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UK INFRASTRUCTURE: BOOM TIME

An economy is only as strong as its infrastructure. Good quality roads, bridges, telephone networks, airports, hospitals and schools are needed to keep a country moving.

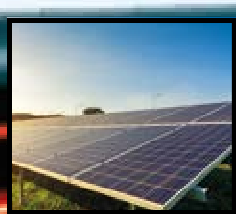
However, as the world changes, so does the nature of the infrastructure it needs. And funding these changes has become a political issue.

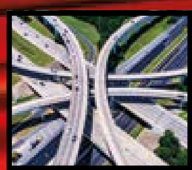
The government through slogans like “levelling up” and “build back better” wants to build new homes, schools and hospitals to serve its growing population.

But the three Ds of de-carbonisation, de-globalisation and digitalisation are also creating a thirst for more investment into infrastructure. For example, to remain competitive Britain needs secure and reliable internet coverage and the data centres that feed them.

Then there is revamping the energy market to decarbonise the economy.

The opportunity to meet the changing needs of society means that infrastructure could become something of a boom industry. Read the following pages to find out how.





INTERVIEW – ACHAL BHUWANIA

UK INFRASTRUCTURE: A PRIME MARKET

The chief investment officer of infrastructure fund manager Equitix discusses the attractions of the UK's mid-market, the importance of investing responsibly and why investor confidence is returning to Britain.

Tell me about Equitix and how you're positioned in the UK?

Equitix has been investing in UK infrastructure since 2007. Today, we are one of the largest mid-market investors in the asset class with six UK offices, over 180 UK-based infrastructure professionals and more than 280 UK assets across all major sub-sectors, including transport, renewable power, environmental services, social infrastructure, data infrastructure and network utilities.

Equitix began investing in social infrastructure when there was a focus on public-private partnerships (PPPs) and private finance initiatives (PFIs). At the time, these established assets provided long-term inflation-linked cashflows which matched the attributes pension fund investors desired.

We capitalised on this, building what is today one of the largest social infrastructure portfolios amongst UK-based fund managers. For example, we provide more than 80,000 school pupil places, 15,000 social housing dwellings and 1.2 million streetlights.

Over time, infrastructure as an asset class and the market opportunity has shifted and with that, so has our investment strategy. We have evolved and now hold investments in a diverse range of sectors. In the renewable energy sector alone, we have invested £2.5bn to date and provide the equivalent of 13% of the UK's total installed energy capacity.

We own or are shareholders in a number of high-profile assets which are part of the critical infrastructure of London – Barts and the Royal London hospital, the M25, HS1, the leasing of Elizabeth Line trains and numerous schools as well as healthcare and public sector properties. These assets significantly help the UK to operate efficiently. Across the length and breadth of the country you'll find our assets – from offshore wind farms in Wick and hydro dams in Perthshire, to a swimming pool in Penzance, electricity networks in Manchester, fibre broadband and energy from waste plants throughout England, onshore wind, offshore wind, solar power, rail, road and aviation….and we're incredibly proud of that. I believe that the enormous diversity these assets showcase, is a critical factor to our growth and successful track record.

We have the largest team of infrastructure professionals in the market and this is one of the key attributes of Equitix: our people. Not only does the depth of our team and breadth of their knowledge support us instrumentally, but the ever-expanding network this promotes is invaluable. This also gives us our competitive advantage in sourcing and executing investment opportunities. The majority of our fund deployment is originated on a bilateral, non-competitive basis.

Additionally, because of this large team we can ensure we maintain a local presence for all our assets. Our local

teams know the area, its people, and they understand the projects inside out. They have passion and dedication and we are fortunate to have such a fantastic array of talented individuals at Equitix.

However, importantly, we have retained our core investment strategy – our centre of focus remains on critical infrastructure and assets which serve the communities in which they are located. We are particularly attracted to capital-intensive sectors in developed markets, with low-demand risk, inflation linkage and downside protection.

Our agile and focused approach to investing entails a fully integrated approach to considering material sustainability factors throughout the investment lifecycle. As long-term, responsible investors we focus on driving sustainability in our investment strategy, for example, targeting investment in climate-related opportunities, whilst actively managing sustainability-related risk across the portfolio and providing transparent reporting to investors.

