Goldman Sachs | Asset Management

THE IMPACT OF INFLATION AND RISING INTEREST RATES ON INFRASTRUCTURE INVESTING

By David Walsh

The first half of 2021 saw the global economy continue its recovery from the initial shock of COVID-19. The megatrends in infrastructure that existed prior to the pandemic continued to accelerate, particularly around the digitization of our economy and the transition toward renewable energy. The stronger economy in 2021 supported higher infrastructure valuations and active deal making, and this was further strengthened in the U.S. by President Biden's Infrastructure Investment and Jobs Act, which passed through both Houses before being signed into law on November 15, 2021.

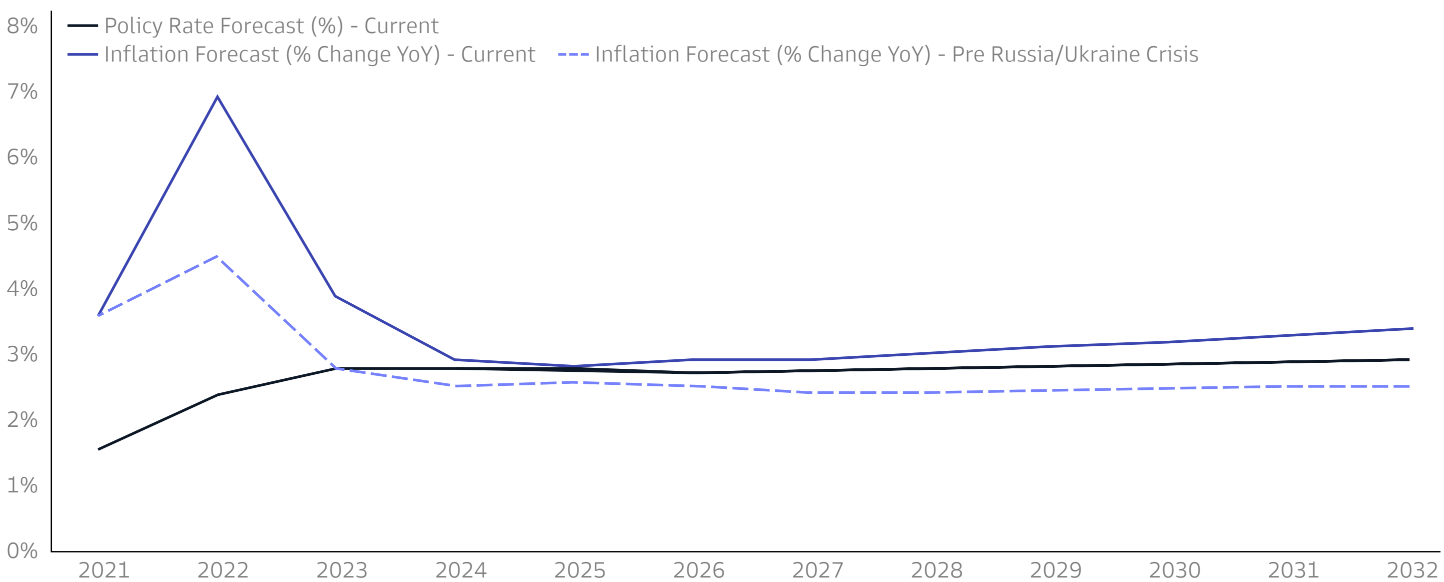
However, the supportive environment for infrastructure was challenged in the latter half of the year as inflation showed itself to be more persistent than initially expected, and the market's expectations of interest rate hikes increased. This picture has now been further complicated by the conflict in Ukraine which continues to impact supply chains and energy prices, muddying the situation for policy makers as the fear of inflation is quickly becoming the fear of stagflation.

As shown below, Goldman Sachs Global Investment Research forecasts global inflation to remain sharply elevated throughout 2022 (with expectations rising even further after the start of the Russia / Ukraine crisis) before declining toward target over the next 10 years, with central bank rates rising from 1.6% in 2021 toward 3% over the long-term.

