is lower should assist in bringing more transactions to market as both buyers and sellers feel the market and assets have accounted for and adjusted to higher rates.

Chart 1: Real GDP Growth Forecasts, % Year-on-year



Source: DWS Investment GmbH as of July 2024. Note: f = forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

Economic growth in Europe is expected to accelerate, but the combination of rates remaining elevated and weak external economic conditions as the Chinese and American economies slow could cap growth in the region at unremarkable levels[1]. Private consumption should become a larger driver of the growth picture with inflation having fallen and wages risen, although investment levels from businesses and industry might limit growth prospects in areas like construction. Again, this growth scenario will be important for the performance of the infrastructure asset class; although all assets should have downside protection, merchant assets that have benefitted from higher inflation in recent years will now be more exposed to the slow

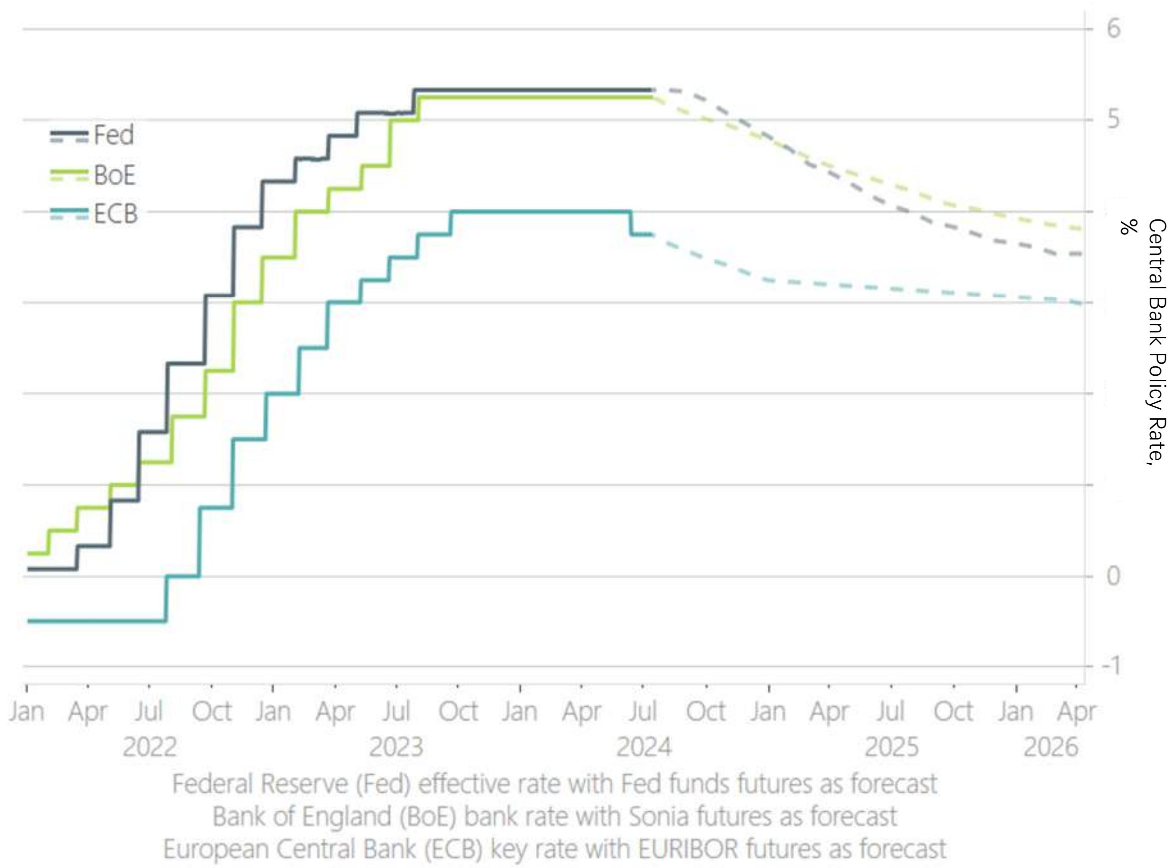
[1] Oxford Economics, DWS Investment GmbH, June 2024.

growth environment without the benefit of elevated levels of cash generation. Contracted and regulated businesses with more secure demand profiles should present more robust returns profiles in a weak demand environment, although we note there remains pressure on regulated assets from regulators with regards to cost-of-living pressures and regulatory review periods.

