

Impact of COVID-19 on infrastructure

Global infrastructure markets

The impact of COVID-19 is unprecedented, affecting assets across the investment spectrum. Of most relevance to infrastructure investors is the shutdown of economies, lower oil prices and stress in the credit markets. The infrastructure sector has been resilient during previous crises, but how will it respond to this one?

Key takeaways

- The COVID-19 pandemic has triggered the most abrupt global economic shutdown of modern times, and we believe the infrastructure sector is being tested as never before.
- The most immediate impact is being felt at airports where there is a dramatic decline in passenger numbers during widespread lockdowns. Toll roads are also facing a sizeable hit while ports tend to lag global GDP shocks.
- Oil and gas exposed assets are being further hurt by falling commodity prices amid the current oil price war.
- 2020 revenue estimates of publicly-listed infrastructure companies have seen a 8% downward revision by equity analysts so far.
- We believe earnings estimates can be a more meaningful indicator of the impact to private infrastructure than public market movements which can be more volatile.
- Infrastructure companies have strong liquidity and were able to withstand the initial phase of the crisis but recapitalisation is likely to be required and could take place in a tightening debt market.
- Infrastructure remains attractive as a diversifier given low historical correlation to other asset classes and yield pick-up over risk-free rates.

Declan O'Brien, Head of Infrastructure Research and Strategy, Alex Leung, Analyst, Research & Strategy Infrastructure

The COVID-19 pandemic has continued to wreak havoc on global businesses in recent months with major economies shut down for unknown durations, and GDP contraction for 2020 looking set to be more severe than the Global Financial Crisis in 2008/9.

While significant volatility is expected to continue in the months ahead, monetary and fiscal measures are distorting the impact of the severe revisions to GDP growth and supporting valuations. We have seen a widening of spreads in Europe and the US however this is being partially offset by the cuts to base rates which is providing some relief for borrowers.

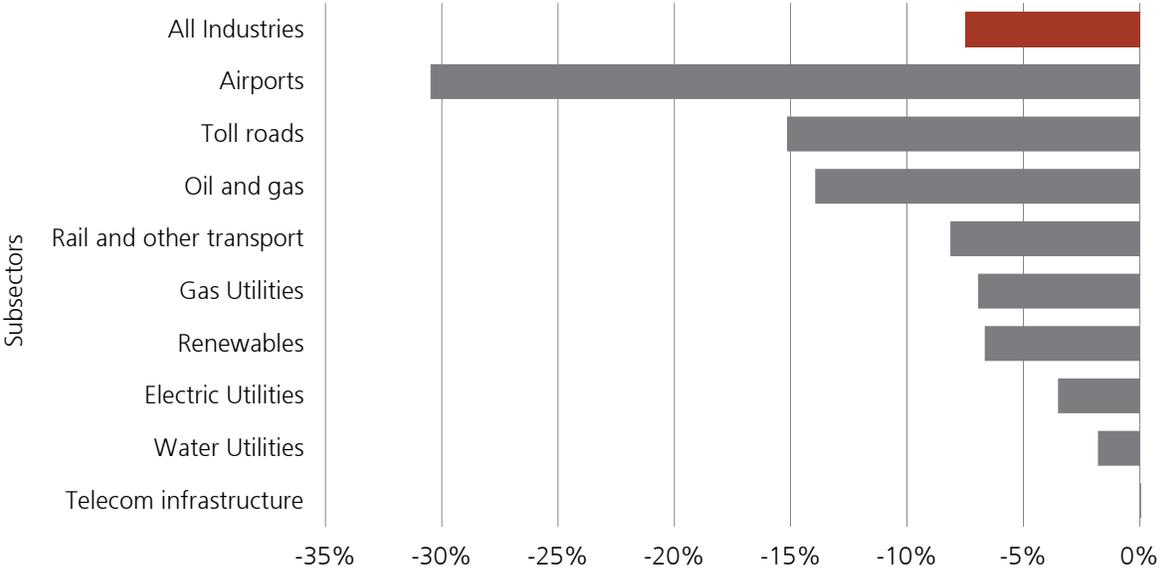
The oil price war between Saudi Arabia and Russia led to a 50-60% decline in crude oil prices, adding further stress to some infrastructure assets.

