Outlook special

Potential impact of COVID-19 on global infrastructure markets

March 2020

Mixed outlook for infrastructure assets

UBS

UBS Asset Management

Introduction

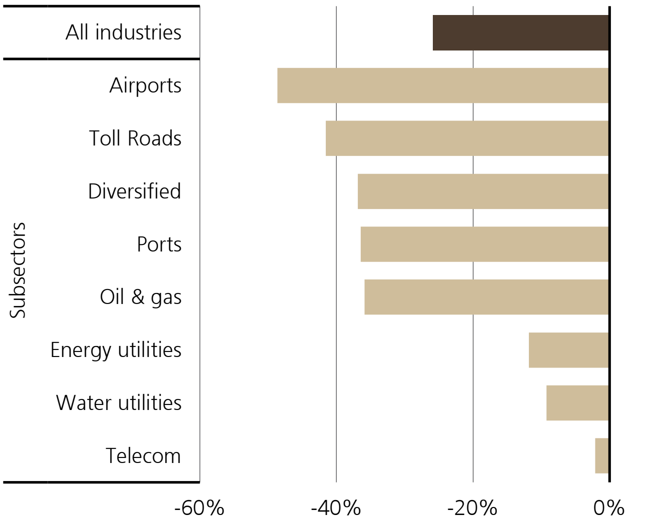
The impact of spread of COVID-19 has been more severe than initially expected. The oil price collapse has compounded its impact on the wider economy, equity markets and credit. As major economies essentially shut down for unknown durations to control the spread of COVID-19, pinpoint economic forecasts are unrealistic. Of most relevance to infrastructure investors is the likely sharp contraction in GDP growth (at least in the short term), lower oil prices and stress in the credit markets. Infrastructure companies could also face operational issues if employees are unable to work or supply chains are interrupted.

Unsurprisingly, the sectors most exposed to an economic shock are GDP-correlated assets such as airports, ports and toll roads. The impact on demand-based transportation this time is more pronounced as countries around the world ramp-up travel bans and advise against non-essential travel. This impact can be seen in the stock market reaction by infrastructure sector (Figure 1).

Due to the lack of available real-time data for the private infrastructure industry, we rely on public infrastructure performance as a proxy. The obvious limitation to this type of analysis is that public markets tend to be much more volatile than private markets, as seen in the dramatic decline in public market valuations in Figure 1.

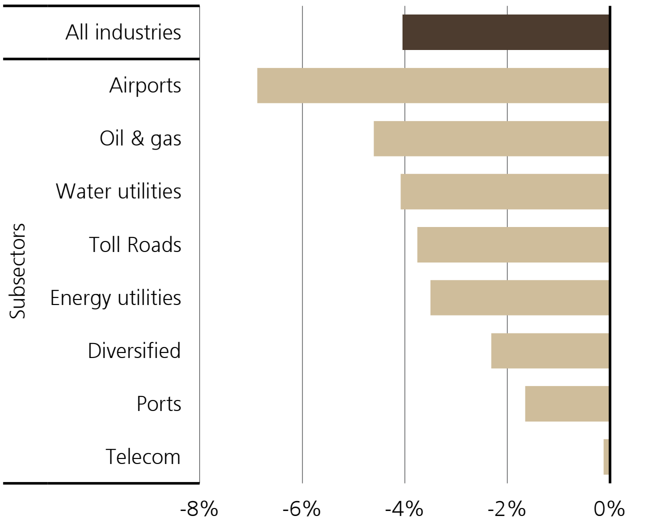
However, if we look at the underlying revenue estimates of these publicly- listed infrastructure companies, we can see that analysts expect 2020 revenues for the broader sector to take a 4% hit, with airports again showing the most downside. If the current situation remains unresolved, we could see further downward revisions to these revenue estimates. We believe that earnings estimates can be a more meaningful indicator of the likely impact to private infrastructure valuations than stock market movements. This is because private infrastructure valuations are adjusted to reflect the changes in actual and projected cashflows of the underlying assets.