1.2 New Economic Normal

It remains to be seen how the economic picture will evolve over the longer-term. After years of benign inflation and low interest rates, the previous economic equilibrium has certainly come to an end, but the level at which inflation and rates may settle will be driven by numerous competing themes. From an inflationary perspective, the key thematic investment trends of demographics, digitalisation, deglobalisation and decarbonisation could all keep spending levels elevated. However, the unknown productivity impact of greater efficiencies derived from the use of artificial intelligence (AI) and other technology could be disinflationary. As it stands, rate cut expectations have been moderated thus far in 2024 as economic growth and core inflation have remained above expectations. This gives a good indication that it is highly unlikely that cuts will head towards previously dovish levels. However, with the peak of the inflationary period related to the post-pandemic and Russia-Ukraine crisis now having passed, intertest rates are expected to become more accommodative[2].

Chart 2: Central Bank Policy Rate, %



Source: Macrobond of July 2024. Note: August 2024 onwards = forecast. Forecasts are based on assumptions, estimates, views and hypothetical models or analyses, which might prove inaccurate or incorrect.

[2] Oxford Economics, July 2024.

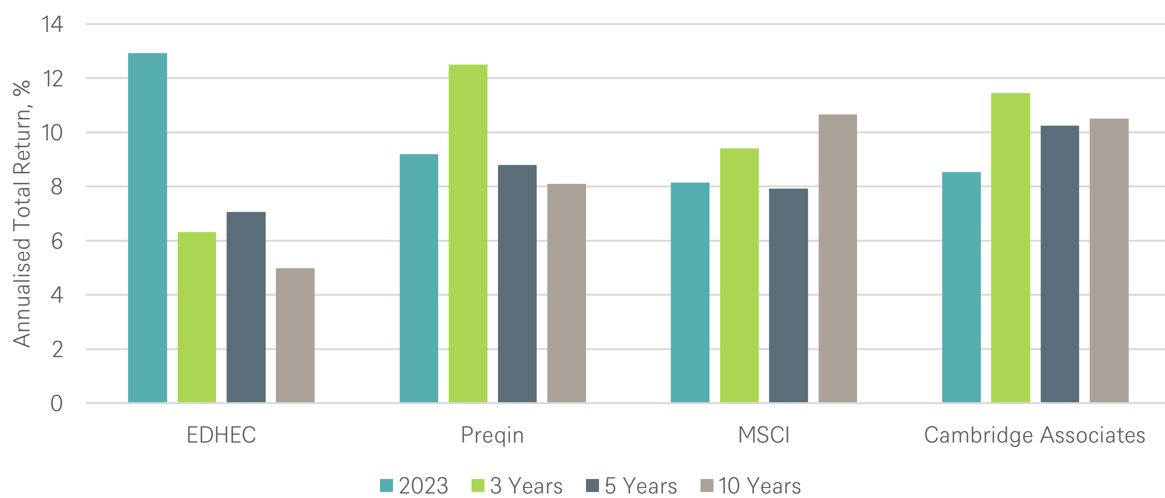
2 / Market Update

Unlisted infrastructure equity produced a consistently strong performance in 2023, with a range of private market benchmarks confirming this. In 2024, returns will face pressure.

2.1 Consistent performance throughout volatility

Despite the challenging macroeconomic conditions, the infrastructure asset class performed strongly over 2023. Both asset-level and fund-level benchmarks highlight infrastructure asset characteristics such as strong market position and inflation linkage as fundamental to delivering in the range of 8-13% total return in a year where other asset class benchmarks struggled to be in positive territory. This puts 2023 in line with 3-, 5- and 10-year annualised total returns for the asset class, highlighting the low-volatility nature of infrastructure returns and how they can help provide stability within portfolios.

Chart 3: Private Infrastructure Benchmarks, Annualised Total Return, %



Source: USD, Value Weighted Indices - Preqin Infrastructure Index, EDHEC Infra300, MSCI Global Quarterly Private Infrastructure Asset Index , Cambridge Associates Infrastructure Index. Data as of July 2024. Note: EDHEC and MSCI data show asset level performance, Preqin and Cambridge Associates show fund level performance.

As expected, returns thus far in 2024 seem to be moderating, reflecting the weaker lift to revenues from inflation – which has now fallen in most markets – and the costs of doing business, which have increased due to higher borrowing and labour costs. The EDHEC Infra300 benchmark shows a year-to-date (YTD) total return of -0.5% as of July 2024, while the Q1 2024 YTD total returns for the MSCI and Preqin indices stand at 2.62% and 5.0%, respectively[3].

