Deals Infrastructure Highlights

November 2024 Edition

pwc

Welcome to the November 2024 edition of our Infrastructure Newsletter

As we move towards the end of 2024, the global infrastructure investment landscape presents a mixed picture. While the year began with optimism for a rebound following a subdued 2023, the reality has been somewhat tempered. Deal activity has improved compared to last year, but it hasn't reached the heights that some had anticipated. According to Preqin's Q3 report, the unlisted infrastructure fundraising market saw a further decline, with only US$15.6 billion raised in the quarter (US$18.6 billion in Q2), which was just ~52% of the quarterly average over the past five years and a substantial drop from Q1 fundraising haul of US$45.2 billion.

Latest figures show year to date fundraising of US$82.9 billion, indicative of GPs being in the market for longer to reach close, perhaps driven by more uncertain deal processes, albeit generally seeking to raise larger funds. Additionally, dynamics underpinning valuation gaps between vendors and bidders are still playing out, potentially impacting bidder pools and ability for processes to close, leading investors to seek the elusive bilateral transaction.

Despite these challenges, there is a significant amount of dry powder—estimated at US$336 billion globally—seeking investment opportunities. Key investment themes include decarbonisation and digitisation (see our August 2024 edition of our Infrastructure Newsletter). Energy transition remains a hot topic, with a shift in thinking about the future energy mix, including the role of fossil fuels, in particular gas. Digitisation, particularly the growth of data centres, is driving demand for energy and infrastructure.

This month, we delve into 2 main topics:

1. Valuing ESG in Infrastructure: Navigating the Evolving Landscape
2. Economic Outlook Impacting Deals

Valuing ESG in Infrastructure: Navigating the Evolving Landscape

Environmental, Social and Governance (ESG) in infrastructure valuations is becoming increasingly top of mind for key stakeholders. This is not a new phenomenon but really came into mainstream recognition following the initial wave of ESG focussed fund marketing and has steadily grown in board room prominence on the back of global sustainability goals and evolving reporting requirements. As such, asset managers and valuers must navigate a complex ESG landscape in their bid and financial reporting valuations.

Below, we discuss the increased focus on the 'impact' of ESG on value, driven by global sustainability goals and the inflow of ESG-focused investment funds. Whilst academics have highlighted the benefits of adopting strong ESG practices, pointing to lower cost of capital and market outperformance, there are more fundamental questions that ask, *is the outperformance that the academics identified sustainable?; and was it purely driven from ESG alone?* Care must be taken in the blind adoption of 'ESG premia' from the academic research which runs the risk of overpricing (or double counting) the benefits that may already exist in your selection of earnings multiple or the beta for your discount rate. Additionally, and on the other side of the coin, simply adopting the downside cost of carbon abatement and ESG initiatives may miss the value enhancement (or saved) from implementing those initiatives. We highly recommend running thorough comparisons of what you are adopting in your cash flows for ESG initiatives and costs and comparing that to what you are seeing in your comparable benchmarks to minimise the risk of double counting benefits or costs.

Importantly, in our view, 'ESG' (as it is referenced in media) is more akin to a framework that helps stakeholders in understanding how a company manages opportunities and risks in response to environmental, social or governance issues. As such, there is a larger question relating to the correlation between a strong management team and strong ESG practices. ESG alone is not the driver of value, the use of ESG initiatives (and any other significant corporate initiatives) outlined and implemented by a strong management team will drive value.

Value of ESG

Academic papers suggest that ESG performance leads to higher value due to companies with high ESG ratings outperforming the market over time[1]. In addition, investors are favouring ESG positive investments and often demanding that businesses embrace ESG[2] goals. Conversely, there is a demand for trust and transparency, and ASIC[4] and the ACCC have been focused on greenwashing propaganda. Whilst it is sometimes difficult to establish a definitive causation between the adoption of ESG practices alone and higher share price performance, there is a significant correlation between these factors.

This is evidenced by the fact that companies with higher ESG ratings, on average, had lower frequency of stock-specific risks, avoiding large drawdowns in their market capitalisations and thus representing a risk-mitigation premium[3].This correlation could be partially explained by the fact that embedding ESG considerations in the decision making of a company is an inherent trait of high performing management teams who are aware of and seek to benefit from broader market trends. As such, boards should be tracking ESG performance to ensure strong governance processes are in place as well as establish initiatives to ensure strong performing managers are appropriately incentivised. Going forward, with mandatory sustainability reporting in Australia commencing in 2025, Boards and management will be required to have appropriate governance in place to oversee and track progress of ESG performance against targets[5]. The aforementioned benefits highlight the importance of integrating ESG considerations into infrastructure business strategies to drive long-term value and sustainability.

