How the infrastructure sector can shake off the troubles of 2018

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Gravis Capital Partners' Will Argent explains what the death of the private finance initiative means for infrastructure investors in the UK.

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It has been quite a year for the infrastructure space. From the death throes of the outsourcing firm Carillion in January to the formal ending of PFI (private finance initiative) for government contracts in the Autumn Budget, barely a month has gone by without the sector hitting headlines.

The woes of the outsourcing firms and a shift against public-private partnerships have all played a part in damaging the perception of the infrastructure sector over the past year, adding to the slow erosion of faith that began after the Labour Party slated PFI contracts at its 2017 conference.

Nevertheless, however bad the news has seemed for the sector, there is little reason for investor sentiment to be permanently impaired.

Chancellor Phillip Hammond's budget statement that the time of PFI was over was far from being 'new news'. The number of fresh PFI contracts being written has been dwindling over the past few years, and that is reflected in the modest level of PFI exposure within the VT Gravis UK Infrastructure Income fund. What was far more interesting – and important – was Hammond's pledge to honour existing PFI contracts, as was his announcement that the private sector would play a very significant part in the development of the government's £600bn national infrastructure and construction pipeline.

Clearly, the role of private investment in these projects will be critical. The public sector cannot fund them alone, and while we do not know what structure a future framework will look like, we can be sure the private sector will be very much involved in helping push development of the pipeline through to completion.

In much the same way as the ‘death’ of PFI does not spell the end of private investment opportunity into UK infrastructure, the drama surrounding the collapse of Carillion should not spell doom and gloom for investors either. The drama of January was a story of serious mismanagement at a firm working on very slim margins. While obviously the Carillion case led investors to focus on the level and concentration of exposure among infrastructure companies to private contractors, ultimately it had nothing to do with the assets themselves. In addition, in the fallout from Carillion’s collapse, the infrastructure sector has demonstrated it has crisis management plans in place and was able (and continues) to work through the problems effectively.

Future opportunities

I’m no political commentator, but it is clear, that given a very unstable Conservative leadership at present, political risk is something infrastructure investors should remain aware of. Looking into next year there are two areas where we expect to see continuity in political support irrespective of which party is leading the country. The healthcare and renewable energy sectors offer, in our opinion, attractive opportunities for investors.

In the renewable space our main exposure is to wind and solar power projects which have continued to form a key component of the UK’s drive to decrease our reliance on fossil fuels. With cross-party support for the so-called ‘green agenda’, ultimately things like subsidy payments should be left well alone and the sector should continue to offer solid returns.

There are also new, growing areas of investment opportunities such as energy storage which looks set for an interesting future. It is still early days for the sector and our exposure will be modest while issues such as the visibility of cash flows remain, however we see it as an area that will see a lot of growth in the coming years, offering a solution to how we harness and distribute the increasing amount of energy generated from renewable sources.

Within the healthcare sector there is a drive to rationalise the NHS estate and with that, create more large ‘hubs’ where primary healthcare, such as access to GPs and chemists, can be improved. There is improved funding to deliver it and cross-party support, so it should result in opportunities that offer a reliable and steady source of returns, all while helping to provide vital social services.

Both sectors are attractive as we believe these initiatives are likely to be supported under any government, unlike PFI. Exposure to them should help minimise the macro risk that is present across infrastructure portfolios while still offering up a pipeline of promising opportunities.

Moving up the capital structure

It is an understatement to say that the next year looks uncertain for the UK, but by ensuring exposure to assets where ongoing political support is perhaps less controversial, we should minimise risks thrown up by that lack of clarity.

Part of minimising risk may involve increasing our exposure to corporate bonds as yields in infrastructure-linked debt have been rising. It's a potential area to deploy cash in order to lock in attractive yields and move up the capital structure which offers relative safety and the potential for lower volatility, both of which should be priorities for investors in the coming months.

Will Argent is fund adviser to the VT Gravis UK Infrastructure Income and VT Gravis Clean Energy Income funds. The views expressed above are his own and should not be taken as investment advice.