Buyer-seller expectation gaps have been a key concern within expectations for the infrastructure market's performance, as other real asset classes have seen significant discounts as the impact of the higher rate environment was factored in. Examining differences between benchmarks can be instructive in explaining how infrastructure did not follow a similar path from a returns perspective. If assets were priced under a purely mark-to-market methodology, then asset prices would likely have reacted in

[3] Inframetrics, Preqin Pro, MSCI Private Assets, July 2024.

line with movements in other long-dated asset classes such as government bonds or real estate. However, given infrastructure assets are unique by nature and can offer returns uncorrelated with the broader market, asset pricing is less driven by market dynamics, plus, overall, discount rates have not moved significantly. Rather, business plans impacted by higher costs have seen some downward revisions to valuations, but it has not impacted the market at-large. Comparing the quarterly capital growth components of total returns of the MSCI Private Assets Infrastructure Index and the EDHEC Infra300 shows this divergence, although note that the constitutent assets within the benchmarks do differ so the business characteristics may also drive some of this.

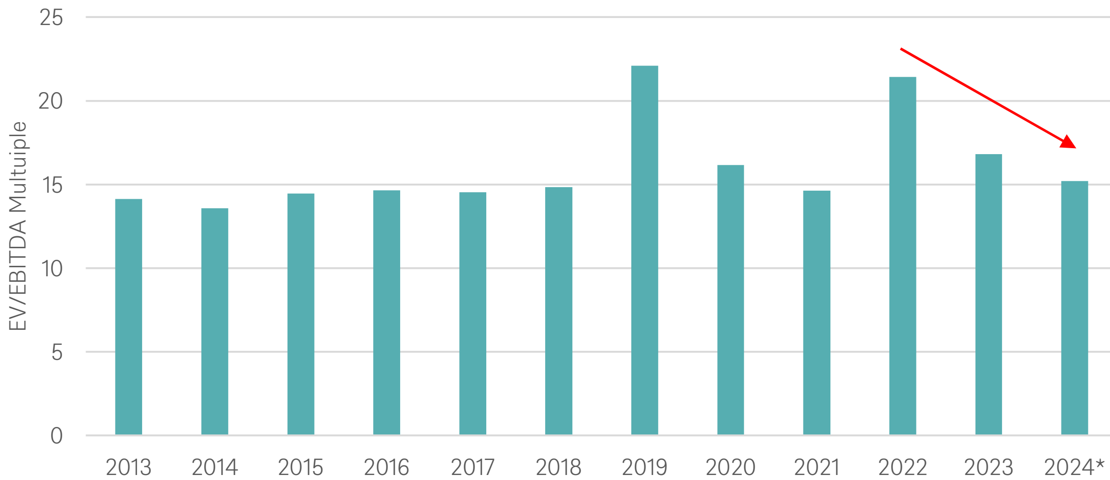
Chart 4: Unlisted Infrastructure Equity Indices, Jan 2021 - Dec 2023, Capital Return Growth, %

Source: EDHEC Infra300, MSCI Global Quarterly Private Infrastructure Asset Index. Data as of June 2024.

The lack of significant broad-based discounts in the market is in line with what has been witnessed in the transaction market thus far in 2024. Average EV/EBITDA multiples achieved on closed infrastructure transactions has declined relative to 2023, but not to levels which would be considered discounted to the historical range[4]. Again, in a higher rate environment those businesses which have a significant reliance on capex to fuel revenue growth have seen costs increase and profitability come under pressure. Fundamentally, many of these sectors – such as fibre and electric vehicle (EV) charging infrastructure – typically benefit from long-term secular tailwinds which can present investors significant capital deployment opportunities, but short-term pressures on capital deployment will see intense scrutiny on business models.

[4] Infralogic, July 2024.

