Inflation, infrastructure and private equity

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The ongoing impact of the pandemic and the current war in Europe has pushed inflation in the UK to an alarming 40-year high – and there is similar news in the US, where figures are also close to those of the early 1980s. Global markets are volatile and awash with fears of rising interest rates and slowing growth, so you could be forgiven for feeling a little uneasy at the global and economic outlook right now.

But what does this mean for the private equity industry and, specifically, infrastructure assets? In this briefing, partner Alexander Curry, from the Corporate team in Jersey, explains what rising inflation could mean for infrastructure projects and the wider private equity industry.

What does inflation mean for private equity?

In 2021 the private equity industry was setting record highs in terms of buy-out activity and fund raising, and taking advantage of opportunities where others were less confident to tread. Indeed, according to *Preqin*, the size of the private equity market had tripled in the prior decade to over US$6 trillion by November 2021. The outlook for 2022 was very much more of the same and predictions were looking strong for this sector – albeit with some emerging concerns over possible future interest rate rises.

With interest rates now on the rise there is increasing interest from investors for investment opportunities that will afford some protection against inflation.

According to the latest *Private Equity Wire Insight Report,* released in May 2022, infrastructure investment looks set to continue its global ascent in 2022 as the fastest-growing alternative asset class by fundraising and assets under management which, according to *Preqin*, will reach USD1.87 trillion by 2026, overtaking real estate to become the largest real asset class.

To underline the level of interest, *Private Equity Wire* have reported that up to 79%per cent of LPs (investors) plan to increase their allocation to infrastructure in 2022, with 30 per cent intending on keeping the same level of exposure to the asset class.

Why will infrastructure perform better than other asset classes when measured against rising inflation?

The contractual framework of many infrastructure projects provides a degree of flexibility so as to permit rate changes where required to future proof such projects against interest rate rises and inflation.

According to *Blackrock's Inflation & Real Assets Report 2021*, real assets outperform traditional asset classes during high inflation environments with many infrastructure assets having an explicit link to inflation through regulations, concession agreements or contracts, thus providing natural inflation protection.

In addition, *DWS's CIO Quarterly View, 9 March 2022* considers that, in general, in regulated infrastructure sectors in the US (such as utilities and transport), there is a high probability that inflation can be passed on to customers through increased tariffs.

So how does it work in practice and what are the specifics to look out for?

The contractual framework adopted by infrastructure projects provides the answer to this question.

The *Brookfield White Paper, May 2021*, sets out a useful summary of certain characteristics which come into play across many of the key sectors within the infrastructure asset class:

1. Transportation
    a. Toll road assets: often toll road contracts allow for the operator to set toll pricing at its discretion.

    b. In an inflationary environment, the tariff increases in this model are often in excess of inflation.

    c. Over time this results in increasing cash flows, which, in turn, drive increasing asset values.

2. Energy
    a. Contracts with inflation protection mechanisms are most notable among liquid (crude oil, refined product, natural gas liquid) pipelines.

    b. The contracts adopt a tariff structure that ensures pipeline operators are sufficiently protected from rising inflation and this helps preserve asset values.

    c. Energy infrastructure assets also indirectly benefit from rising commodity prices.

3. Communications
    a. Price escalators embedded in phone mast contracts contributes to their long-term

growth prospects.

b. The inflation protection from contractual price escalators can account for anywhere from half to two-thirds of expected organic revenue growth, although this varies depending on the specific contract or operator.

4. Utilities

Utilities that are regulated with inflation adjustments will tend to see higher total allowed returns over time, even if their immediate cash return may be lower.

What is the global outlook like for infrastructure projects generally?

In the context of the current macroeconomic environment, the global outlook for infrastructure projects remains positive.

Private Equity Wire has reported that global spending on infrastructure is tipped to grow significantly over the next decade with the following budget allocations worthy of note:

1. The UK's latest National Infrastructure and Construction Pipeline promises £650 billion of infrastructure projects over the next decade.
2. The US is to spend US$1.2 trillion on what President Biden has called "*the decade of infrastructure*".
3. The European Commission has unveiled a major infrastructure investment strategy to mobilise up to EUR300 billion of investment by 2027.
4. China's One Belt, One Road plan predates the pandemic.
5. Countries including India and Indonesia have cranked up infrastructure and energy spending in their budgets since the crises.

Not of all of these projects will be publically funded. Particularly in the US, UK and Europe, private investment will need to be leveraged to fill the gaps in the public purse. Indeed, having spent heavily during the pandemic, *DWS's CIO Quarterly View, 9 March 2022*, notes that governments' coffers have been depleted with higher defence spending now looming as an additional drain on resources.

Jersey for Private Equity

Private equity has always been a key asset class for Jersey as a jurisdiction, which offers an attractive package for investors, including a robust yet flexible legal and regulatory framework, considerable industry expertise, and tax transparency or zero tax for investment funds.

Ogier's multi-disciplinary Private Equity team provides a full services offering to private equity sponsors, their advisers and intermediary law firms, advising on a wide spectrum of fund structures and their particular regulatory and commercial approaches.

We regularly advise the world's largest private equity firms on all aspects of the private equity lifecycle; and we also take pride in helping start-up sponsors launch their first fund structure. Our expertise across each of our jurisdictions means we can assist with both the structuring and execution of complex cross border transactions, and we have been involved in some of the most noteworthy private equity deals completed in our jurisdictions, offering a global perspective to suit an international client base.

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