We prioritise the integration of environmental, social & governance factors throughout the investment lifecycle. Climate considerations in particular are an integral part of our approach to investment, as we pursue opportunities that will help the nation reach net zero and ensure we are building resilient infrastructure in an ever-changing landscape.

Do your overseas investors still see the UK as an attractive investment environment?

We believe the UK is a highly appealing investment destination with a stable political and regulatory environment, as well as a mature and deep infrastructure market. Whilst there was a blip in investor confidence during the liability-driven investment [LDI] crisis in September 2022, and the political turmoil that preceded it, the UK has demonstrated the stability of its markets with the pound since having recovered and inflation coming under control.

In addition, we believe that foreign investors see sterling as a niche currency, and therefore returns today, on a risk-adjusted basis, are arguably better than in a number of other countries in the developed world.

How large would you say the infrastructure funding gap is in the UK?

Research shows that the UK needs more than £1.3trn by 2030 to fund its infrastructure and energy transition needs. Of this requirement, current investment sources are expected to provide just over half, leaving a sizeable gap of more than £600bn.

The UK has under-invested for the last 10 years, so there is a major need to upgrade existing ailing infrastructure. In addition, new innovations and growth segments will likely enhance the opportunity set.

Given budgetary constraints, the majority of this financing will need to come from the private sector and a large proportion of that needs to flow into mid-market assets. The opportunities are huge, and the UK needs to offer the right environment to attract sufficient investment into UK mid-market infrastructure. We managed this successfully in December.

> **The energy transition is hugely positive. It benefits everyone, bringing a shared universal perspective on a cause we can all support.**

Equitix raised more than £1bn from overseas investors last year. What does that capital want from UK infrastructure?

Fundamentally, overseas investors want the same as domestic investors – strong returns on a risk-adjusted basis whilst maintaining portfolio diversification.

However, the UK has an added advantage in that it is a leader in a number of energy transition sectors, such as offshore wind, and therefore has the ability to export this experience and intelligence overseas to those investors who are seeking know-how and technical collaboration here in the UK that they can take back to their home markets.

Why do you think this a good time to invest in UK infrastructure?

There is an opportune moment to invest in UK infrastructure today, particularly the private mid-market. In the past two years or so, the funding backdrop has been challenging due to macro-economic drivers such as high inflation, elevated interest rates and specific shock events such as the LDI crisis.

As a result, many listed infrastructure vehicles are trading below net asset value (NAV), limiting their ability and appetite to invest in UK infrastructure opportunities.

That being said, the next government, irrespective of party lines, needs to focus on improving the investment backdrop given the scale of the funding gap.

The country needs not only to incentivise investment from UK investors, such as pension funds, but also make the UK even more attractive for foreign investors and compete with the US and Europe which have excited overseas capital with the Inflation Reduction Act and Green Deal.

But hedging costs for sterling have risen, so isn't that eating into those returns?

Correct. The cost of hedging sterling has gone up, but this isn't a purely negative factor as it is dampening some interest from foreign investors. This is a positive as it means we are not facing a supply/demand imbalance which may otherwise lead to valuation pressures.

Also, as previously mentioned, we see this as short-term. Sterling has proven to be a resilient currency and we are looking for investors who are seeking to invest in this asset class long-term. While hedging costs will move up or down, on a long-term basis the UK continues to be an attractive destination.

Have you seen confidence in Britain return following the LDI crisis?

The LDI shock and the energy crisis resulting from the Ukraine-Russia war led to rapid inflation and impacted equities, leading to the denominator effect which then restricted investors' ability to allocate to alternatives, such as infrastructure.

In the first half of 2023, the UK saw the worst of everything: a sterling crisis, rapid inflation and high interest rates. But our experience, resilience, and foresight meant that our investors were able to benefit from some opportunistic transactions during that time.

As the market improved in the second half of 2023, we attracted £1bn of foreign capital into UK infrastructure assets – so we know firsthand that yes, confidence in Britain has definitely returned.

We are now in a new era of higher inflation and higher interest rates. Whilst we cannot predict the future, despite facing 'high for longer' rates, we do believe that inflation is moving under control and we are at the peak of the interest-rate cycle. That is providing even more confidence in the market today.

What impact has the cancellation of HS2 had on Britain as an investment proposition?

