

Deals Infrastructure Highlights

November Edition

pwc

In this inaugural Deals Infrastructure Newsletter, we focus on key themes we are seeing unfolding in the infrastructure space. Coverage includes:



Global infrastructure update – insight from global specialists on the infrastructure investment market



Changes to taxation thin cap rules and how that will impact gearing



Increasing importance on the environmental, social, governance (ESG) mandate seen in recent deals



Valuation insight – focused on the impact of current macro-economic environment on valuation of listed and unlisted infrastructure assets and managers



Global perspective

What are we currently seeing in global markets?

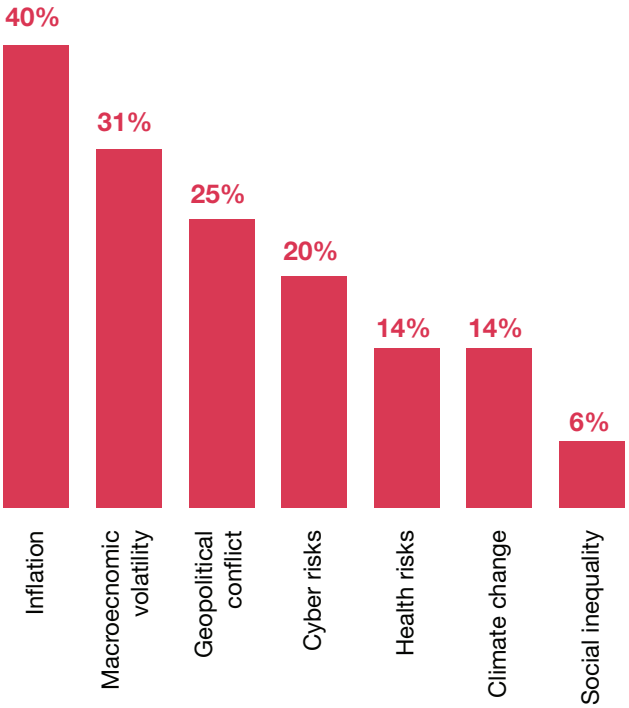
Following post COVID-19 tailwinds driving strong interest in core/core+ infrastructure and an attractive energy transition thematic resulting in a robust performance during 2022, the infrastructure sector has continued to maintain steady performance during H1-23, albeit in an increasingly challenging macroeconomic and geopolitical climate. The key themes that have impacted infrastructure investment activity in 2023 include:

- Inflation and elevated interest rates have made the market more complex which is driving increases in cost of capital translating into higher return expectations and as a consequence, shifting LPs interest from core infrastructure to core+ opportunities, higher up the risk return curve.
- The new macroeconomic environment has impacted profitability and risk is resulting in some dislocation between vendor versus buyer valuation expectations, driving a number of processes to become protracted (and in some cases, withdrawn). We are seeing fewer auctions and more “bespoke” processes with a more limited bidder field. One area of opportunity is public company takeovers where we have seen some activity as investors try to create deal opportunities.
- To a certain extent, the unfolding geopolitical climate, overall macroeconomic conditions and the possibility of a recession in certain global markets is also influencing portfolio allocation driving investors to pursue active management of their holdings, which in turn is creating bandwidth challenges resulting in a temporary “hold” on investments.
- Infrastructure and renewables fundraising has dropped notably during H2-22 and H1-23, with the decline driven by a combination of factors, including delayed financial closes and temporary infrastructure portfolio weighting exceeding allocation caps driven by devaluation of non-infrastructure holdings. This slowdown also has implications for the ability of funds to undertake new deals although the amount of dry powder has built up over the last 5 years.

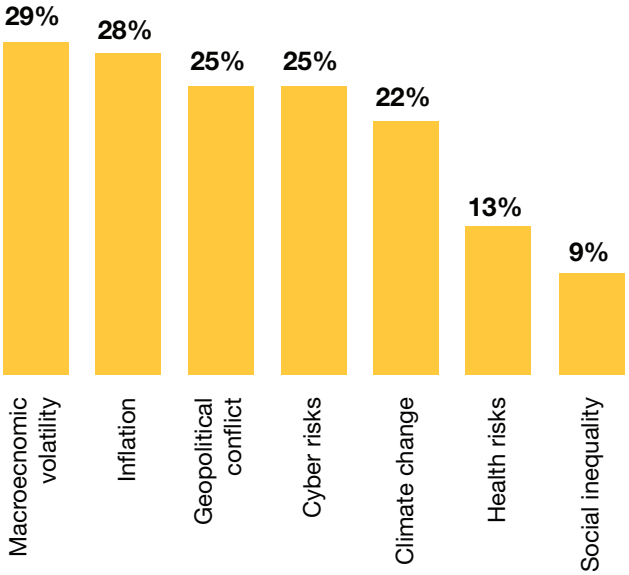


Per PwC's annual CEO survey, inflation and macroeconomic volatility stand out more prominently than other key threats in the next 12 months than over the next five years

Next 12 months



Next five yesrs



What should we expect during the rest of 2023?