Chart 5: Average Closed Infrastructure Transaction EV/EBITDA Multiples, x

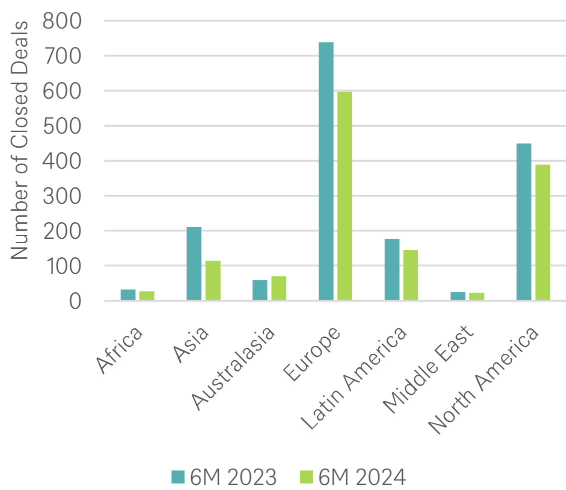


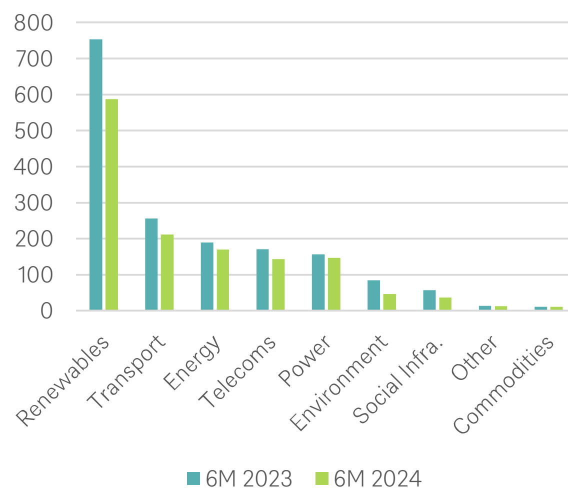
Source: Preqin, Infralogic, DWS Infrastructure Research, June 2024. Note: Aggregated EV/EBITDA averages above are derived from over 900+ transactions with data available. *2024=YTD.

While delayed beyond original expectations, with terminal interest rates now reached and the cutting cycle underway, the infrastructure transaction market should begin to accelerate over the second half of 2024 and into 2025. The European transaction market has remained the largest from both a value and volume perspective , while we continue to expect transport to be a key area of opportunity in the months ahead as the post-Covid recovery is realised and assets are brought back to market[5].

[5] DWS, Infrastructure Strategic Outlook 2024, https://www.dws.com/insights/alternatives-research/infrastructure/infrastructure-strategic-outlook-2024/

Chart 6: Closed Number Of Infrastructure Transactions – First 6 Months, By Region (LHS) and Sector (RHS)



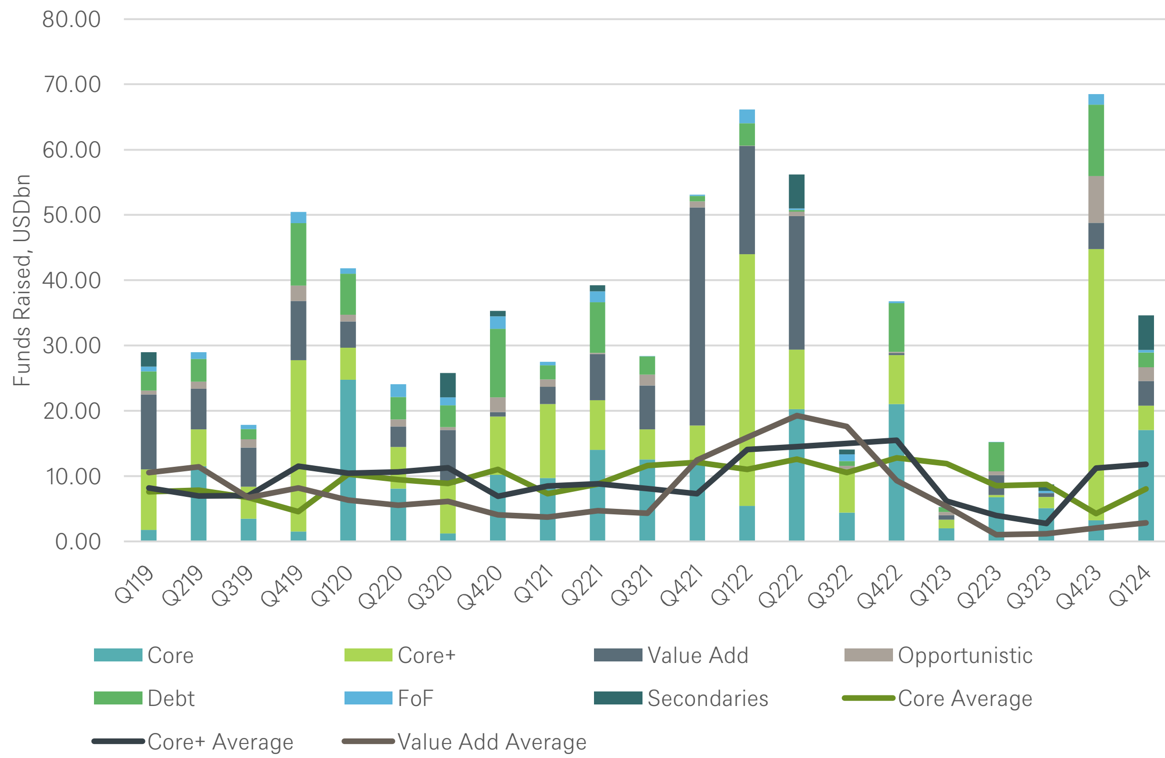


Source: Infralogic, July 2024.

