German Infrastructure - The Great Corona Reset

A. Introduction

This note is the product of much personal pondering and a desire to bring together multiple threads of thought into a coherent defensible 'view' of the most likely immediate and lasting impact of the current Covid-19 induced crisis (the Crisis) on European infrastructure with a particular focus on Germany.

The 'Great Corona Reset' refers to the aggregate effects of: i) the powerful deflationary impulse provided by the Crisis towards ending/interrupting the current credit super cycle; and ii) lasting behavioural and structural changes that the Crisis will leave behind on German infrastructure investing. In order to gaze a little more clearly into the post-Crisis future, it seems to me, that one must: (i) take a glance back to the point of departure (section B.); (ii) consider the immediate impact (section C.); (iii) come to a view as to the totality of the policy responses (sections D. and F.); (iv) consider the potential health and economic recovery scenarios (section E.); and then finally on the basis of the preceding analysis (v) attempt to differentiate between 'ordinary' short term cycle effects and potential lasting structural changes and trends (section F.).

The Crisis has profoundly changed our view of what is important and with this, will undoubtedly change the future. Entrenched assumptions are being challenged and emotions have been triggered on a diverse range of subjects including: leadership, the social contract, relative abilities of countries to crisis manage, globalisation, supply chains, bio-tech, the environment and climate change, international cooperation, key workers, family, human fragility, sustainability, bio-diversity, work, travel, public space, and our homes.

The effects of the Crisis will also present policy makers in well-positioned jurisdictions with a unique opportunity to direct the destination of the post-Crisis journey.

B. A Glance Back

In 2008, the major central banks saved the world from a financial crisis turning into a severe depression. However, the unorthodox monetary policy, zero bound policy rates and quantative easing (QE), of unprecedented scale pursued since then has brought forward debt financed private expenditure and created a new 'credit super cycle' firing asset price inflation.

Ten-year Bund yields turned negative for the first time in October 2016. Whilst such negative yielding financial assets might be attractive for certain short-term investors, they are damaging for longer term institutional investors who have been forced further up the debt risk curve and/or into investing directly into other unfamiliar 'low risk' asset classes such as infrastructure debt and equity.

More generally, a number of risks and challenges had been building in infrastructure for some time, arguably, immediately prior to the Crisis the market was primed for some form of a correction:

a) Operating assets had been refinanced at very low interest rates indeed and/or sold for outperformance levels of return i.e. all credit cycle gains cashed in.

b) There was little or no more room to move up the risk curve (e.g. development, construction, economic risk).

c) Risk had arguably in many cases been mispriced and capital misallocated.

d) The amount of additional asset price gains to be delivered by ultra-loose monetary policy was limited and diminishing.

e) Increasing premiums were being paid for utility assets with declining rates of regulatory returns.

f) The ever-increasing demand and constrained supply of quality assets was being exacerbated by new market entrants.

g) Unprecedented amounts of 'dry powder' held by funds with growing pressure to allocate.

h) These distortions were further exacerbated by pots of even lower cost foreign capital (notably originating in South Korea).

C. The Immediate Impact

We are in the midst of an unprecedented and truly global combined health and economic crisis. Healthcare sectors are struggling whilst real economies have been simultaneously hit by supply side and a massive 'self-inflicted' never before seen demand side shocks.

In terms of the immediate impact on infrastructure, there is a clear distinction to be drawn between core availability-based assets and the rest. Availability payment-based core operating assets are holding up well despite some asset management challenges (hospital and healthcare PPPs would be the case in point). This is really the only infrastructure asset class that is providing and, subject to having the right inflation protected cash flows, will continue to provide long-term investors with true anticyclical downside protection and stable real returns both in the short term and through an extended period of either inflation or deflation.

Assets in GDP sensitive sectors such as demand-based transportation assets exposed to traffic risk are suffering, traffic volumes have largely collapsed and when they come back will likely come back slowly. Operating airports, toll roads, some rolling stock, and ports have all been impacted. Merchant power generators have also been affected by the fall in the electricity price. Many such investors are fighting a liquidity crisis and those who have been too aggressive with leverage are perhaps having regrets. Price discovery for such assets is currently impossible, the deflationary impulse is strong and asset prices are extremely vulnerable.