Whilst highlighting the above challenges, there are reasons to believe that H2-2023 will be more positive, driven principally by:

- Over US$ 100b of infrastructure capital that is expected to be raised by the end of the year, driven partially by delays in targeted close dates in fund closings.
- Broader consensus that the denominator effect from overweighting of infrastructure holdings in portfolio allocations is temporary, with investors generally taking a long-term view on infrastructure investments.
- The slowdown in fund raising is being bridged by record levels of dry powder.



What are some of the dominating themes that are expected to shape the infrastructure conversation in 2024?

Three words – De-globalisation, De-carbonisation and Digitisation

- **Deglobalisation –** As a consequence of the geopolitical climate and the overall global economic environment, we are observing a focus on supply chains moving closer to home (e.g. investments in domestic rail, roads, logistics, manufacturing facilities etc) along with stronger government support around domestic energy security. This should drive higher transaction volumes characterised by stable cash flows underpinned by long duration contracts and built-in inflation hedges

- **Decarbonisation –** As corporations ramp up activity to facilitate energy transition and security to manage risks due to climate change, this will require a committed deployment of a large amount of capital globally in large scale renewables and decarbonisation solutions across a variety of sectors, including heavy manufacturing, industrials, and consumer markets. Two recent examples include:
  - CPP Investments acquisition of Aera Energy, California's second-largest oil and gas producer to enable emissions reduction and business transformation.
  - The unsuccessful public to private takeover of Origin Energy by Brookfield/ EIG, which represents the opportunity that global investors see in Australia, and the interest in supporting large fossil fuel producers to transition to renewables.

Digitisation – The exponential increase in global data consumption has driven the need for significant investment in digital infrastructure. Key examples include the carve out of inefficient passive telco infrastructure within MNOs so they can deploy balance sheets effectively on active technologies and the build out of data centre capacity.

PwC Global CEO Survey 2023

ESG – Navigating risk and unlocking value

As Australia heads into what is shaping up to be a scorching summer and challenging bushfire season, climate change remains at the forefront of ESG concerns for infrastructure investors. With Australia's mandatory climate-related financial disclosures set to commence from 1 July 2024, we expect to see accelerated action to measure greenhouse gas emissions, set reduction plans and manage climate-related risks and opportunities. Globally, increasing policies and regulations to support climate action are strengthening investment signals for renewable energy and other climate solutions, while also heightening stranded asset risks for existing fossil fuel infrastructure.

The urgency and scale of the energy transition was recently highlighted in the ACCC's decision to approve Brookfield's $18.7 billion takeover of Origin Energy which cited greenhouse gas emissions as a deciding factor. However, infrastructure investors should be revisiting existing portfolios not only to drive net zero alignment, but also tackle broader ESG issues. For example, solar panel supply chains linked to regions with known occurrences of modern slavery may jeopardise ESG commitments and social license if not appropriately managed.



Beyond managing transition risks, the pursuit of ESG-led value creation opportunities is emerging as a strong case for infrastructure investors to diversify into core plus assets – as seen in PEP's recent investment in LMS Energy, a waste-to-energy business aligned to circular economy principles and with strong prospects in Australia's maturing carbon market. Similarly, Morrison & Co's 2022 acquisition of carbon farming business Pastoral Partners Australia capitalises on the expected growth in demand for high-integrity carbon credits, and redefines the bounds of an infrastructure investment in the ESG context.

Linked to carbon, we are seeing strong interest in biodiversity on a global scale, with Ardian France recently launching a nature-based fund for €1.5 billion to be invested in carbon sequestration projects that restore forests, wetlands and mangroves. Closer to home, Australia's plans to create a world-first Nature Repair Market could be the incentive needed for local infrastructure funds to deploy necessary capital towards biodiversity restoration – watch this space!



