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UBS Asset Management

Sustainability and value creation key in an evolving infrastructure landscape

Chase McWhorter, Institutional Real Estate, Inc.'s managing director, Americas, recently spoke with **Andrew Morris,** managing director and head of Infrastructure Equity for UBS Asset Management's Real Estate & Private Markets (REPM) business. Following is an excerpt of that conversation.

In the past few years, UBS adjusted its strategy and approach to investing in infrastructure. Could you walk us through the direction UBS took?

We started as a global, diversified core-focused business. As the industry has matured, the best investors have become increasingly specialized, and we have followed suit. We've been focusing on building specific capabilities in infrastructure sectors we think are the most attractive, and in the past five years, that has been in the digital and energy transition in the two largest markets – North America and Europe.

Our business remains committed to the small- and medium-sized enterprise part of the market, where we believe competition is lower, valuations are more reasonable and returns are attractive.

Our focus on control investments has increased, avoiding consortium deals where decision making can be difficult in an increasingly complex environment. In tandem, we have evolved our teams' capabilities and processes to enable us to execute more complex value-creation plans, while always making sure our infrastructure portfolio companies deliver stable and predictable cash flows as they mature .

Finally, we have the research capability to support the business and help us have a stronger understanding of the underlying fundamentals of our focus sectors, supporting strategy and underwriting calibration.

This evolution of our business and capabilities has allowed us to carve out a relevant niche and has translated into better investment success.

How is UBS seeking to address the evolving needs of increasingly sophisticated investors?

As large investors' allocations to infrastructure have matured, they are thinking about how to complement their existing portfolio construction decisions. Typically, this is more control over where capital is deployed, be that markets, sectors or even individual asset selection, and the asset-risk profile.

For example, there has been a proliferation of single-asset continuation funds, where seed assets give investors the chance to appraise the assets in which they will invest.

We've sought to work with large investors, providing them a more tailored approach through customized mandates where they can design and implement a bespoke investment strategy. It's a different style of relationship and requires upfront effort and a clear joint understanding to manage successfully over time.

How has UBS found value in an increasingly competitive market?

By being focused on sectors where we have developed deep expertise and have conviction. Those sectors have strong tailwinds and strong regulatory and supportive legal regimes. Our active asset-management and value-creation focus has also given the team a clear understanding of how we add value and the levers to pull in each portfolio company we buy.

We typically create value by deploying capex to expand or build new infrastructure. For example, we have been building new data centers and tower assets, expanding and densifying fiber networks, and at our renewable-energy assets, building new wind and solar power plants. Another strategy is to look for different entry points into an asset, an example being where we have repowered a wind farm portfolio and extended its useful economic life.

By staying in the mid-market space, where there is less competition and we feel valuations are more reasonable, we can support the growth and make a material difference to these SMEs through investing, as well as improving their operations, controls and management.

With many investors targeting digital infrastructure, can we consider this sector a bubble?

Digital infrastructure has been a focus for many investors, and the pandemic increased the importance of these assets and of having a digitally connected economy. This demand has increased deal flow and driven up the price of assets. Today, with higher interest rates, inflation and lower projected economic growth, there is arguably limited room for further multiple expansion, and we may have seen the top of the market. Back in the third quarter of 2022, public market valuations for towers and data center businesses had already materially declined, and at this point, investors seem to be cautious on further digital exposure.

Is the performance of digital infrastructure justifying the high valuations paid for these assets?

As we move to a full-fiber world, this will provide a long tailwind of growth opportunity. However, not all digital-infrastructure businesses will benefit equally, as different subsectors mature, and there are common trends impacting future performance that investors should be thinking about.

First, can these businesses, over an extended period, increase prices to their customers? In the United Kingdom, we've seen double-digit increases to retail prices, which is not sustainable. While that might provide short-term benefits to investors, there may be longer-term negative effects as customers look to save money.

Second, with significant growth pipelines and capex planned, does cost inflation impact projected returns on growth investment? Investors take full capex-cost risk in many digital businesses, and the historically benign inflation and interest-rate environment have masked this underlying risk.

Finally, with all the projected build, there is risk of overcapacity and infrastructure competition leading to price erosion or lack of usage.