Interest rates and inflation are both important variables that infrastructure investors should be cognizant of, particularly in the context of the asset class often being viewed as an inflation hedge. Goldman Sachs Asset Management ("we") believes that infrastructure investors should focus on two key questions:

1. What is the impact of rising rates on the infrastructure market?
2. If inflation is not transitory, will infrastructure exhibit the inflation hedge characteristics that investors expect?

World Policy Rate & Inflation Forecasts (2021-2032E)



Source: Goldman Sachs Global Investment Research. The Policy Rate is the interest rate used by central banks as an instrument of monetary policy. Euro Area references the ECB deposit rate, US references the Federal Funds Target Rate, etc. Aggregated figures are Purchasing Power Parity(PPP)-weighted averages. For % Change YoY Inflation, aggregated figures are calculated based on seasonally adjusted numbers.

WHAT IS THE IMPACT OF RISING RATES ON THE INFRASTRUCTURE MARKET?

We believe that infrastructure valuations in certain market segments are elevated. A key driver of this has been historically low interest rates, which has allowed many direct investors to participate in infrastructure markets with a low cost of capital. This may have contributed to some of the premium pricing recently seen in the most competitive auctions. As interest rates rise, there may be a softening in the premium pricing of some assets as the cost of these investors' capital increases. However, there is reason to believe that the "floor" to infrastructure valuations is likely to remain elevated, even if interest rates rise.

The key reason being the significant increase in the level of capital participating in infrastructure markets. As infrastructure GPs have raised more capital, and as a number of institutional sovereign and public entities have invested directly in infrastructure (more frequently in core type assets), the competition and prices for these assets has increased. These pools of capital are relatively stable, and are expected to continue to participate in infrastructure markets, so we expect the demand for infrastructure assets to remain high.

Further to this, we believe the higher returning, value-add strategies are less sensitive to interest rate rises. The reason for this is twofold:

1. Value-add strategies naturally have a higher discount rate applied into their pricing and valuations, so any increase in interest rates is a much smaller component of underwriting
2. Value-add assets, on average, tend to use less leverage at the portfolio company level, and therefore are less sensitive to interest rates.

Finally, the impact of an increase in interest rates on infrastructure investing may also depend on the extent of the increases, and how quickly they are made.

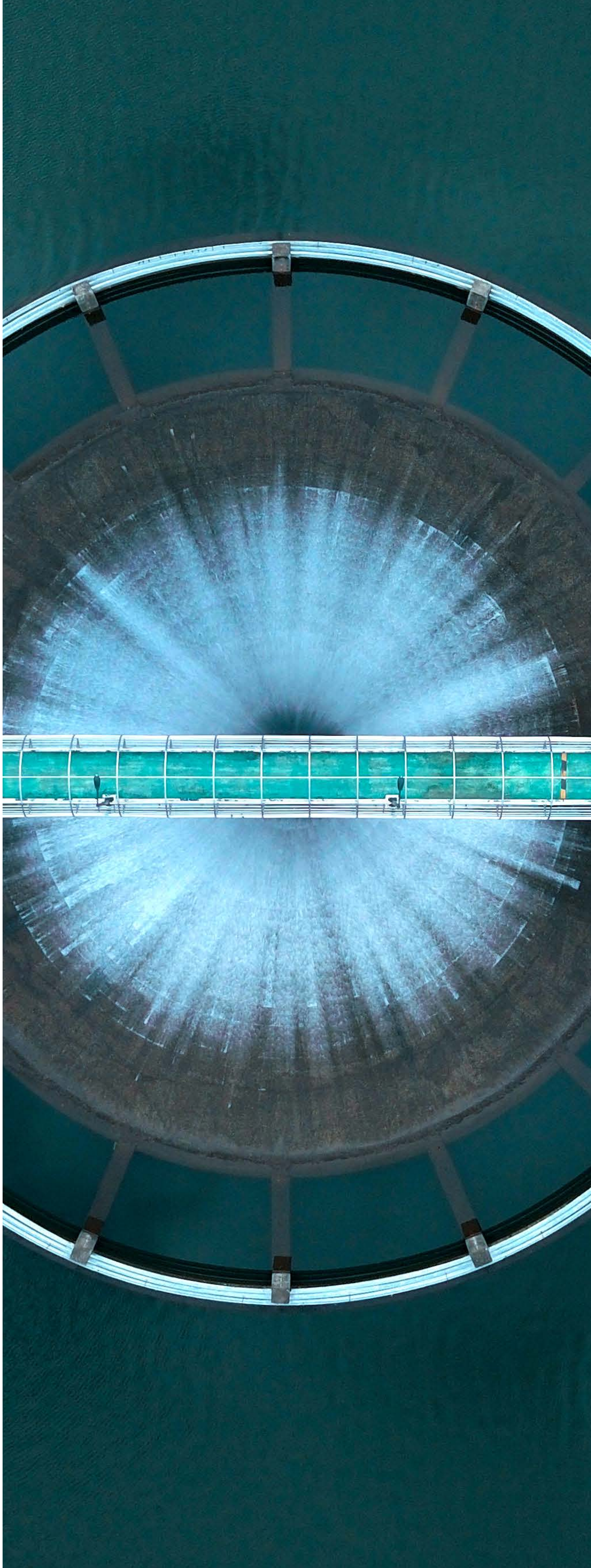
- **A large and rapid rise in interest rates** may spur a correction in the premium prices for core infrastructure assets; however, we believe the risk of this scenario is low, given central banks continue to show caution in regards to supporting growth while the pandemic continues to disrupt the global economy.
- **A slower and/or smaller rise in interest rates** may soften infrastructure pricing, but we believe it is unlikely to cause a significant "shock". One reason for this is the embedded inflation protection that infrastructure assets are perceived to provide, giving investors a degree of comfort in their exposure to the asset class.