The recovery in the transaction market will be fundamental in supporting fundraising activity. A lack of capital returned to investors has seen allocations to infrastructure in 2024 stall, or at least not return to the levels seen in the record-breaking 2022 fundraising year. In Q1 2024, more capital was raised for infrastructure than in the first three quarters of 2023[6]. This aligns with infrastructure investor survey results which continue to point to a greater desire to allocate capital to infrastructure and that the denominator effect has largely passed. However, liquidity will likely only return to the fundraising market once a higher volume of transactions are completed, with investors set to be writing smaller tickets up until that point.

[6] Preqin Pro, July 2024.

Chart 7: Infrastructure Fundraising, By Strategy



Note: Average represents 4-quarter rolling average. Source: Preqin Pro, May 2024.

Movement of capital towards infrastructure continues to be targeted towards larger funds. This is a natural evolution of the asset class as more capital has flown into the sector, with large-cap generalist funds occupying the top of the market along with major private market players entering the market and injecting capital through M&A. These trends create opportunities in the mid-market segment of the asset class, particularly Core Plus assets which can be scaled up through business growth to become large-cap assets, supplying new large-cap assets. There is a comparatively small pool of large-cap assets for an increasingly large pool of large-cap investors to deploy capital into, and as the auction market begins to pick-up with the transaction market, larger players may dominate access to more traditional assets, driving other investors to look for newer assets to acquire.

3 / Investment Outlook

We continue to see value in the European Midmarket for the infrastructure asset class given the potential for diversification, value and a strong regulatory environment. Within this context, political risk remains a salient issue for investors and the digitalisation thematic continues to draw attention to data centres and their role in facilitating the growth of artificial intelligence (AI).

3.1 Political Risk Remains In Focus

Much of the political risk for the infrastructure market that was highlighted in the 2024 Strategic Outlook may materialise in the second half of 2024. Numerous elections across Europe have taken place in June and July, resulting in shifts in governing power in, for example, the UK and France. While there will be resultant changes in policy, we remain fundamentally positive on the European infrastructure market because of the broad-based strength of the policy foundation for infrastructure. The European Parliamentary elections are instructive in this sense; while the make-up of the parliament members have shifted following elections in June, the key policy drivers – including Commission President Ursula von der Leyen – are still in place to push forward with a policy agenda focused on facilitating private capital investment in areas such as the energy transition and European economic independence. Consensus in the European market towards the need for energy security and digital capabilities help ensure that the policy environment will remain supportive and continue to evolve to address the needs of investors in future.

Conversely, when looking at political risk in other markets, more binary outcomes such as those in the upcoming November election in the US could see significant disruption to future policy making in thematic areas like the energy transition. While we view it unlikely that a change in administration would see significant changes or a rolling back of the Inflation Reduction Act (IRA), new policy formation in that space – such as demand side support for sectors where the IRA has focused on supply stimulation – is less likely. Such policy formation is more likely to be focussed on more traditional energy sectors.

3.2 Drivers Of The Data Centre Boom

Amidst elevated political risk and a transaction market that remains subdued, data centres remain an infrastructure sector that attracts significant investor interest and that has been more resilient from a valuations perspective relative to other digital assets. Data centre market capacity forecasts were already bullish prior to the release and early adoption of artificial intelligence (AI) capabilities, but now further capacity is expected to be required; in Europe alone, AI-dedicated capacity could potentially drive twenty-five percent of data centre growth up to 2035[7]. The spread between conservative, baseline and optimistic market scenarios for future data centre capacity growth is wide, but certainly capacity demand is set to increase, and we expect three key trends to drive market development:

- Cloud demand/digitalisation: Outside of the AI story, continued growth in cloud service requirements should remain the chief driver of data centre demand as the digitalisation of industries continues to gather pace.
- Sovereignty: As with other strategic sectors, there is a drive within Europe to increase domestic data storage to ensure data is held under the jurisdiction of national data privacy laws. Additionally, as AI becomes viewed as a strategic sector by governments, there will be a greater need to have domestic processing power to develop national AI capabilities.
- Resource constraints: Combined with the desire to develop more domestic data centre capacity, the saturation of existing data centre markets like the FLAP-D (Frankfurt, London, Amsterdam, Paris and Dublin) region, could see the development of new data hubs, predominantly where land prices and data centre development costs are lower and there is available renewable energy and grid connectivity.

[7] Morgan Stanley Research, 'European Data Centres to Grow 5x by 2035', February 2024.

AUTHOR

Richard Marshall
Head of Research, Infrastructure

Important information