Figure 1: Performance of listed infrastructure by sector (two-month total return)



Source: Bloomberg, March 2020

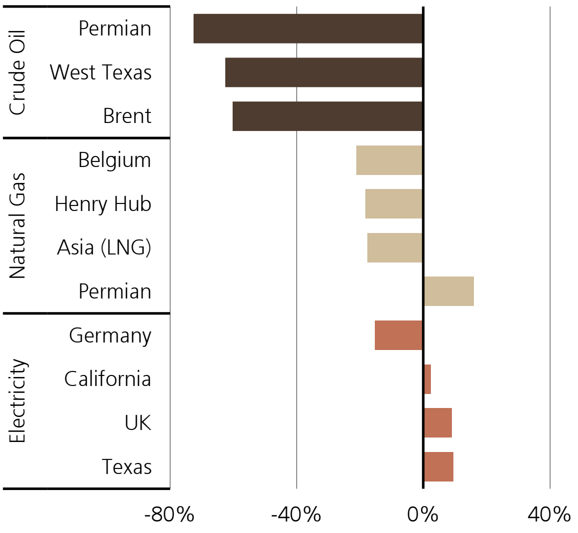
Figure 2: 2020 revenue estimates for listed infrastructure by sector (two-month change)



Source: Bloomberg, March 2020

While COVID-19 was already wreaking havoc across financial markets, Saudi Arabia decided in March to launch an oil price war against Russia (and implicitly, against the US shale oil industry). Oil prices have since fallen more than 50%, which has broader implications across other commodities, as well as energy exposed infrastructure investments. Just as it is uncertain how long the coronavirus pandemic will last, it is also unclear how long Saudi Arabia will continue its oil price strategy. The Kingdom requires an USD 80/bbl oil price to balance its budget, which means the current ~USD 30/bbl price should put significant pressure on its fiscal health.

Figure 3: Global and regional commodities
(two-month performance)



Source: Bloomberg, March 2020

For now, investors should brace themselves for continued uncertainty, and develop mitigants against various financial, operational and sector-specific risks, which we will attempt to address in this report.

Considerations by sector

Transportation
As with previous pandemics such as SARS and Ebola, airports are likely to be the hardest hit sector. In addition to being highly correlated to GDP, the extensive travel bans being imposed globally will have a detrimental impact on passenger numbers. The Airports Council International Europe (ACI) has provided some early indications of the impact, saying that European passenger traffic was down 54% in the week between 9-15 March compared to a year ago. In Italy, Atlantia's Aeroporti di Roma (ADR) was down 71% year-on-year over the last week. Clearly, a complete travel ban could completely wipe out earnings for some airports leading to a liquidity crisis (see below). Airports will be able to flex some costs to mitigate a decline in passengers but according to ACI, around 80% of its members' costs are fixed. While lost revenues may be partially recovered once COVID-19 settles, this will depend on how long the outbreak continues.

Other user-paid transportation assets such as toll roads, carparks and ferry companies will be similarly impacted by a partial or full shutdown of economies. While the concern for these assets is liquidity in the short term, the performance of these assets would be impacted in the longer term if GDP growth forecasts are revised downwards. Ports have fared better to date, perhaps reflecting their lower exposure to passengers and that they may not yet have received the full impact of the China shutdown. Trade continues to flow but ultimately the future outlook for the sector is intrinsically linked to the production levels in China and the rest of the world.

Energy and utilities
Based on recent commodity price movements highlighted in Figure 3, it is clear that oil is suffering the most as it is more susceptible to Saudi Arabia's price wars. This will negatively impact midstream infrastructure exposed to shale oil basins – as oil and associated gas (a by-product of oil) from regions such as the Permian Basin decline – while counterparties such as shale oil companies become more distressed.

On the other hand, a decline in US shale oil production is positive for midstream infrastructure exposed to pure-play shale gas basins such as the Marcellus, as low-cost associated gas will no longer be available to flood the markets.This in turn means shale gas regions such as the Marcellus and Utica will have to step in to fill the supply gap left by the oil basins.

This will offset some of the headwinds from lower industrial activity and weaker LNG demand, and is likely one of the main reasons why natural gas prices have not declined as much as oil recently. Despite slowing industrial activity, wholesale electricity prices have held up relatively well due to higher residential power demand, upward pressure on natural gas price in some regions, and uncertainty around greenfield projects currently in the pipeline.