There is evidence of these issues affecting digital businesses across different markets, a clear example being the challenges in the *altnet* sector in both the United Kingdom and Germany.

Energy transition requires significant capital. How is UBS addressing this megatrend?

Energy transition and sustainability are key focuses for UBS asset management and our infrastructure franchise, where we have already developed subsector-specific strategies. In the power sector, we have been investing in renewable energy and have developed specific capabilities in the utility-scale battery-storage sector with a dedicated team. Similarly we are focusing efforts on the decarbonisation of transport needs. Our research team is assessing the different clean-energy technologies and solutions, such as hydrogen, renewable natural gas and carbon capture, utilization and storage (CCUS), and EV charging to help us identify which emerging business models will be sustainable and successful longer term. Identifying the right entry point is a challenge, and we are looking for opportunities that are economically competitive, provide market solutions and are not overly reliant on subsidies.

Our commitment to sustainability isn't new. In 2017, we were one of the first to develop an Article 8 strategy, and our energy-storage strategy was Article 9. Today, much of the market has now moved on to launching Article 8 strategies. We have continued to push the boundaries in terms of how we can differentiate ourselves as an investor and demonstrate that our investing activities are having a beneficial impact on society.

We are still at the very beginning of what needs to be done to decarbonize our economy and the sources of power and energy. There is a long way to go, and this sector will continue to present interesting opportunities for investors and will be a key focus for our business going forward.

One of infrastructure's key attractions has been inflation protection. How are you seeing this play through assets?

Infrastructure's key premise is to provide long-term, stable returns with inflation protection. But as the definition of infrastructure has expanded, the direct inflation link in underlying businesses has, to some extent, been diluted. Investors are digging in to understand how inflation is affecting revenues, costs and capex. In core infrastructure, assets typically have contractual revenue streams that allow investors to pass on inflation. But when you're running at high inflation levels for a prolonged period, you need to be sensitive to the impact on customers and other key stakeholders, which is likely to mean some "give and take" in any pricing decision

In the core-plus market, businesses typically have more flexibility to set their own prices, but in a more competitive market with higher price elasticity of demand consequences.

Inflation is well understood in the energy markets, and merchant exposure has benefited business during this period of higher inflation. In digital, inflation is less understood, and the sector is going to be tested through a period of slower grow and higher inflation. It appears that certain types of digital businesses and markets are likely to provide better inflation protection.

As interest rates have risen, have you seen valuations reflect a changed cost-of-capital environment?

The rise in rates impacting investors' portfolios has led to a slowdown in decision making and taken momentum out of the market. The fundraising environment is harder and transactions are taking longer to close, as bid-ask spreads are emerging between buyers and sellers, indicating cost of capital is resetting.

Fixed income now presents an attractive proposition for institutional investors. Infrastructure has benefited during the past low-rate decade as a yield-replacement strategy, and that dynamic has now flipped. Infrastructure still offers diversification benefits, but it is likely investors will start to expect higher returns from infrastructure.

We've seen valuations reset in public markets, and relative-return institutional investors typically move first to adjust their cost of capital to changing economic fundamentals. In the meantime, the dry powder raised the past few years may support valuations as that capital gets deployed. The rising cost of debt, however, will reduce the leverage available and may put downward pressure on valuations.

We believe the outlook for the asset class remains positive, and high-quality businesses should deliver sustained performance through the ups and downs of the economic and financial cycle. The depth and breadth of expertise and capital now represented by the sector make the infrastructure market crucial to our collective goal of building a more resilient, sustainable low-carbon future for our economies and future generations, and UBS intends to play a leading role making this happen.

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UBS ASSET MANAGEMENT

UBS Asset Management's Real Estate & Private Markets business actively manages investments of around $114 billion globally and regionally within Asia Pacific, Europe and the United States, making it one of the largest asset managers in real assets worldwide. Our capabilities reach across the risk/return spectrum, ranging from core to value-added and opportunistic strategies. We offer both direct real estate, infrastructure equity and debt, and food and agriculture investments, as well as indirect exposure to leading real estate, infrastructure, private equity and private credit managers. Investors can access our diverse product range across open- and closed-end private funds, investment trusts, listed funds, REITs and bespoke separately managed accounts. (Data as of Dec. 30, 2022, unless otherwise stated.)

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