What could derail Britain's infrastructure investing boom?

Claire Smith considers potential developments that may negatively impact upon infrastructure investment

The UK has for many years been heralded as a treasure trove of investable infrastructure assets. Core infrastructure equity has been generating double-digit internal rates of return (IRRs) and there has only been one instance of an A-rated UK infrastructure bond defaulting, over a 34-year period (versus 10 in the US)[1]. However, sceptics fear that may be coming to an end on the wave of some recent developments.

• Firstly, the Labour Party has stated a desire to renationalise all infrastructure assets should it come to power.

• Secondly, the UK water and energy regulators, Ofwat and Ofgem respectively, have stated publicly that infrastructure asset owners should not be making such large profits off the back of their investment into core UK assets.

• Thirdly, Brexit. While many believe this won't overly impact UK investor demand for UK infrastructure assets, currency volatility could scare off foreign investors seeking the low volatility, highly predictable, cashflows that infrastructure usually offers.

We will analyse each of these factors in turn and consider the impact on private infrastructure equity and private infrastructure debt.

Labour government would renationalise

Labour's 2017 manifesto and subsequent policy announcements have stated the party will renationalise some or all of the water, energy and rail sectors, along with Royal Mail and a number of PFI deals (private finance initiatives).

There have been varying estimates of how much it would cost to renationalise all UK infrastructure. The Centre for Policy Studies estimated it would cost over £55.4 billion for energy, £86.25 billion for water, £4.5 billion for Royal Mail, and £30 billion for PFI nationalisation, although they note this estimate is particularly uncertain[2].

Figures from *Infrastructure Investor,* a specialist publication, show that since PFI's inception, in 1992, there have been 716 operational projects with a total capital value of £59.4 billion[3].

The Social Market Foundation, commissioned by a group of water companies, estimated that the upfront cost of renationalisation would be £90 billion, which includes a 'typical' acquisition premium of 30 per cent[4].

The disparity in the estimates stems from a few factors, such as whether the government would pay the regulated asset value (RAV) or the enterprise value (EV) for the equity component, which can differ significantly depending on the sector and the asset. Even for assets that don't have a regulated asset value, equity valuations can vary markedly depending on the calculation methodology and the assumptions used in the modelling. This makes the acquisition price for an equity asset especially uncertain, particularly where there is a bilateral negotiation with a captive buyer and not a competitive bidding process.

Conversely, debt to private infrastructure companies is facilitated through either bonds or loans. These debt instruments are legal contracts between two parties that clearly outline the principal and interest payment schedules, so there can be no room for negotiation on the value of the debt. The main risk for debt holders is if the debt is prepaid before the end of the agreed term and there is no protection for such an outcome. If renationalised, a UK government may elect to prepay the debt early, as it may be able to refinance it more cheaply through the issuance of government bonds.

Regulatory risk

There has been a lot of discussion over strategic UK water and electricity assets and their performance versus the profits taken by their owners.

The main criticisms have been around the price set for consumers and the assumptions in the cost, which lead to large profits paid to the equity owners, while some argue the service is sub-par. Another point of contention has centred around companies structuring their finances with offshore lending facilities, reducing or negating the level of corporation tax they pay. This in part is due to tax deductions on interest payments to these offshore vehicles.

When Ofgem and Ofwat set energy and water prices, they factor in the cost of servicing debt. Some sceptics argue they have been too generous when setting the funding costs that have historically generally been less than budgeted, increasing profits for the asset owners. Regardless of whether or not this is true, it is fair to say that in future even if the budgets for interest on debt are reduced, it will affect the equity owners' profits rather than the returns that debt holders receive, as debt returns are contractual and equity dividends are not.

Brexit

We do not believe that Brexit will affect demand for core UK infrastructure. A key feature of infrastructure is that it relates to an essential service that is generally not transportable between countries. So, whether Britain is part of the European Union or not, this shouldn't affect the UK's need for water, energy, social housing, and so on. However, where Brexit does have an impact is on the UK currency.

At the start of 2016 £1 bought €1.358. On 1 March 2019 a pound only bought €1.161, a fall of 14 per cent. Given that the final outcome of Brexit is still impending, many foreign investors are waiting before committing to an increased exposure to the pound.

For equity owners, we have seen a tendency to hold on to UK assets until Brexit passes and other investors become more comfortable with the pound. This has reduced the supply of investable equity assets in the UK – an advantage for equity owners who have the luxury to be able to wait out the storm.

For debt, as it has a legal maturity date, it needs to be refinanced regardless of market conditions. Less foreign investors lending to the UK could actually lead to an increase in returns on infrastructure debt, particularly if the European Investment Bank stops its historic practice of providing 50 per cent of the debt to UK infrastructure assets. The reduction in liquidity could prove profitable for investors still willing to lend in the UK, either as they have sterling liabilities or if they're able to hedge their currency exposure (or withstand it).

Conclusion

The potential risks and rewards of investing in UK infrastructure have clearly changed significantly over recent years so investors need to rethink how they approach such assets. The main trends we have seen, in the industry – potential renationalisation, regulatory reforms and Brexit – may all pose significant risks for UK infrastructure equity owners. Conversely, we think these exact challenges may actually increase the opportunity for investors in debt who are willing to lend to UK infrastructure assets.

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[1] Moody's "Infrastructure & Project Finance: Infrastructure default and recovery rates, 1983-2017"

[2] "The Cost of Nationalisation", Centre for Policy Studies, 21 January 2018.

[3] Infrastructure Investor, "UK's Labour vows to nationalise PFI deals", 26 September 2017.

[4] "The cost of nationalising the water industry in England", Social Market Foundation, 5 February 2018.