

# THE NEW FRONTIERS OF INFRASTRUCTURE INVESTMENT

## MARSH & McLENNAN COMPANIES 2014 INFRASTRUCTURE CONFERENCE RISK HIGHLIGHTS

### On October 2, 2014, in London, Marsh & McLennan Companies hosted its 2014 Infrastructure Risk Conference: “The New Frontiers of Infrastructure Investment”.

The conference built on the success of our 2011 and 2012 conferences in London and New York respectively, bringing together more than 100 practitioners and stakeholders from across the infrastructure sector – public sector, equity, debt, construction, risk management, and other legal and technical specialists in this field.

Through a series of interactive panels, the conference sought to provide an updated and holistic view on how best to enhance and protect the economic value of infrastructure investments around the world. This briefing provides an overview of the day’s events and highlights key themes that emerged from the conference.

Marsh’s Edwin Charnaud, chairman of the Global Infrastructure Practice, first provided delegates with a review of global infrastructure challenges, asking whether the sector is entering a new phase; one in which more asymmetric risks – regulatory risk, consumer backlash, technology risk, and global events – will take centre stage.

This was followed by a keynote address from Michael Drexler, head of Investor Industries at the World Economic Forum, who discussed the recent reduction in project finance volumes, particularly in emerging markets, and offered his thoughts on how the private sector and policymakers could better attract long-term investors in order to bridge the gap going forward.



## THERE IS TOO MUCH “NEW MONEY” FLOWING INTO REGULATED, CLASSIC INFRASTRUCTURE ASSETS

There is an incredible amount of competition for classic, regulated infrastructure assets, which have consequently become oversubscribed. To add to this, there is great concern about whether the risks involved in these assets are being adequately priced and factored into valuations, and the consensus would appear to suggest that they are not.

At the same time, there is currently too much “new money” flowing into the infrastructure space given the limited opportunities for investment, and this means two things. Firstly, there is an increasing desire for higher risk-adjusted yields in the infrastructure space, resulting in a growing interest shown towards brownfield and some greenfield investments in particular. Secondly, in an environment such as this, there is an increased need to ensure that the risks involved in infrastructure projects are – even if not well priced – understood and managed as well as possible.

Institutional investors, in particular, are worried about rising asset valuations and the growing competition for the most desirable assets, as well as the impact these will have on future returns. There is a need to work the assets that are acquired harder, and to place an increased emphasis on managing the potential downside risks.

## HOWEVER, THERE IS A LARGE FUNDING GAP IN OVERALL INFRASTRUCTURE INVESTMENT

Despite heavy investor competition for regulated assets, the World Economic Forum estimates the current gap in global infrastructure funding to be as much as US\$1 trillion dollars per annum, and rising. Public spending on infrastructure projects has been curtailed since 2008, and there is little sign of this changing in the near-future. However, public money is just part of the solution; insurance companies, pension funds, and other institutional investors currently allocate just 0.8% of their US\$50 trillion capital, and this figure could and should increase substantially.

Practitioners and advisers in the infrastructure space must engage with the public sector and policymakers who can help reduce the funding gap and increase the supply of investable assets. There is a need for more creative approaches to working with the public sector; ones which, at one and the same time, find solutions to address underlying infrastructure shortages and make it possible for policymakers to accommodate greater levels of investment from their side.

Importantly, this engagement should be undertaken in a positive and constructive manner so as to generate greater opportunity for private investment in infrastructure projects, which benefit from government buy-in and support. Policymakers have societal commitments they need to meet; the infrastructure investment sector as a whole needs to be a more engaged and effective enabler for these.



## THERE IS GREAT OPPORTUNITY AND RISK IN DEVELOPING ECONOMIES

The infrastructure sector is, perhaps more than any other, dependent upon the basic structures that make our world possible. Political risk and societal development ultimately impact our ability to work with policymakers and public officials in making public infrastructure projects happen.

Developing economies face an acute gap in infrastructure spending, but also offer the greatest potential for large-scale infrastructure development. Political and societal risks pose major threats for infrastructure projects, however, and in developing countries these risks appear to be increasing. On the other side of the coin, improvements in infrastructure are one of a number of ways to alleviate societal, and thereby, political risks. There is therefore a need for the sector to be more actively engaged with the national and international entities and organizations that make it possible for infrastructure investors to deploy capital effectively in this space.



## APPROACHES TO ASSESSING AND MANAGING RISK ARE EVOLVING

Rating agencies are developing new models to identify, quantify, and evaluate various types of risk. Counterparty, as opposed to pure construction risk, is most likely to cause a greenfield project's default, and rating agencies are now thinking, in a much more active way, about possible downside and default risk scenarios resulting from main and key sub-contractors. It is therefore understandable that this is now a major consideration going forward for greenfield investors.

Transparency and active engagement during the development cycle is of vital importance for assessing risk, particularly with management teams, in order to ensure that benefits can be realized – not just to investors and management teams, but also for consumers and other stakeholders. However, the need for transparency and active engagement goes beyond working with management teams; it must involve transparency with contractors and other partners during the development process, openness around risk throughout the entire life cycle of the project, and working closely with regulators to reduce the potential for the occurrence of unpredictable regulatory change. A detailed understanding of regulatory decision-making processes, and an appreciation of the “weak links” that may render existing regulations and policies unsustainable – threatening revenues that are dependent upon them – must be a key part of the due diligence process.

More broadly, there is an increasing acceptance in the investment community that effective risk management requires meaningful focus and resourcing on an ongoing basis post-acquisition. There is no one right risk management model, but it typically goes beyond mere top-down monitoring from end investors, and calls for more active engagement with operation and maintenance counterparties and internal management teams, potentially supplemented by more active involvement on specific value-critical issues.

## ENVIRONMENTAL RISKS (AND RESPONSES) ARE INCREASINGLY IMPORTANT

The industry faces unique and specific challenges in response to increasing environmental regulation, climate change-related risk, and the demand from institutional investors for evidence of sustainable practice. A “do nothing” approach is not an option, as ultimately this is likely to be value destructive – assets may become uneconomic, or even “stranded” if short-term cost considerations overshadow longer-term risk reduction benefits.

Instead, environmental risks must be fully incorporated into mainstream due diligence and post-acquisition asset management processes, and accounted for through prudent, long-term business planning. In some cases, environmentally future-proofing assets could prove to be value-enhancing rather than simply risk mitigating.

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