WILL INFRASTRUCTURE BE A HEDGE AGAINST INFLATION?

Whether infrastructure will indeed act as an inflation hedge is a more complicated question. Given the somewhat amorphous definition of infrastructure assets today, we believe investors should avoid treating infrastructure as a homogenous asset class with universal inflation hedging properties. We agree that infrastructure assets, on average, are less sensitive to inflation, and in many environments will perform ahead of other growth focused assets and evidence the resiliency and defensiveness that investors expect. However, the extent of the inflation protection can vary dramatically based on the following factors:

- **Pricing Structure:** Infrastructure investors often seek businesses with long-term contracts to provide income stability and certainty. Those investors that stay true to the key infrastructure characteristics and invest in assets and services that have either explicit inflation linked pricing or those that have true inelastic demand will likely enjoy the inflation protecting attributes. However, if an asset's pricing does not reset with inflation or is unable to pass through any input cost inflation, the impact from a prolonged inflationary environment could significantly erode value.
- **Input Costs:** If inflation is being driven by energy prices, wage growth, and/or raw material prices, the impact on infrastructure businesses could be significant. There are mitigants to this, but it is more pronounced in some assets versus others. Those assets with larger labor forces and those that are undergoing heavy capital expenditure (requiring raw materials) are more at risk if they are not able to generate proportional increases in revenue. Conversely, a number of the new-economy infrastructure assets have more structural protection from input inflation given lower exposure to energy prices and raw materials, and tend to have proportionally smaller labor forces.

CONCLUSION



Higher inflation and rising interest rates will continue to provide opportunities and challenges for infrastructure investing and reminds us that not all infrastructure assets are created equally. Rising interest rates may put pressure on the recent premium pricing that we have seen in the largest core assets, but should have less of an impact on value-add assets, which have less interest rate sensitivity; while rising inflation may aid those infrastructure businesses with inflation linked pricing, inelastic demand, and stable cost structures, while adversely affecting those that don't hold such attributes.

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David is a managing director in Alternatives Capital Markets and Strategy (ACMS), which oversees institutional capital markets, capital raising and client strategy across all direct investing and open-architecture alternatives strategies throughout Goldman Sachs. Previously, he was a member of the public markets investment team in Alternative Investments and Manager Selection. David joined Goldman Sachs in 2016 as a vice president and was named managing director in 2021. Prior to joining the firm, David worked at Investcorp for two years and UBS for nine years in both London and New York. David earned a BS in Economics from Monash University in Australia.

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