1 HBR. (2022). The Financial Benefits of ESG. Harvard Business Review.

2 McKinsey & Company. (2021). Why ESG is Here to Stay.

3 MSCI ESG Research. (2022). ESG Investing.

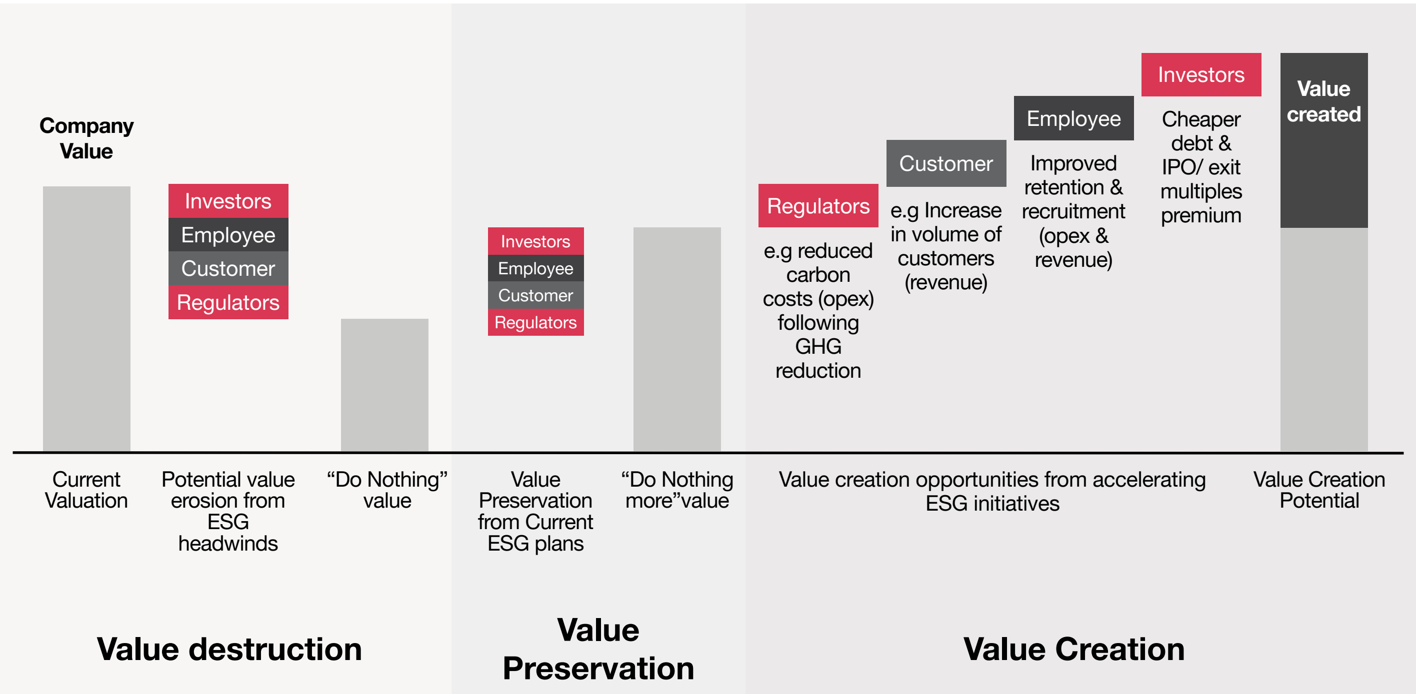
4 ASIC continues action on misleading claims to deter greenwashing misconduct

5 PwC - Sustainability reporting standards and legislation finalised: mandatory sustainability reporting begins

The Challenge and our approach to ESG Valuation

Due to the current lack of standardised reporting it is extremely complex to estimate the stand alone value of ESG. For instance, in valuing a data centre operator it is difficult to assess whether the ESG performance of the business is a leader or laggard compared to others in the sector due to inconsistent sustainability reporting frameworks. The coming shift in sustainability reporting will drive greater consistency and improved comparability but you will still need to have a deep understanding of the asset and its comparable companies to ensure that the value you are ascribing to ESG is not being double counted in your own valuation (or not at all).