Finally, regulated utility networks remain relatively resilient to the near-term volatility, given their cash flows are protected by regulations or long-term contracts. This is evident in the outperformance of energy and water utilities among the publicly traded infrastructure subsectors in Figures 1 and 2. However, while asset owners will benefit from the increased residential demand, the ability of the customer to pay may be reduced, potentially increasing bad debts – the likely impact will depend on the level of fiscal stimulus

Social infrastructure

The impact on public-private partnerships (PPP or P3s) is likely to be limited as these projects typically have long-term availability-based contracts that are less dependent on volume developments. These structures have been widely used for school and hospitals. The ability to operate these assets could become more challenging in this environment; however, the contracts typically contain favorable force majeure provisions.

Infrastructure investors are also invested into non-PPP social infrastructure assets such as private hospitals, lab testing and care homes. These are more exposed to demand risk but the current health crisis should results in higher needs for hospital infrastructure and lab testing although there could be pressure on them to perform a public service. Operators do face significant operational risks around operating sensitive assets at this time of crisis.

Communications

With many countries in lockdown requiring the population to work from home, data usage is expected to surge, which is positive for communication assets such as fiber, towers and data centers. This epidemic may also make companies rethink their disaster recovery plans and lead to a longer-term boost to data center activity, which can offer services such as remote hands. With schools closing and parents working from home, households may see their broadband capacity tested to the limit, which may lead to upgrades in the longer term.

However, it is not all rosy for the sector. The current surge in data usage is putting a strain on some networks, which could elevate operating costs in the near term.

In addition, as in the case of utilities, telecommunication companies (telcos) may experience increasing bad debts from the end consumers. As telcos are generally highly indebted as the industry is very capex intensive, certain telcos may struggle to refinance at favorable terms creating liquidity issues. Many of the assets owned by infrastructure companies are divestments from telecos. In many cases, the seller remains a large customer which inherently exposes the asset to the telcos' fortunes.

General considerations

Liquidity

We know from previous crisis that liquidity is a key concern. Some key features of infrastructure assets are their high EBITDA margins and strong cash generation, which can mitigate a decline in traffic; however, these are of limited benefit if there is a complete shutdown unless the owners have built up substantial cash balances.

Infrastructure assets tend to have leverage at the asset although gearing levels are much lower than GFC levels (41% vs. 61% in 2008). Infrastructure debt financings normally require a liquidity reserve of at least six months' debt service that will allow owners to continue to service interest and principal during a significant outage.

Infrastructure owners should be less exposed to refinancing risk than the wider corporate universe as owners have typically taken advantage of the very low interest rate environment to secure long-term debt. Inevitably some owners will need to refinance during this period. The liquidity in the investment grade space should hold up well but spreads in the high yield space have widened by around 100bps in Europe and 150bps in the US since the start of the year – although the impact is somewhat offset by the Federal Reserve Board 110bps cut.

Operational risk

Infrastructure assets often provide essential services to communities through the provision of utilities, transportation and social infrastructure. A key focus for asset owners will be the health and safety of their employees. Restrictions on employees and trade could make the assets more challenging to operate. They may also result in capital expenditure projects being delayed, which could affect longer-term returns. Supply chain disruptions can lead to a delay of equipment – and therefore delay of construction projects – although some relief may be available under concession agreements or through construction and operational contracts.

Conclusion

We have seen a range of policy responses in the major economies through a combination of interest rate cuts, quantitative easing and fiscal supports for businesses and individuals. So far they have had limited impact in stabilizing the equity and debt markets. The situation is clearly very fluid. The permutations and combinations are so varied that scenario analysis is necessary to evaluate contingency plans on portfolio companies and for investments into new assets.

There are still many unknowns about the impact for the infrastructure sector and the wider economy. While power prices have held up well so far, what will the impact be if major economies shut down all industrial production? Who will pay for the extensive government support packages – higher taxes, austerity? Longer term, will this crisis permanently change how the world consumes energy, healthcare, transportation, education, telecommunication and other essential services? For now, the only certainty is continued uncertainty and volatile times ahead.

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