Utilities, renewables, communications and social infrastructure are well placed while transportation and non-core energy assets may underperform. Natural gas and power prices could recover faster than oil prices.

Declan O'Brien

The pandemic has had an impact across infrastructure sectors and those most exposed to an economic shock are GDP-correlated assets such as airports, ports and toll roads. Social infrastructure, renewables and telecoms have seen less of an impact. The oil and gas sector has also been hit by the Saudi Arabia price war and falling demand. Even without COVID-19, we believe oil prices would have still collapsed based on Saudi Arabia's actions, as we saw in 2014.

2020 Revenue estimates for listed infrastructure by sector*3-month change



Source: Bloomberg, April 2020. Note: *Categories are from GLIO, equally weighted

How will COVID-19 impact sectors?

Transportation

- User based transportation exposed to passenger volumes will be the most impacted most notably airports, toll roads and ports. Airlines are becoming more distressed which could put airports under further strain.
- As lockdown measure begin to be eased toll roads, car parking and ports should see strong rebound
- Transportation assets with a high percentage of freight traffic could be the relative winners

Oil and gas

- Oil exposed infrastructure will suffer (especially at US shale basins like the Permian Basin)
- This is a particularly important for North America as oil and gas typically accounts for ~40% of total infrastructure investments
- Infrastructure exposed to pure-play shale gas basins may benefit, as the shutting of shale oil wells reduces overall gas supply, allowing other areas to fill the gap

Power and utilities

- Economic lockdowns have significantly impacted power demand and prices around the world
- Renewables energy projects have been viewed as more stable investments during the crisis
- Power and utility assets are considered essential despite the slowing economic activity, and are still staffed to maintain operations, however, the Energy Information Administration estimates 39% of greenfield power projects in the US are delayed as COVID-19 causes disruption in supply chains

Telecommunications

- Extensive "stay at home" advice is creating a surge in data usage through video conferencing, gaming, streaming and network virtualization
- This epidemic may also make companies rethink their disaster recovery plans and lead to a longer-term boost to data center activity, which can offer services such as remote hands
- With schools closing and parents working from home, households may see their broadband capacity tested to the limit, which may lead to upgrades to fiber in the longer term

Social infrastructure – Public-private partnerships (PPPs and non-PPPs)

- PPP typically have long-term, availability-based revenues which will mitigate the impact of COVID-19
- Infrastructure-lite non PPP are mixed as they often have lower margins and shorter-term debt structures

Infrastructure debt markets

- Transactions that have paused will need to come back to the market, most likely in H2
- Additional pipeline driven by recapitalizations to replenish liquidity, maintain dividends, fund capex and restructurings for projects that are breaching covenants (lock-up and default) or because of rating downgrades
- Liquidity is generally strong with infrastructure companies able to service debt and short-term maturities
- The balance of power may shift from sponsors to lenders with lenders likely to push back against covenant-lite deals and sponsor friendly features

Impact on valuations:

- Sectors least affected are utilities, renewables, telecommunications, contracted transports and PPPs
- Core infrastructure assets with high margins are more resilient
- Leverage will be key determinant
- We currently estimate a 9-17% impact on private infrastructure valuations

Infrastructure has historically been a good diversifier to other asset classes with low correlation and downside protection. With valuation drops come buying opportunities, as shown by well performing fund vintages from 2009 and 2010.

Alex Leung

Alessandro Merlo, Head of Investment Infrastructure Debt

From a debt perspective during the lockdown phase we have seen infrastructure companies benefitting of strong liquidity combined with the ability to reduce operational costs and delay capex, and therefore withstand the impact of the lockdown relatively well. In this phase the primary financing market has almost shut, while we have seen more activity and opportunities raising on the secondary market.

