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CAPITAL MANAGEMENT

Infrastructure Investing in an Inflationary Environment

FEBRUARY 2022

INTRODUCTION

Current inflationary pressures have raised questions regarding the impact of rising prices on investment performance. The inherent characteristics of infrastructure make the asset class well-poised to weather such an environment.

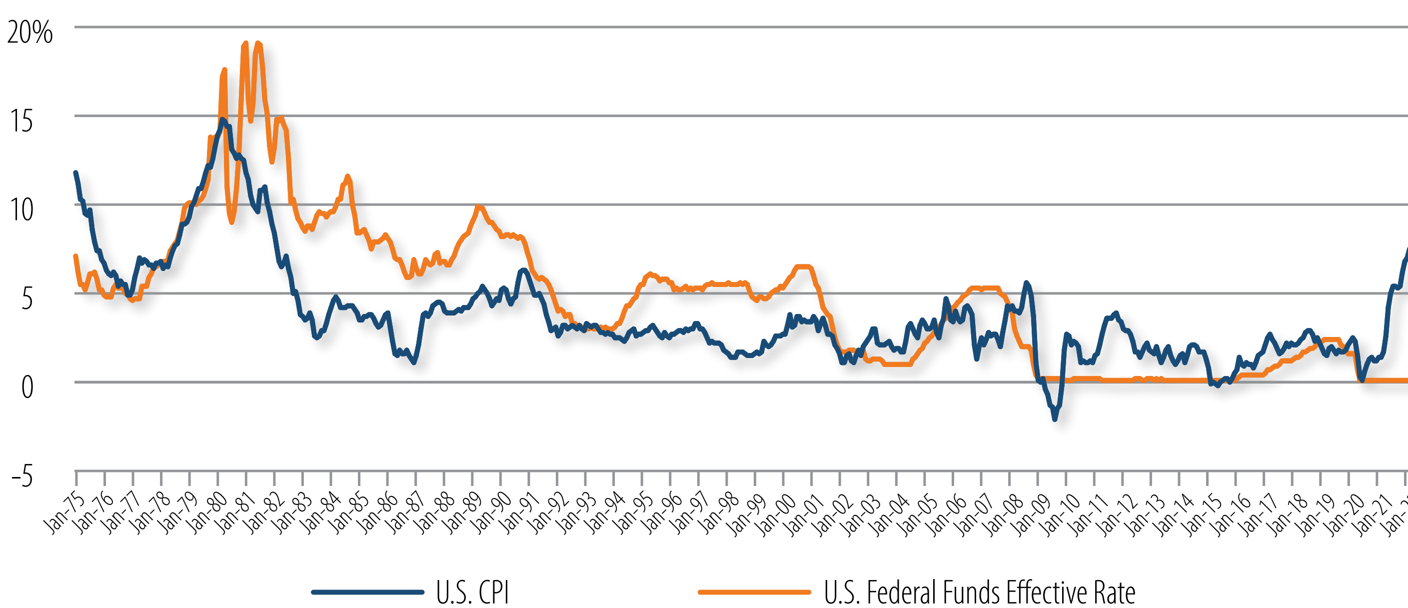
Current Inflationary Environment

Following a global environment largely characterized by persistently low inflation and interest rates, the loose monetary policies, stimulative fiscal policies, and supply chain disruptions resulting from the COVID-19 pandemic have spurred the reemergence of inflation around the globe. In January of 2022, the U.S. consumer price index had increased 7.5% from the prior year—the largest increase since 1982 (see figure 1). Further, in no previous period has inflation exceeded the Fed funds rate by a wider margin, which has resulted in severely negative real short-term interest rates. Additionally, central bankers are primed to hike rates in the near term as a means of combatting growing inflationary pressures.

Impact on Infrastucture Investing

Infrastructure assets—typically physical assets that serve an important and crucial role in societal functioning and activities—possess numerous characteristics that leave the asset class well-positioned as the world enters a new inflationary environment. Given their role, infrastructure assets typically have inelastic demand and limited competition, often due to the monopolistic nature of such assets and the high barriers to entry. As such, despite the increase in the price of goods and services consumers face during times of inflation, there is minimal impact on the use of infrastructure assets. For example, regardless of price, roads, bridges, and ports, along with power generation, water, waste management, and other utilities, are essential to our daily lives. Relatedly, such assets often include contractual links to inflation, which allow the assets to benefit from the increased costs passed on to consumers. Many power and utility investments contain links to infla-

Figure 1. U.S. Annual Inflation Change vs. Federal Funds Effective Rate



Source: U.S. Bureau of Labor Statistics, St. Louis Federal Reseserve Economic Data.

tion through regulations, contracts, or concession agreements, in which pricing is somewhat tied to increases in inflation.

