

Infrastructure investing: Increasing financial stability and prosperity

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Infrastructure has evolved as an investment asset class. With increasing investment needs, the participation of private capital has increased as well. However, a funding gap remains putting economic development at risk. The 2008 financial crisis has shown that infrastructure contributes to higher resilience of the financial services sector. Hence, policy makers are well advised to further improve the conditions for privately funded infrastructure build-out. This will improve confidence in financial services offerings as it stimulates economic benefits and increases portfolio stability.

Situation today

Infrastructure investment needs have increased over time. In the late 1990s, annual global investment needs were below USD 2 TN¹. Until 2040 they are expected to increase to nearly USD 4 TN annually. The Infrastructure Outlook of the G20 Global Investment Hub expects total infrastructure investment needs of USD 94 TN until 2040. This implies a funding gap of USD 15 TN² as shown in Figure 45.1.

The case for privately funded infrastructure

Therefore, stimulating infrastructure investments and closing the funding gap will contribute to GDP growth. Longer-term GDP gains might even be higher if these investments are not financed by public budget deficits³.

¹Credit Suisse (2016), *Airport Anyone? Investing in Infrastructure*

²Global Investment Hub – A G20 Initiative, *Investment Outlook (2020)*, refers to 2016–2020 time frame; <https://outlook.gihub.org/>

³Jeffrey M. Stupak (2018), Congressional Research Service, *Economic Impact of Infrastructure Investments*

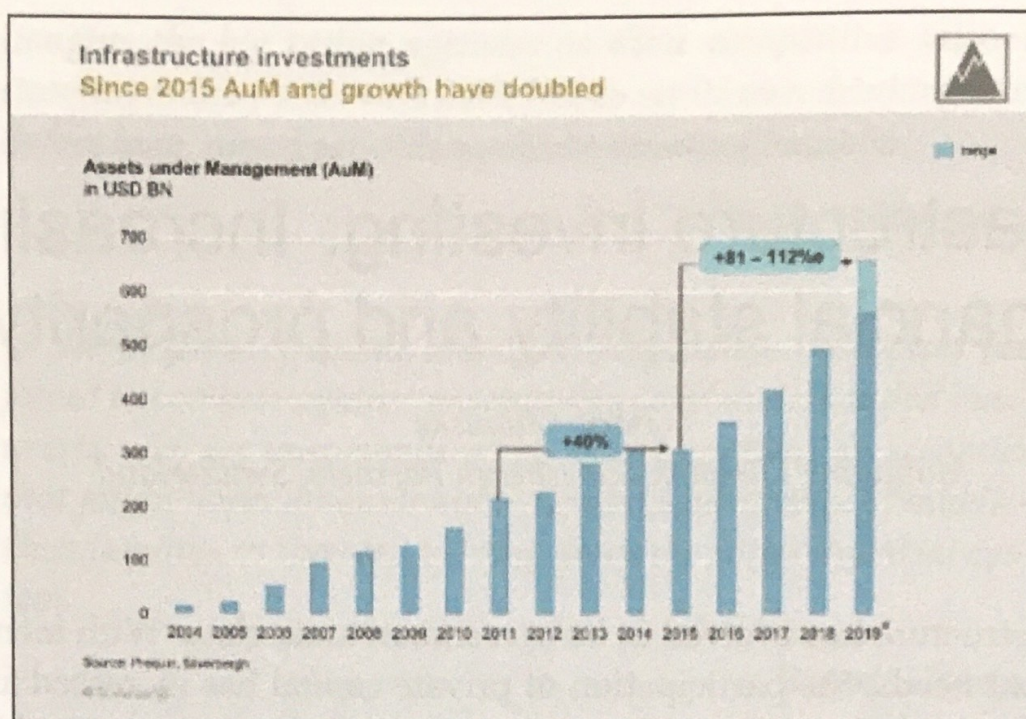


Figure 45.1: Infrastructure-Investments

From an investor’s perspective, infrastructure is less risky than corporate bonds. It exhibits lower default rates, higher recovery rates and better ratings compared to corporate bonds. Moody’s rated 92% of infrastructure securities ‘investment grade’ compared to 42% of corporate bonds⁴. Additionally, core infrastructure functions as a diversifier in investment portfolios vs. stocks and bonds given it’s neutral to negative correlations⁵. This is a set-up for a win-win situation.