I have been asked that question by a number of foreign investors. The point is that HS2 is publicly funded infrastructure, so it has not directly impacted private investors. But it has, however, led to questions from some investors about the government's commitment to infrastructure projects.

The government made the decision, which it had to for various reasons, but it creates challenges for future mega infrastructure projects in the UK.

Most UK pension schemes invest overseas. What needs to change for them to increase their domestic exposures?

UK investors need to see evidence that domestic infrastructure is attractive on a risk-adjusted basis and provides strong liability matching to their objectives. This is something that we at Equitix have demonstrated to our UK pension fund investors since inception.

We also need to widen the flexibility of investment structures in UK infrastructure and make it easier for pension funds to fit the sector into their wider alternatives strategies.

What trends do you see emerging in UK mid-market infrastructure?

We're seeing the core global mega trends of the energy transition, de-globalisation and digitalisation presenting various opportunities in UK mid-market infrastructure.

The energy transition needs huge volumes of capital. In this space, for example, Equitix is helping asset developers recycle capital into new projects by making long-term investments into renewables, transmission, and distribution assets. We are also seeing exciting developments in home decarbonisation and smart energy, which on its own could present a £100bn-plus opportunity in the UK.

De-globalisation is fuelling an interest in initiatives such as local supply chains and preparing the nation for an ageing population – something which our social infrastructure portfolio is focused on.

We believe digitisation will start to present opportunity in growth areas such as the AI economy but is also strongly linked to the energy transition as we explore more climate mitigation technology.

Importantly, as there is less capital available seeking these investments, there is a material opportunity to earn returns on a risk-adjusted basis that are more attractive than I have seen in the last five years.

Are investors focusing more on debt or equity to gain exposure to UK infrastructure?

It's a mixed bag. A number of investors have been lured over to private credit during the past 12 months because higher interest rates and structured debt investments presented more attractive risk-adjusted returns versus equity.

However, private credit doesn't offer the same duration as private equity, which is needed for liability matching. This is therefore a more near-term focus, and we believe that in relation to inflation-matched returns and duration, equity provides a better opportunity set.

How is the energy transition impacting valuations?

The energy transition is hugely positive for our country, in many ways. It benefits everyone, bringing a shared universal perspective on a cause we can all support.

For our investors, our assets and the people who use them every day, it's no longer enough to simply say we will build them to be adequately sustainable. We are looking at this at a much deeper level, to ensure we understand how to actively steward our assets, taking into account consideration of climate, biodiversity, communities and supply chain factors as part of our approach to futureproofing and protecting value in the portfolio. This helps ensure we meet LP demands and the evolving expectations of infrastructure users. From an investment perspective, it has led to material opportunities for capital deployment – but that in itself has created a need for liquidity. Given where interest rates are today, we cannot simply borrow to solve that liquidity requirement.

This means valuations have been adversely impacted and, whilst there has been a slight correction in UK infrastructure valuations towards the end of 2023, there remains a disconnect which creates a good environment to buy assets on an opportunistic basis. The liquidity requirement means that on a risk-adjusted basis, the sector continues to be more attractive than a few years ago.

However, considering the resilience of this sector, infrastructure is a lot more attractive compared to asset classes like real estate, which have suffered more heavily due to rising interest rates and the global mega trends.

What trends do you expect to see in UK infrastructure in the coming years?

As I see it, the opportunity in UK infrastructure continues to be extremely strong. For the most part, I see more of the same driven by the mega trends discussed earlier.

Equitix is well placed to take advantage of these trends, providing a stable long-term home for critical infrastructure assets in the UK as well as offering a stable source of dividends and long-term liability matching for pension investors.

Additionally, the ability to source robust risk-adjusted returns across mature sectors in the UK helps attract much needed foreign capital into the UK. This further overseas investment has the ability to transform UK mid-market infrastructure investing in the next 10 years.

The UK has gone through almost a decade of relative economic restraint and its infrastructure has suffered from under-investment. This means that any potential new government will have to think about providing the right environment and the right framework for attracting that much-needed capital – this is critical if we are to bridge the £600bn funding gap to 2030.

Nonetheless, at Equitix we are incredibly excited about a wide range of opportunities available in the UK, particularly in the mid-market infrastructure space. In the near-term, the scale of capital required provides us with ample opportunity for growth, and in the long-term, global mega trends will have the potential to transform the sector and offer highly attractive investment opportunities to our investors.