In the medium term, once lockdown measures ease, we are expecting to see a backlog of transactions, which have been paused during the lockdown, to come back to the financing market, as well as a strong need for recapitalization of companies to relaunch capex plans, mitigate the economic impact of the crisis and cure lock-ups and defaults. We believe this will create interesting entry opportunities for debt investors in general and especially for mezzanine financing.

Bronte Some, Head of Infrastructure Equity Europe, Perry Offutt Managing Director, Head of Infrastructure Americas

As activity resumes, there will need to be a focus on liquidity positions and business model re-evaluation for a post COVID-19 world. We expect activity overall to pick up first with the re-launch of stalled transactions and also in areas such as renewables and digital that have been less adversely affected.

Where are the best risk/reward opportunities in today's market? Quick answer: stay diversified.

- Contracted/regulated cash flows that offer significant stability to support a current yield
- Well-capitalized, GDP-sensitive assets (i.e., transportation) that will benefit over time from a growing economy
- Sectors such as renewables and digital that will benefit from macro factors

We are seeing demand and valuations holding up well for essential transportation assets with sustainable capital structures.

Perry Offutt

We believe that in building a diversified portfolio, investors will also need to acknowledge that the trends towards ESG and energy transition are real and that the growth of data and connectivity is not going away. In small to mid-market space, we continue to progress opportunities in the renewables and communications space. Both sectors have held up well though managers will need to take a view on power prices in a post COVID-19 world and on ability to deliver on business plans in the telecoms space.

Q&A:

1 How is the crisis impacting the availability and cost of financing for infrastructure transactions?

Alessandro Merlo (AM): In the short term, we are seeing a lot of volatility and banks widening their spreads for infrastructure financing of anything between 50-75bp while we would have expected a bigger reaction especially given what we have observed on the listed market.

In the long term what we would expect and what we have seen in the 2008/9 crisis, banks will see the impact on the cost of their liquidity and will further adjust prices and the public market will come down a bit and we will find equilibrium.

We will observe a relatively stable widening of spreads in the medium term - 75-100bps for investment grade infrastructure and because of the wider need for financing to come in the next 12-18 months there is likely to be reduced availability compared to what we saw pre-crisis.

2 Do you think there will be less opportunity to deploy capital in 2020?

Bronte Somes (BS): We are aware of processes stalled or waiting to be launched and some of these will be further delayed or may require some work before they can be bought back to market.

In the second half of 2020, we will see some stalled and postponed deals to come to market. This could make for a busy second half but overall volumes could be down for 2020 as not all processes will resume or come back to market.

Where funds are nearing their maturity we may see some managers access secondary markets for liquidity with some LPs rolling with the assets and new LPs coming in. This would further reduce primary deal flow for managers although could allow some LPs to deploy capital. In near term, we may see distressed opportunities where equity capital is required or sellers that might want to divest non-core assets to recapitalize their core assets.

Some of the pause may also be due to managers having to reassess valuations of their assets. We have tried to recalibrate prices as required for Q1, however, the information set is still incomplete and price recalibration will occur more meaningfully in the second and third quarter.

3 Given the current market situation when do you think is the right time to invest in infrastructure?

AM: The capacity to transact in difficult markets have historically offered attractive investment opportunities to private market investors as evidenced in previous crises. We expect to see many investment opportunities to materialize in the next 12-18 months, when the squeeze on liquidity is going to happen and where the short term impact on economics and financial ratio will be seen.

We believe infrastructure is a long term play that offers superior returns for investors "look through the cycle". The current crisis can offer an attractive entry point. In fact, in the last few weeks we have been very active to position well for phase two. We have already been attending lender education online sessions to prepare for transactions that some sponsors are really preparing for as soon as the market reopens. We are gearing up on the debt side to tap into the market dislocation.

BS: Prices will start to recalibrate. Selective positioning across sub sectors in terms of where you want to deploy and where you will benefit from post COVID-19.

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