On the one hand, the public sector is challenged to finance its traditional obligations.

On the other hand, employees are asked to increase their provisions for retirement. This provides capital to finance infrastructure build-out.

What investors require...

In order to match longer-term cash-flow profiles and liabilities, investors—especially insurance companies and pension funds—allocate capital to infrastructure in particular through infrastructure debt. As such they do not seek maximum returns but stable and reliable returns. They require three elements.

⁴Moody’s (2017), Default research: Infrastructure Default and Recovery Rates, 1983–2016

⁵JP Morgan Asset Management (2019), *The correlation conundrum: Why diversification is more than “stocks vs. bonds”*

1. Visibility over high quality infrastructure investment project pipelines.
2. A stable regulatory framework mitigating political and regulatory risk. This refers to value levers directly linked to project performance like revenues, costs and contextual considerations like tax regimes and trade policies.
3. Transparency over project performance across the project lifecycle and on the key volatility drivers with the ability to influence project returns⁶.

...and what is lacking

From a European perspective, significant progress has been made to develop infrastructure markets. The European Fund for Strategic Investments (EFSI) in cooperation with the European Investment Bank (EIB) has contributed significantly not only through capital commitments to this development but also through a clear institutional framework. However, member states might further develop their national frameworks allowing for more investment activity and deal flow.

1. Project pipelines: Pipelines vary in quality which translates into exposure to volatility, e.g. geological conditions, construction, and technology risk, uncertainty about planning processes, and revenue recognition.
2. Regulatory framework: At times the investment process lacks certainty and transparency. Hurdles have been a) post investment changes to initial revenue/tariff schemes (renewable energy in Southern Europe), b) opposition to facilitate private co-investments (Germany), c) unclear risk sharing mechanisms, or d) dependency on 3rd party stakeholders.
3. Project performance: There is a lack of clarity how to measure project performance and how to compensate investors also in the case of changing project assumptions.

Digitization as a risk management lever

Digitization of infrastructure can take a key role in helping to reconcile public and investor interests. Measuring performance has never been easier and available at lower costs than today. Sensors are increasingly integrated into

⁶Silverbergh Partners (2017), Managing Infrastructure

fixed and mobile infrastructure (rolling stock, locomotives, ships etc.). Infrastructure performance data (e.g. usage, status, cash flows) can be attributed to the respective assets through the IIoT⁷ platforms. This allows one to disaggregate risk-return profiles, and to reliably and timely document investment performance⁸.

Implications for the regulatory agenda

Regulators and policy makers can enact a set of initiatives already today.

1. Provide updated high-quality project pipelines: Assess and evaluate each project from an investor's perspective. Invest in narrowing down volatility drivers and develop a mitigation response.
2. Upfront de-risk (some) infrastructure projects: Australia and New Zealand develop infrastructure projects to operational maturity. Once they are in operations and have proven to be successful, they are sold. The public sector collects revenues which are then used to further develop the infrastructure pipeline.
3. Establish a risk-sharing scheme and conflict resolution mechanism and integrate them into contractual frameworks. For illustrative purposes let's take transportation. It is often the case that traffic forecasts are not met. This results into conflicts between governments and investors as a deterioration of this parameter impacts revenues and costs. As a consequence, investments and the associated public service might be at risk. Hence, it is advisable to seek conflict resolution mechanisms on predefined parameters which lead to adjustments in compensation if historic expectations are not met.
4. Review capital requirements for new evolving infrastructure asset classes and risk-return profiles: Digitally tracking and reporting operational and financial performance allows to refine the understanding of risk profiles. This may justify differentiating capital requirements.

Summary

Maturing institutional and contractual frameworks by integrating risk-sharing schemes and conflict resolution mechanisms will create a win-win situation.

⁷Industrial Internet of Things

⁸Boris Galonske (2018), *The Future of Transportation Executive Briefing 2018* (p. 156 -159), *The Evolution of Smart Transportation Infrastructure*

Infrastructure funding gaps will be closed and the resilience of the financial services sector will increase with direct benefits to investors i.e. pensioners and consumers.