In addition to being able to weather an inflationary environment, infrastructure assets can also stand to benefit from inflation. Commodity and construction prices often rise with inflation, resulting in more-costly new-builds and asset expansions, which subsequently serves to further limit competitive pressures and supply. Additionally, infrastructure investment, operation, and improvement often requires relatively high levels of debt. As such, borrowers benefit from being able to repay their debt quicker with less-valuable dollars, particularly in regard to fixed debt. Coupled with the defensive characteristics inherent with infrastructure assets, these traits could serve as attractive and compelling differentiators of the asset class in an environment marked by high inflation.

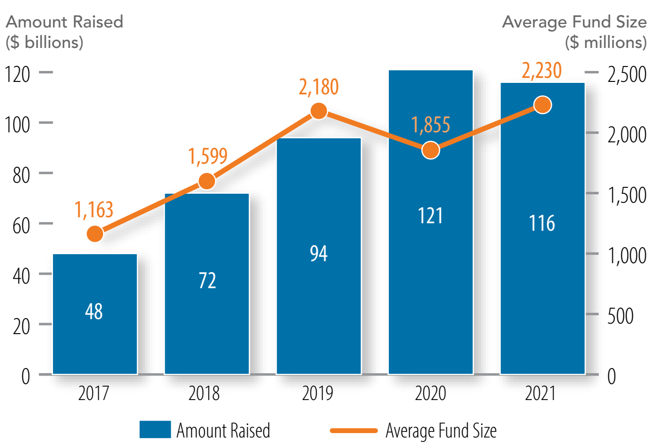
In such an environment, infrastructure assets also provide investors a differentiated refuge that may offer both stable and attractive relative yield, as well as upside potential. The underlying defensive characteristics of such assets—inelastic demand and contractual inflationary links—result in largely stable and predictable underlying cash flows, which can then be returned to investors as dividends or distributions. Alongside this, over the life of an asset, owners and operators can implement revenue optimizations, efficiency improvements, recapitalizations, and other initiatives that serve to contribute to the appreciation of the asset's value over time. With this, investors benefit not only from a relatively stable and attractive yield through ownership but also from the steady increase in value resulting from the numerous value-add and optimization initiatives implemented by operators.

The current inflationary environment, along with a growing set of needs and gaps in infrastructure—

Figure 2. Infrastructure Assets Benefiting from an Inflationary Environment

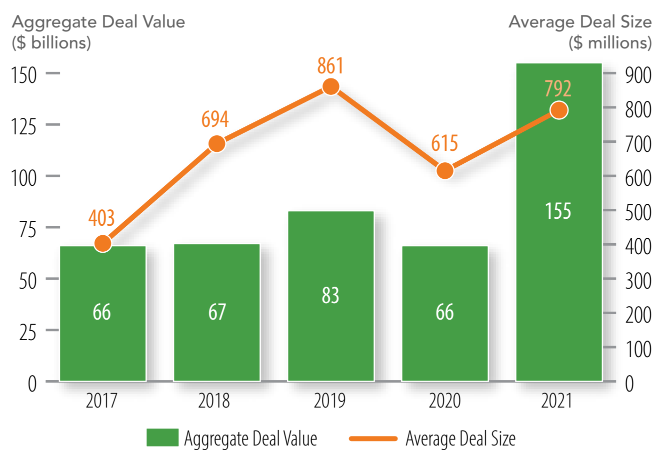
such as those in the energy transition, storage, and digital telecommunication verticals—has led to a pronounced and renewed interest among investors and operators in the infrastructure space. Additionally, the recent supply chain disruptions and constraints have served to further underscore the importance of infrastructure to the broader economy and the need for greater infrastructure investment and improvement. As the infrastructure manager universe has steadily evolved and grown over time, so has fundraising, which has experienced an upward trajectory over the past five years. According to PitchBook Data, global infrastructure fundraising exceeded $110 billion in both 2020 and 2021, signifying strong demand and support for such assets among investors and limited partners (see figure 3). Infrastructure investment activity has similarly experienced substantial growth in recent years: over the past three years, global infrastructure investment has totaled at least $60 billion in value annually, and the $155 billion in activity during 2021 represents not only an annual record but also an increase of more than 80% from the prior annual record set in 2019, according to PitchBook Data (see figure 4).

Figure 3. Global Infrastructure Fundraising



Source: PitchBook Data, Inc.

Figure 4. Global Infrastructure Investment Value



Source: PitchBook Data, Inc.

CONCLUSION

As inflationary pressures introduce a new degree of uncertainty and risk not experienced by asset managers in recent years, infrastructure remains a very compelling asset class that possesses uniquely differentiated characteristics and tailwinds that leave it well-positioned in an inflationary environment.

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