KEYNOTE INTERVIEW

The inflation effect

LPs are rigorously interrogating managers' inflation protection credentials and those strategies with the highest correlation are likely to prove fundraising winners, says Campbell Lutyens' Gordon Bajnai

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Q How is infrastructure fundraising being impacted by the current geopolitical and economic environment?

Infrastructure has been one of the fastest growing private markets asset classes in recent times and total assets under management in closed end infrastructure funds is about to surpass $1 trillion. Annual fundraising, meanwhile, has ranged between $120 billion and $140 billion consistently in recent years and 2022 got off to a particularly strong start, with almost as much capital amassed in the first six months as in the previous 12.

Indeed, supply of infrastructure fund offerings has been significant and growing. By our calculations, there are around 350 funds currently in the market, looking to raise an aggregate $250 billion. However, geopolitical shocks, combined with the switch to a high inflation environment, has caused a sudden slowdown in fundraising as many LPs temporarily press pause on their investment activity. So, if I had to describe the current fundraising environment, I would probably say that while it isn't a car crash, there is certainly a significant traffic jam.

Q But infrastructure is typically considered to be a safe harbour in times of economic turbulence. Do you expect appetite to pick up relative to other asset classes?

Absolutely. When a traffic jam clears, cars pick up speed once again and that is what I think we will see here. The arrival of a higher-for-longer inflationary environment marks the start of a new chapter in investing and after this temporary slowdown in fundraising, I think infrastructure will be a relative beneficiary of this changed macroeconomic environment.

After all, infrastructure's number one selling point has always been that it is less GDP correlated and more inflation protected than other asset classes. In fact, inflation is actually accretive to returns for some infrastructure strategies and revenue models. We have recently conducted a major LP survey which found that the vast majority of investors expect to increase their allocations to infrastructure going forward. That isn't going to happen immediately. It will probably start to come into

effect from next year onwards. But I do believe that demand for infrastructure will grow relative to other private markets asset classes as a result of this new macroeconomic environment.

Q How is the emphasis of investor due diligence shifting to reflect the changing economic backdrop?

The number one question that LPs are asking when they are introduced to a new fund is what is that manager's track record when it comes to inflation protection. Any GP looking to raise a fund must, therefore, have completed a comprehensive inflation sensitivity analysis. This is typically carried out asset by asset and then combined to offer a portfolio-wide perspective.

GPs must also be prepared to answer questions about the investment thesis that they follow and how that will be impacted by inflation. And, of course, inflation not only impacts revenues and costs, but also interest rates. LPs are therefore increasingly asking questions about the cost and tenor of leverage, whether that leverage is fixed rate or floating, and what all of that means for expected returns.

Meanwhile, rising interest rates also have implications for both entry and exit valuations. A higher base rate and riskier economic environment will increase the discount rates used to discount future cash flows, which should theoretically bring down exit valuations. That is, of course, a concern for investors who want to understand how well protected existing assets in a portfolio are likely to be from this trend.

Conversely, however, at some point, this should also lead to the opportunity to invest in new assets at lower valuations, which should go some way to redressing concerns that many investors have had over high prices, particularly in certain infrastructure segments, for some time. In short, inflation will impact the revenues and cost base of infrastructure assets; it will impact the cost of leverage and it will affect both entry and exit valuations. LPs will need to assess all of this in relation to the specific asset categories that a GP invests in and that will impact their decision on whether or not to commit to a fund.

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Q Does a high inflation environment also intensify political risk in the infrastructure space?

I do think that political risk and regulatory risk are intensified in periods of high inflation or in periods where energy prices are skyrocketing, as we are seeing right now. Politicians have a strong inclination to change market regulation, be that pricing systems or regulatory formulas, in environments such as this and LPs are paying close attention to this topic. Contracted assets, or assets with offtake agreements with investment grade counterparties are being viewed more favourably as a result, as they are less exposed to this kind of regulatory risk.

Q What role do exchange rates play in investor decision-making?

The relative strength of the US dollar when compared to other currencies around the world is certainly a growing concern for some non-US LPs, because it makes investing in US dollar funds more expensive. LPs are making judgement calls on whether or not the dollar is going to revert to the norm in terms of its value against the Euro, for example, as well as the Japanese Yen, Korean Won and numerous other currencies around the world. If that doesn't happen, it could have a material impact on returns. This is a topic of discussion that has just started to emerge over the past couple of weeks.

Q Are you seeing any shift in appetite among the various risk parameters from core through to value-add as a result of the economic environment?

A lot of money flowed into core infrastructure during the pandemic. This was largely because the level of negative yielding investment grade bonds around the world went from around $7 trillion to $17 trillion, which left institutional investors looking for fixed income alternatives with a similar risk profile but positive yield. Core infrastructure became the obvious beneficiary.

We see continued interest in core infrastructure today. However, in this higher inflation environment, more consideration is being given to the absolute return expected from core assets going forward. That is leading some investors to take refuge in higher returning core plus and value add strategies, where inflation is deemed to be less of a concern. Meanwhile, those asset classes right across the risk/return spectrum that offer particularly strong inflation protection, and where IRRs may even be positively impacted – not just 100 percent inflation correlation but more than 100 percent – will be in extremely high demand.

Q What sectors are proving particularly popular?

The one silver lining in this otherwise exceedingly challenging fundraising environment, is the energy transition. The tailwinds that already existed in this sector are blowing more strongly than ever before. The drive to combat climate change was already the single biggest mega trend driving infrastructure allocations before the Russian invasion of Ukraine. Since then, energy security has become equally important with decarbonisation on the political and investment agenda – which means the force of tailwinds has doubled.

It is important to recognise, however, that energy independence means different things in different geographies. In the US, energy independence could theoretically be achieved by activating more shale gas and oil fields, whereas in Europe, there is only one way forward: pushing further away from traditional fossil fuels. That makes energy transition assets a clear winner in the current environment, alongside assets concerned with LNG, which is a clear medium-term winner of these changes.

Q How significant an impact is regulation having on energy transition infrastructure?

The regulatory environment is extremely supportive. In Europe, there is SFDR, of course, and our recent survey shows that a significant majority of LPs believe that Article 8 fund classification is going to become a must-have in the near future and Article 9 assets are also in high demand. But there is other regulation around the world that is proving beneficial for the sector as well.

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The Inflation Reduction Act that was recently passed in the US is providing well targeted economic incentives. The SEC has also proposed reporting and monitoring guidelines for sustainability. Australia has passed an important piece of legislation and Japan and other jurisdictions are also moving in the same direction. Germany, meanwhile, has increased its incentives around renewables as a result of war in Ukraine. The regulatory backdrop, generally, is definitely favourable.

Q What are investors looking for in an energy transition manager?

What I can certainly say, is that investors are not willing to make compromises when it comes to returns. They are not prepared to sacrifice financial performance for a positive impact on climate change. And they don't need to. There are GPs within the energy transition space that cater to every appetite on the risk/return spectrum, from 6 to 7 percent super core funds to 20 percent-plus IRR higher risk strategies.

And while we see a significant number of energy transition specialists, particularly those focused on certain segments such as offshore wind, solar and more recently hydrogen, we are also seeing some of the largest players in the market announcing decarbonisation strategies across their existing portfolios. The energy transition is not just about power generation and distribution, it is also about the decarbonisation of classic infrastructure, including aviation assets, railways and ports, for example. We have even seen some firms starting to use the secondary market to access capital to fund the decarbonisation of existing assets. That is a new development that is just beginning to emerge. With new challenges, innovative solutions will emerge within the infrastructure asset class. ■

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