As always in valuations, xit ultimately comes down to fundamental analysis of what you are including in your forecast modeling and comparing that to what you see in benchmarking of comparable companies. This should help you identify the value at risk of 'doing nothing'; the value preserved by 'doing nothing more' and the potential for value created by 'doing more'. In terms of what we are seeing in the market, the majority of management teams and valuers are only at the stage of identifying the potential value at risk and therefore the value that can be preserved from implementing ESG initiatives.



Best practice in valuations is to incorporate the impacts of sustainability initiatives and risks in the forecast cash flows first. After understanding as much as possible in terms of what others are doing in the market and what your comparable set of companies are doing then (and only then) do you adjust your discount rate. If you simply adjust your discount rate for an ESG risks/premia based on academic research, you run the material risk of double counting the ESG impacts or upside.

What do I need to work it out?

When understanding the value of ESG on an infrastructure asset, it is important to deploy a multidisciplinary set of skills as it will require an understanding of direct and indirect linkages between ESG initiatives and potential cash flow impacts. Furthermore, as mentioned above, to mitigate the risk of double-counting, it will also require an understanding of what may or may not be incorporated in the other factors of your valuation such as the discount rate. Consequently, we recommend the combination of strong sectoral experience and expertise in ESG reporting and valuations to consider discount rates coupled with the technical / operational expertise of the management team to amend forecast cashflow modelling.

We are actively working with funds to undertake periodic valuations of assets and estimating the value preserved through ESG-related expenditure (capex and opex). Moreso, taking our data centre example from above, we have seen investors' use technical experts to estimate the value preserved (from being able to retain current clients) and the potential value created by investing in new energy efficient cooling systems (which would significantly reduce the target asset's power usage effectiveness (PUE)) to potentially attract new clients seeking higher energy efficiency (due to AI compute requirements). Similarly, analysis can be considered across the various components of the future cash flows (such as third party provided pricing estimates, forecast capex initiatives and discount rate) to ensure ESG initiatives and risk assessments are not overly conservative.

Increasingly, impairment testing for audit purposes will need to ensure ESG considerations are correctly modelled, scenario tested and an appropriate discount rate is utilised without double counting the risks. This should include the quantification of potential financial impacts to assets and the business as a result of climate-related risks under different climate risk pathways. For example, assessing the myriad of potential options for decommissioning coal infrastructure and utilising the underlying asset base for alternative use such as renewable energy or natural capital infrastructure.

What benefits will I see from deploying best practice?

Utilising the methods above, especially through a focus on cash flow impacts will allow you to gain greater insights into the ESG aspects impacting your business and will allow you to assess with greater clarity what is a real risk versus what may just be perceived. Furthermore, it will allow you to run scenario and sensitivity analysis on the costs and benefits of your ESG initiatives to understand not only the potential impacts on financial performance and value but also the impacts on your sustainability reporting objectives and ESG targets.

As with any set of initiatives, ESG initiatives must also be weighed against all the other strategic imperatives of the business. Using more detailed cash flow modeling will enable you to better understand the key decision points for implementing various initiatives and the interdependencies of those decisions.

Conclusion

In summary, as ESG-related regulation matures and capital providers seek greater transparency, leading infrastructure asset managers will use ESG valuations to demonstrate better risk management and value protection, positive ESG outcomes and long-term value creation. The focus should be on appropriately adjusting cashflows to reflect ESG factors and utilising relevant benchmarks to your comparator group.

Economic Outlook impacting Deals

Our chief economist, Amy Lomas, provides insights into the economic factors influencing infrastructure deals, focusing on Australia's mixed growth outlook.

Deals have been impacted by differing views of macro forces and we have seen a bidder/seller spread and deals taking longer to complete. This is unlikely to change in the near term based on the current conditions and outlook, which remain mixed. The easing of global and Australian inflation brings the promise of lower future interest rates and cheaper capital. While there is some upside with key trading partners, especially China, the rise of US protectionism and the prospect of substantial increases in US tariffs casts a dark shadow over Chinese demand.