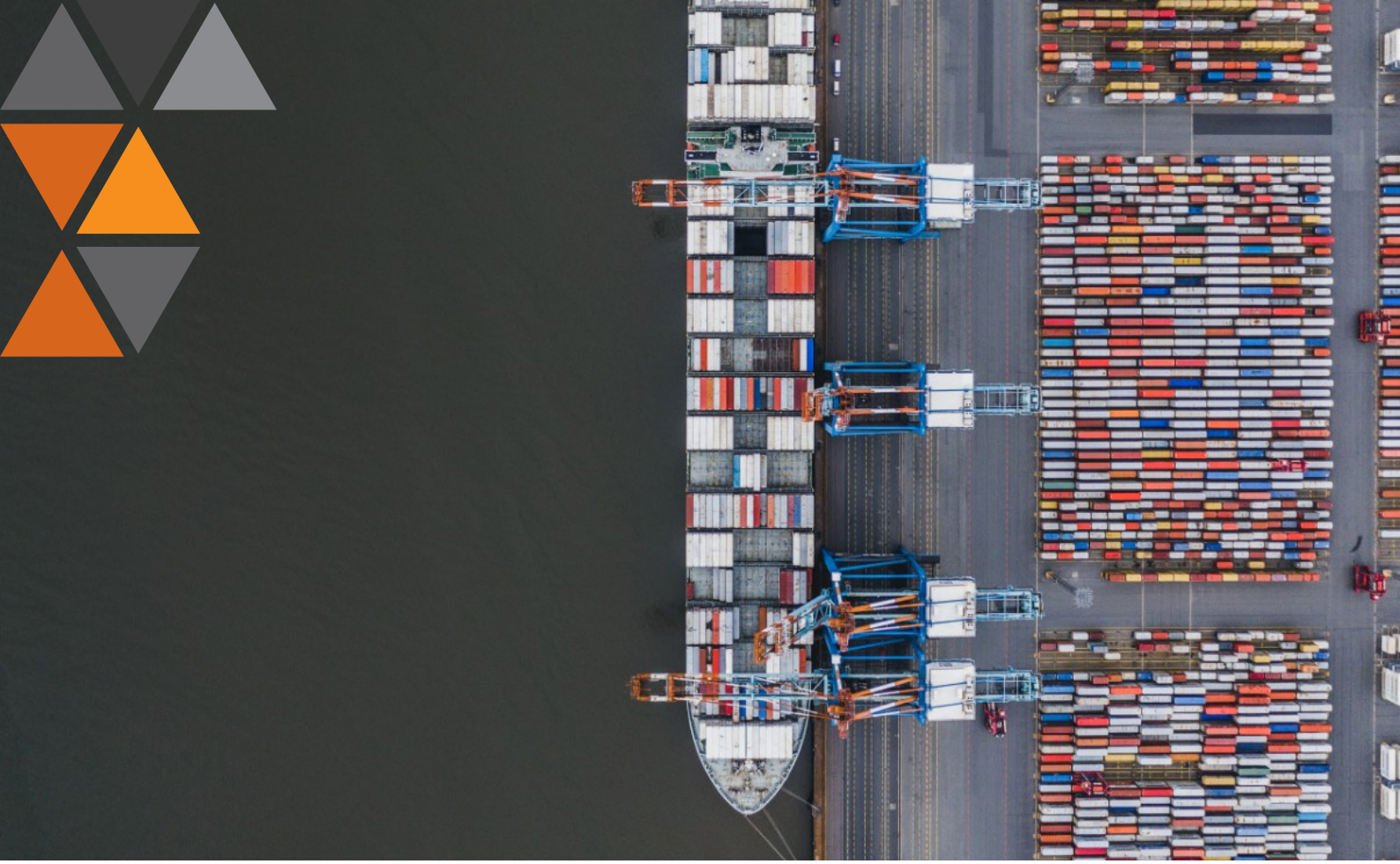
Tax update – Changes to Australia's thin capitalisation rules

The Government's thin capitalisation reforms are expected to be enacted shortly. When enacted, the changes will broadly take effect for income years commencing on or after 1 July 2023. This follows a detailed Senate review process which concluded at the end of September, and additional changes proposed by Treasury in October and November to address a number of deficiencies in the previous drafting, many of which were directly relevant to the infrastructure sector.

