Infrastructure in the post-pandemic world

Infrastructure outlook for 2022

Global economy stutters, but still on track with recovery

The infrastructure sector continues to be resilient with robust performance across debt and equity. The sub-sectors worst hit by the pandemic are showing green shoots, recovering in line with the macro environment.

We see some challenges to the economy around supply chain disruptions, inflation and rising infections. At the same time, we also see strengthening market and policy tailwinds around decarbonisation and digitalisation, which support performance and investment volumes.

This article will highlight several key themes for the infrastructure sector in 2022.

Theme 1: Supply chain disruptions

The current supply chain crisis stems from four main factors: increasing consumer demand; lower production capacity; labor shortages; and logistical challenges. During the pandemic lockdowns, spending on consumer goods increased, partly boosted by stimulus packages and the inability to spend on services. Factories and logistics infrastructure were unable to keep pace, especially as many source countries such as China operated zero-COVID-19 policies.

The Baltic Dry Index, which measures the cost of shipping raw materials, increased by 2.5 times between January and mid-September, before falling 50% in October and November. This recent drop in the Index may be a sign that the supply crisis is easing. However, it could take some time before we see more slack elsewhere in the supply chain, as structural issues such as truck driver shortages could take years to resolve.

For infrastructure investors, there are some winners and losers across the sectors. Assets exposed to freight, especially ports, rail, and logistic infrastructure are performing strongly. However, projects currently in the construction phase may experience cost overruns and delays. For example, many greenfield renewable projects around the world are having difficulty securing solar panels and wind turbines due to global supply chain bottlenecks.

Theme 2: Decarbonisation

The COP26 conference took place in November 2021 against the backdrop of a global energy crisis. Perhaps it is not surprising then, that the outcome was underwhelming. Many of the announcements made at COP26 are aspirational without tangible policies. This leaves it up to individual countries and organisations to set local policies.

This year, the EU introduced the Fit for 55 proposals that aimed at reducing emission by 55% (of 1990 levels) by 2030. The centerpiece of the proposal is to expand the EU Emissions Trading Scheme (ETS) to more sectors (e.g., shipping) and to tighten emissions.The package was a major contributor to the doubling of the ETS price over the past year to EUR 70/tonne. We expect this to provide tailwinds to the switch to low carbon fuels and towards cleaner transport.

The US also made a major announcement regarding the reduction of methane leakage at oil and gas production sites. Since methane has 84-86x more global warming potential than CO2 as a greenhouse gas over 20 years, a commitment to reduce methan leakage by the US, which is the largest oil and gas producer in the world, would have a material impact on climate change.

Across energy infrastructure, renewables remain attractive due to secular tailwinds, although some new projects are facing supply chain constraints. On the other hand, fossil fuel exposed infrastructure will face increased regulatory headwinds. Finally, energy storage will also become an increasingly important piece of the energy transition puzzle, and new opportunities will continue to emerge as the sector matures.

Theme 3: Digitalisation

Digitalisation is a universal theme, and data consumption growth continues to drive digital infrastructure investments. High-speed internet became a necessity for most households during the pandemic, and there is growing evidence that consumers are willing to pay a premium for faster internet connections.[1]

In Europe, investments continues to go into full fiber with strong government support, as the number of fiber-to-the-home (FTTH) subscribers is expected to more than double between now and 2026. On the other hand, US high-speed internet rollout is a mix between 5G and fiber. US wireless capex is forecast to grow to almost USD 40 billion by 2022, vs. the USD 30 billion average annual spend in the last 10 years.

For investors, telecommunication infrastructure across towers, fiber and data centers are all attractive investments, given the long runway for global data consumption growth. However, the pandemic has also put a huge spotlight on the sector. This can be viewed as a double-edged sword – on the one hand, it could attract more market liquidity and government support, but on the other hand, it could also attract more competition and regulatory scrutiny.

Private infrastructure market performance

We saw strong fundamentals across our equity, senior secured and high yield strategies in 2021. Energy transition and digital assets performed well and continue to make up an increasing share of transactions. These features mirror the broader market trends below.

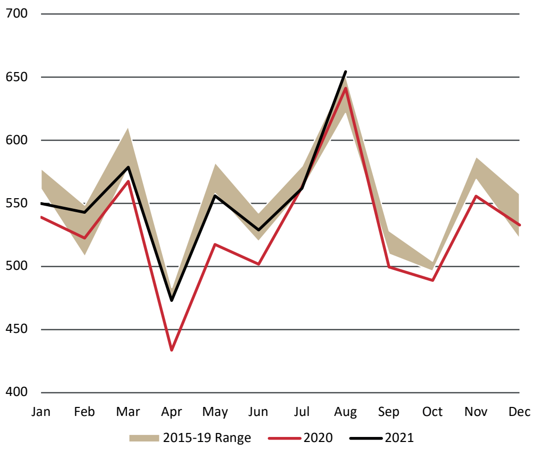
Infrastructure equity

Infrastructure equity recorded strong performance for the year to June 2021 with MSCI reporting a total return of 8.6%. This follows a relatively resilient 2020 – in the circumstances – with total returns of 1.8%. These MSCI returns are in line with the returns from EDHEC of 9.2% for the year to September 2021. As with the previous year, the income component of returns remained stable at around 5%, highlighting the quality of cashflows coming from essential infrastructure assets.

Infrastructure debt

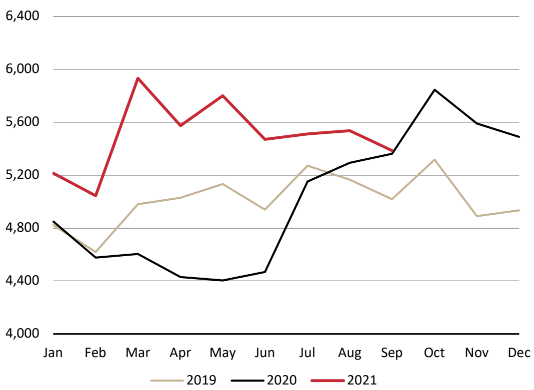
The infrastructure debt market continued to be resilient in a challenging market environment, with significantly lower defaults and downgrades versus corporates in the year to March 2021. This reflects the essential nature of infrastructure assets, as well as the structural protection which is common to infrastructure financings. Apart from a brief period in 1Q20 when public market spreads widened to reflect market uncertainly, private infrastructure debt has offered a sustained premium versus public corporate bonds. This premium is required by investors to compensate for the investment being perceived as less liquid. However, for infrastructure, it is more than an illiquidity premium, it is a complexity premium, which is made up of the ability to source, structure and execute complex transactions.

Figure 1: Electricity supply (US and Europe) (TWh)



Source: Bloomberg, November 2021

Figure 2: Container volumes (EU and top 5 US ports) (000 TEUs)



Source: Bloomberg, November 2021

Final thoughts

The infrastructure sector continues to recover well from the pandemic, showing robust risk-adjusted returns. We see a strong recovery in transportation sectors as economies re-open. Furthermore, the two themes that we consistently highlight, decarbonisation and digitalisation, continue to show very strong fundamentals and benefit from positive political support. While we are optimistic about the outlook for infrastructure, our conviction is somewhat fragile in the short-term due to rising infection rates and supply chain concerns. Secular tailwinds and government support will continue to grow the investable universe for infrastructure, although attractiveness of each opportunity could vary significantly depending on region-specific market dynamics and local policies.

FOOTNOTES

1 UBS Evidence Lab – European Telecoms Consumer Survey, August 2020

UBS