With Australian Government budgets stretched, the volume of government infrastructure commitments is past its peak, but delivering the pipeline continues to place pressure on an already tight construction labour market. And the demand for infrastructure investments remains high, particularly in energy and transport, which brings new opportunities for connectivity and public-private partnerships. Cautious optimism is key, especially with ongoing political and geopolitical uncertainty.

Global inflation easing and upside in key markets

Uncertainty about the state of the global economy has affected global investment flows in the past year or so, with tight monetary settings resulting in an overall decline in fund raising, project finance and M&A. Despite the US election outcome, uncertainty remains with limited information currently available about the commitments made and their relative priority for the US President elect.

Advanced economies are progressively getting inflation down back towards target ranges of around 2-3% following a sustained period of monetary tightening. Central banks are carefully monitoring the balance between inflation, unemployment and growth in an environment where uncertainty remains elevated and brings with it upside and downside risks to growth.

Cash rates across advanced economies are coming down, with the most recent significant move being the US Federal Reserve cutting the official interest rate by 50 basis points in September. While a cut was anticipated by the market, the scale was at the bolder end of what was expected, signaling nervousness at that time about the US growth outlook. Leading indicators such as the Purchasers Managers Index and the US bond yields curve indicate expectations of sluggish growth ahead. Policies aimed at curbing US migration and raising tariffs will amplify downside risks to growth and inflation. The US remains Australia's number one source of foreign direct investment and fifth largest export destination, so the relative economic performance of both countries, and the exchange rate, will influence capital flows and income. A lower Australian dollar could prompt more US-initiated deals.

[4] IMF, October 2024 World Economic Outlook

In early October Australia's top export destination, China, announced a major stimulus package to boost spending and investment, comprising a comprehensive set of monetary and fiscal initiatives that will increase the availability of credit and liquidity, increase government spending and stabilise the property market. The scale of the stimulus is material and should help China achieve its target output growth of 5%, although the current weak pace of growth combined with US tariffs will make this increasingly difficult, even with an additional stimulus round announced after the US election result.

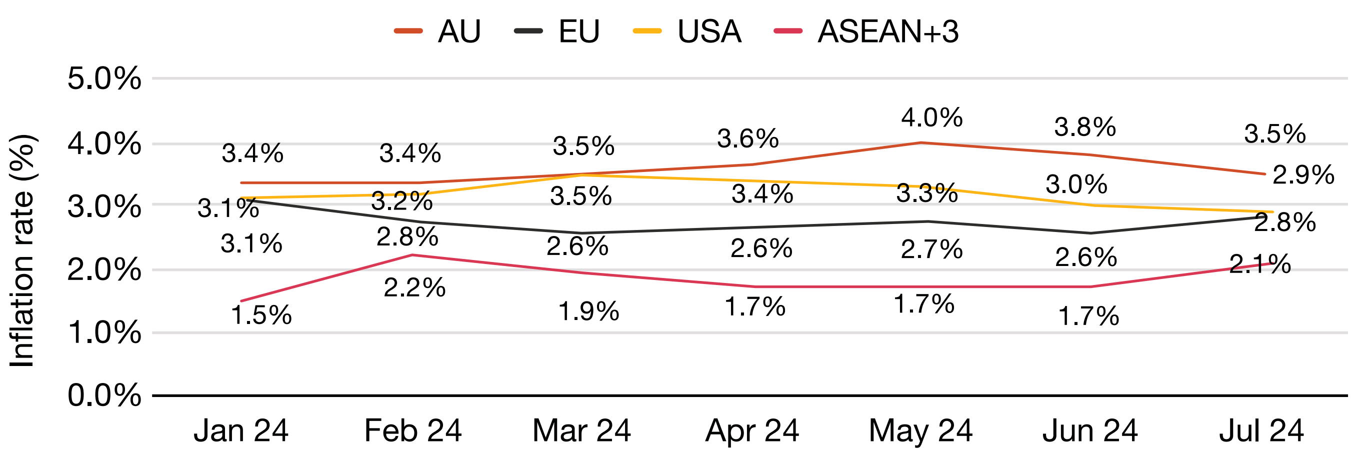
Growth rate spread in 2024 amongst Australia's other top export destinations is notable, with Japan below 0.5 %, South Korea has lifted to 2.5%, and India is settling in around 7%[6].

