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Pair of projects build up interest in sector

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There is no doubt that the UK government is committed to infrastructure. Two projects are providing a strong macro driver for the sector, and the momentum behind the country’s desire to move to more sustainable and renewable energy is strong.

With growing inflation expectations, the potential for index-linked income, as well as strong capital growth in certain sectors, is making the asset class more appealing by the day.

Of the two projects, Hinkley Point C (HPC) – a nuclear power reactor in Somerset, set to go live in 2027 – will cost around £30bn, while Crossrail – a new southeast to northwest rail line across London opening next year – has racked up around £15bn of infrastructure spend.

HPC will be the earth's most expensive asset, and generate 7 per cent of the UK's energy needs.

In turn these numbers demonstrate that renewable energy in the UK, currently providing only 24 per cent of energy needs, is a vital sector. Installed solar and wind-generation projects are excellent assets, generating predictable amounts of energy over the long term, with almost no running costs.

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Looking through to the underlying assets, rather than simply analysing premiums to stated net asset values (NAVs), is vital in understanding value in the renewables sector.

There are three crucial factors to consider that help demonstrate value in the sector as it stands. The first is looking at yields at purchase price. These are not under pressure given the ongoing supply of projects, with levels still in the high single digits despite persistently low gilt yields.

In addition, the discount rates being used to generate NAVs remain conservative, as they are set by boards or external consultants, and generally lie in the 7.5 to 8.8 per cent range, versus 20-year gilts at 1.6 per cent.

Another boost to the market is the amount of pension funds and insurance companies wishing to lend on long-term fixed rates against UK public sector-derived cashflows at rates below 3 per cent. Leverage of this nature is further enhancing value for investors.

The backdrop is similar in the pure infrastructure sector. Increasingly, the government is focused on infrastructure investment, which has stimulated asset production and reduced downward market pressure on the rates at which assets are acquired.

The ultra-low gilt yield environment is producing structural leverage that enhances investor returns, and boards are still using conservative discount rates of between 7.5 and 9 per cent.

When infrastructure funds have disposed of assets in recent times, they have done so at substantial premiums to the valuations. HICL, a £2.7bn infrastructure investment trust, sold its interest in the Colchester Garrison MoD Project at 25 per cent above the valuation. The £1.1bn John Laing Infrastructure trust sold two projects this year at 36 per cent above book value.

Another macro driver is inflation, which is picking up globally. Analysis suggests that most inflation in the global system is non-core.

Nevertheless, any meaningful pick-up is of strong benefit to infrastructure assets. For example, the £562m Bluefield Solar Income Fund saw an increase in the long-term assumption of retail prices index increase its NAV by 2.8 per cent.

An additional macro driver – somewhat unexpectedly – may be the Conservative party manifesto policy to cap standard variable tariffs (SVTs) for energy utility firms.

At first it seemed possible that a draconian cap based on competitor average rates could emerge. Should it go ahead, the central case appears to be a cap at the individual company level on the amount by which the SVTs can exceed the lowest tariff.

Among the majors, a 6 per cent cap would cost Scottish and Southern Energy roughly £131m of revenue and Centrica £441m. But the companies would be expected to mitigate this substantially by raising their cheapest tariff, with dividends payouts of 6.3 and 6.4 per cent likely to be maintained.

What is clear is that an understanding of the developing regulatory and political process will provide opportunities to find attractive, risk-adjusted investments in the sector, since prices move on sentiment rather than on fundamentals.

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