Broadly, under the default test, the changes will limit debt deductions based on 'earnings' rather than the current balance sheet approach. The existing safe harbour, arm's length debt test and worldwide gearing tests will also be replaced. As a result, the tests from 1 July 2023 will be:

- **Fixed Ratio Test** – debt deductions limited to 30% of the 'tax EBITDA', with excess deductions able to be carried forward for up to 15 years.
- **Third Party Debt Test** – disallows debt deductions to the extent that they exceed debt deductions attributable to external third party debt. No carry forward of denied deductions.
- **Group Ratio Test** – net debt deductions limited to 'group ratio' multiplied by tax EBITDA. No carry forward of denied deductions.





The changes will also implement a new 'debt creation' rule (which may deny debt deductions from 1 July 2024 and will apply to debt arrangements in place prior to this date) and expand the application of Australia's transfer pricing rules requiring additional arm's length analysis to support the quantum of debt.

Many taxpayers will find that further work is necessary to gather the internal data relevant for applying the new rules, conduct the analysis to quantify their debt deduction thresholds, maintain records to demonstrate compliance and implement procedures to streamline their ongoing tax compliance processes.

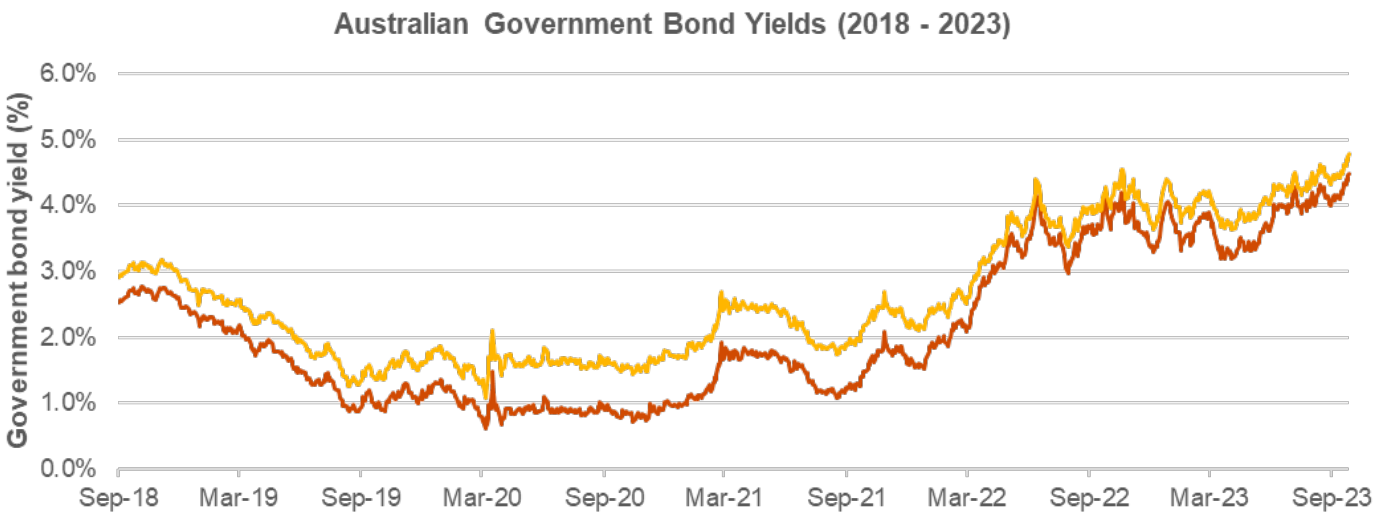
For a more detailed analysis of the proposed changes, please refer to our recent PwC Tax Alert.

Valuation insights

Over the last 18 months, central banks all over the world have been increasing interest rates in an effort to tackle overheating in local economies and combat high inflation. In Australia, the 20 year and 10 year government bond yields have increased from historic lows in 2020, with the 10 year bond consistently close to or above 4.00% over the past three months . We have observed a correlation between increasing government bond yields and the MSCI World infrastructure index, which has experienced a downward trend since May 2021.