Collectively this presents a mixed bag in terms of assessing demand for Australian exports, but given its scale, will largely hinge on the performance of the Chinese economy.

A mixed Australian growth outlook

Australia's macro growth outlook is mixed, with output growth forecasts for 2025 lifting by around one percent from the current weak levels of 1-1.5%. Underlying inflation remains stubbornly above target levels and high relative to key regions and the US (see Figure 1).

Figure 1: Inflation: AU, EU, USA, ASEAN +3



Sources: Eurostat, Euromonitor, ASEAN+3 Macroeconomic Research Office (AMRO), Fitch

6 IMF, October 2024 World Economic Outlook

Labour market conditions are tight and unemployment is lower relative to other developed economies. Sustained demand for labour is a unique feature of the Australian economy, but some softness is creeping in with advertised vacancies falling. Overall these indicators point to ongoing capacity constraints in the economy that prevent it from meeting demand, including stagnant labour market productivity and under supply of housing. While there are supply side initiatives in place to target these constraints, dampening demand is the predominant fix being employed in the short run. Tackling productivity is the bigger and more pressing need for Australia to lift and sustain growth above current muted levels.

The official cash rate remains at the sustained peak level of 4.35% (in place since November 2023). While there are various views in the market about exactly when the rate could start to come down, with predictions tending to mid 2025, it is the mix of underlying inflation, employment and output that is key to the timing of rate cuts. The Reserve Bank is presently not expecting underlying inflation to fall within the target range until late 2025, but the ultimate timing of cuts will come down to its future assessments of the rate of economic momentum when abstracting for factors that are sustaining demand, such as immigration (which is boosting consumer spending) and the impact of public sector spending.

At this stage there is no indication of a significant weakening in the labour market and output levels, while weak, are broadly as predicted, although unexpected price pressures could emerge if conflict escalates in the Middle East and oil supplies from the Gulf are impacted, and if China stimulus measures flow through to trade and commodity prices. Whilst the outcome of the US election provides a general direction, there remains a lot of unknowns, and combined with an imminent Australian national election, there is a higher level of policy uncertainty and disruption risk.

On balance, assumptions of lower lending rates for investment models appear reasonable, but should be applied with a level of conservatism given elevated levels of uncertainty.

Public sector infrastructure pressures and the impact on deals

Government was the largest contributor to GDP growth over the past year and employment in public administration has been steadily rising along with the value of government construction work relative to GDP. Governments, with the exception of WA, are running very tight surpluses or deficits with notable spending pressures coming from cost-of-living initiatives, and cost growth running at rates higher than revenue growth. With public sector debt accumulating and the pressing need for infrastructure replacements, upgrades and expansion (particularly in the energy sector) there is an emerging need for increased private sector investment.

For example, recently the WA Government took the unusual step of seeking EOIs from the market for the construction, ownership and operation of four new open access transmission lines in the Pilbara. Combined with the opportunities that public sector infrastructure can open up, government infrastructure activity may spur private sector project financing and funding, and related deals activity.

Conclusion

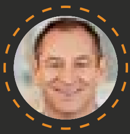
While Australia has some way to go in bringing inflation under control and lifting output, it was the second largest destination for project finance deals last year, likely due to its comparative advantage in energy. Similarly it remains in the top ten of global investment destinations.

With global monetary policy now increasingly in play and global growth stabilising, albeit at a relatively muted level by historical standards, there is room for optimism in deals activity. Downside risks are real and warrant close attention, but on balance we should see an improvement in investment flows and M&A activity.

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.

Transaction Services



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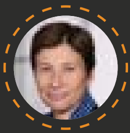

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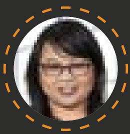

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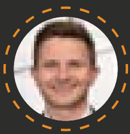

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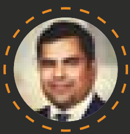

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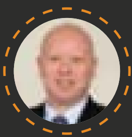

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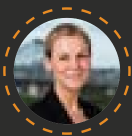

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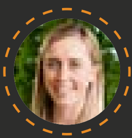

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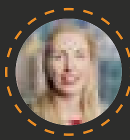

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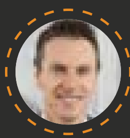

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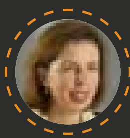

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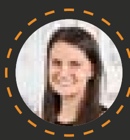

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