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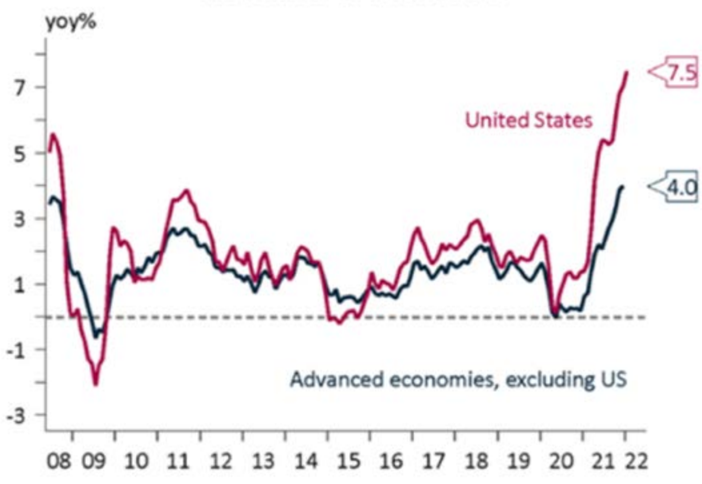
INSIGHT

Infrastructure – rising rates and the "natural hedge"

Inflation has accelerated globally as a result of consumer demand, fuelled by fiscal policy, pushing into supply constraints due to COVID-19 and geopolitical upheaval. US inflation is running at 40-year highs and other advanced economies are at or near similar extremes.

August 2022

CHART 1 US AND ADVANCED ECONOMIES CPI



Source: IFM Investors, BLS, Dallas Fed, Macroband as at 29 July 2022

Central banks were initially quick to label this inflation as "transitory", but it has proven unexpectedly persistent. In response, markets shifted their interest rate expectations. The US Federal Reserve is in the initial stages of an aggressive rate-hiking cycle, with market expectations foreshadowing materially higher interest rates.

Higher interest rates have traditionally been viewed as a negative for the performance of long-duration investments, like infrastructure, as they put downward pressure on asset valuations. This occurs not only because of the potential increase in the cost of borrowed capital, but also because the discount rate that is used to value infrastructure asset cash flows is likely to increase in response

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to changes in the relevant long term sovereign bond rate (known as "the risk-free rate").

While this is true, one could believe the positive linkages that some infrastructure assets have to inflation and economic growth can provide a natural hedge that may be sufficient to offset these negative valuation impacts.

The natural hedge explained

There are two key revenue characteristics that one can target when investing in infrastructure assets.

The first is inflation protection, which usually comes in the form of contracted increases in pricing that are linked to the prevailing rate of inflation. This is often a feature of regulated utilities (like water and power companies) and toll roads, and it normally means that revenues continue to rise as inflation increases.

The second is exposure to economic growth. For some infrastructure assets, volumes, and thus revenues, tend to increase with the size of an economy. For example, toll roads have a variety of linkages to economic variables, with many road concessions benefiting from both rising economic activity lifting traffic volumes as well as toll escalation (often linked to inflation). There is some downside risk here; if rate-hikes are too aggressive and therefore adversely impact economic growth.

Value can also be created by reinvesting capital into investments that grow with their customer base

Infrastructure's natural hedge against interest rate rises occurs because inflation and above-trend economic growth tend to be pre-cursors to, or coincide with, increased interest rates, providing mitigants to the effects of rate increases.

Appropriate capital structures and long-term risk-free rates

Appropriate capital structures can also help insulate infrastructure assets from the impact of rising rates. When interest rates are low, asset owners can refinance debt and lock in the cost of long-term financing at attractive rates.

A few examples of measures infrastructure investors have used in the past include lengthening loan or bond tenors and laddering debt maturities to mitigate refinancing risk; use of fixed-rate debt or use of interest rate swap strategies to largely eliminate floating rate exposures; and using our market presence to access highly competitive debt margins.

One can therefore believe that the positive effect on portfolio performance from rising inflation is expected to be greater than the adverse effects of rising interest rates on the cost of debt.

The impact of rates on asset valuations is also partially mitigated because of the industry-wide practice employed by independent valuers using long-term risk-free rates (recognising the long-term nature of infrastructure assets) as part of their discount rate formulation, rather than the prevailing ten-year sovereign bond rate, for example.

Infrastructure investments can withstand higher rates

Although infrastructure assets are diverse and subject to a wide range of macro-economic exposures, one could expect the performance of a well-balanced portfolio of infrastructure assets to remain relatively robust through an inflationary cycle. This should stand the sector in good stead throughout the rest of 2022, given the possibility that central banks may continue to respond to accelerating inflation with tighter monetary policy settings.

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