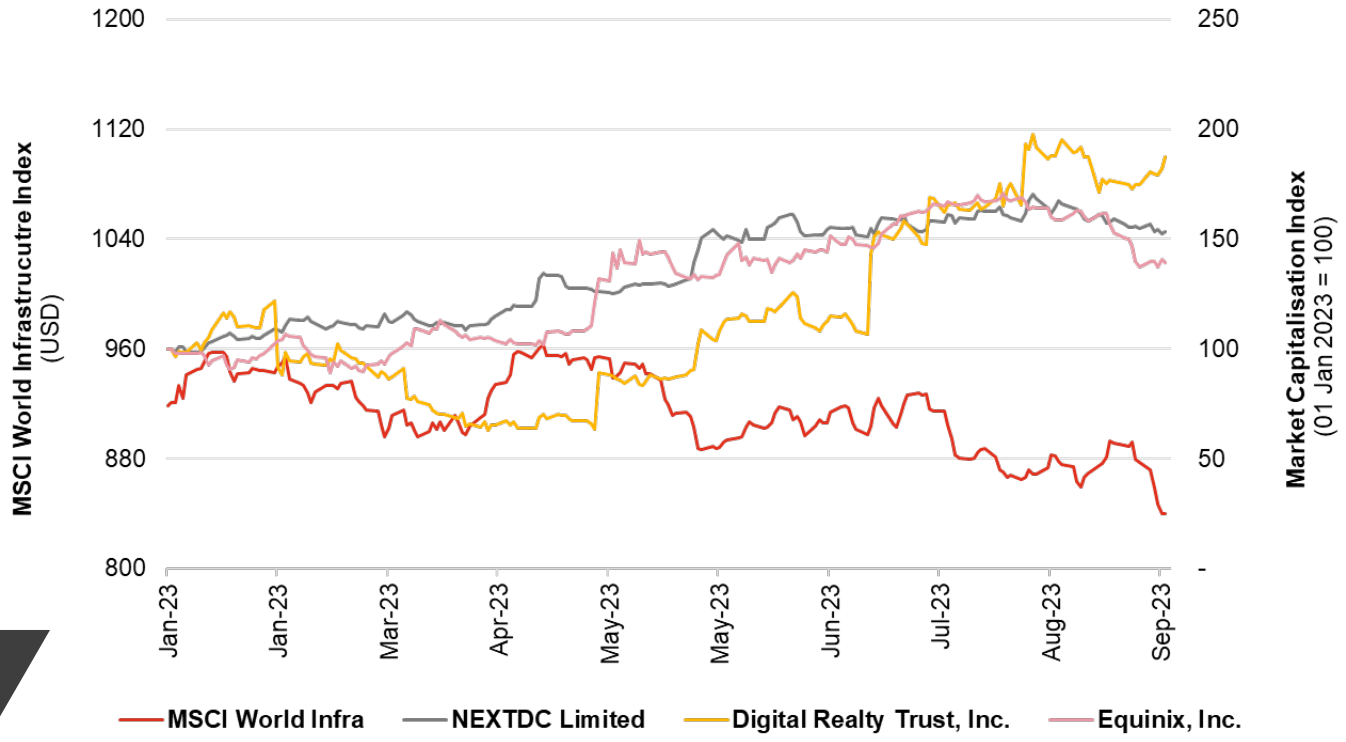
Additionally, with the impact of increasing inflation and tightening fiscal policies by central banks, the MSCI infrastructure index has decreased by c.10% over the past six months.

The cost of capital has increased since 2021 driven by increased inflation, higher real returns on listed companies (as implied by the ASX All Ordinaries index) and more expensive debt. All else equal, we would expect the aforementioned factors to put pressure on equity valuations through higher discount rates to reflect the higher return environment.



However, for some infrastructure assets the inflationary environment could lead to real value gains if pricing escalation terms allow for a full pass through of CPI, effective interest rate hedging strategies are put in place and/or there are strong growth expectations in the near future (such as data centers as discussed further below). For assets that cannot fully pass on inflationary cost increases to their customers or where there is exposure to interest rate fluctuations, there could be a negative real value impact. In this macroeconomic environment, it is important to ensure that there is consistency between the forecast macroeconomic assumptions underpinning the valuation and the discount rate that is applied.

Despite the increasing cost of capital, some sectors continue to present strong growth potential. In the last few months, the advent of artificial intelligence has led to greater demand for data. Data centre projects and companies with such investments are expected to captivate investors' appetite. Despite decreasing equity values of major infrastructure assets listed on the ASX and the MSCI World Infrastructure Index, the equity value of certain companies operating in the data centre space like NextDC, Digital Realty Trust and Equinix have increased by c.20% to 50% since the beginning of the calendar year.



Key contacts – PwC Australia

If you would like to discuss the above topics in more detail, our dedicated deals infrastructure teams would be pleased to assist.

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