With Greenfield projects the picture is more mixed, much depends on the development stage of the particular project, its supply chain, and its ultimate remuneration model. In Germany, construction has so far continued on most projects, however, lenders are delaying committing to project financings for some new projects.

D. The Immediate Policy Responses

Politicians supported by the central bankers are already doing 'whatever they think it takes' to avoid a debt deflationary spiral and the associated structural damage to the economy.

The German government immediately announced a swathe of measures amounting to around €1.2 trillion of support aimed at limiting structural damage to its economy[1]. State aid rules are being flexibly interpreted and foreign direct investment laws are being sharpened against certain types of foreign bargain hunters. Germany has also, after a long absence, returned to the bond market to issue €156 billion of new debt. With a debt to GDP ratio of below 60%, its past prudence means that, all other things being equal, Germany is in an advantageous starting position. When the time is right, demand side fiscal stimulus measures (e.g. cash for clunker schemes, consumption tokens, government investment programmes etc.) will be unleashed.

Germany, despite or perhaps because of a certain vulnerability to de-globalisation, is likely to break with previous economic orthodoxies to direct the destination of the post-Corona journey.

[1] Including an additional € 156 billion of government spending in the form of a 2020 supplementary budget; €50 billion of direct grants to SMEs; and a new economic stabilisation fund (WSF) that can i) use up to €100billion to take direct equity stakes; ii) provide another €100 billion to the KfW to provide loans and cash to struggling businesses; and iv) commands € 400 billion of state guarantees to underwrite corporate debt.

On the EU level, Germany and France have recently announced a joint position on the possible €500 billion EU recovery fund. Under this, budgetary expenditure in the form of grants (not loans) will be provided to regions and sectors most affected by the Crisis. The joint statement explicitly mentions digital and green transformations. Although such a fund falls short of the 'coronabonds' Italy has been demanding, the potential provision of grants and not loans distributed disproportionately towards the southern EU economies could reasonably be seen as a step towards EU fiscal union.

On the monetary policy side, the ECB balance sheet is ballooning, it wasted no time announcing a massive additional bond purchase program[2] (essentially much more QE). It is also making an effort to limit the negative effect of these new policies on the commercial banks who are seen as being part of the solution. The strong reluctance to further reduce policy rates (into negative territory), the provision of regulatory capital relief, funding for lending schemes and general bank funding at attractive rates (as low as minus 1 per cent) are all part of this.

The bond purchase programmes will also offer relief to the commercial banks holding such debt and should operate as intended to keep long term real interest rates low. There will be no room for bond vigilantes disciplining government borrowing. Italy et al. will need to be able to service their ballooning debt mountains – notwithstanding the mutterings of the German constitutional court, a new EU sovereign debt crisis is to be prevented at all 'monetary' costs.

Other major central banks have already crossed the rubicon to direct monetary finance of their government deficits (consistent with 'modern monetary theory'). Era defining government spending supported by central banks could be on its way. In any event, operation reflation has commenced!

E. Uncertainty Prevails!

Much now depends on how well most governments manage to control the pandemic and increasingly keep it under control whilst getting their economies back to work. Economic recovery scenarios are often vividly described by commentators as ranging between "V", "U", "W", and "L" shaped scenarios.

Under a W-shaped scenario, with effective treatments / a vaccine proving elusive, social distancing restrictions will have been lifted too soon and/or a second or even a third wave hits and the pandemic is not brought under control by the first half of 2021. Demand side stimulus will need to be delayed or risk firing blank. An extended W or an L-shaped scenario does not bear thinking about. However, even in such economically and socially disastrous circumstances, regardless of whether spiralling inflation or debt deflation prevails, core availability-based infrastructure assets will outperform (subject of course to the relevant sovereign credit risk itself) almost any other asset class that exists.

A U-shaped recovery seems on balance the most likely and therefore the assumed base case scenario for the purposes of this note. In order to achieve this, or perhaps even a V-shaped recovery, most governments will need to control and keep the pandemic under control by this summer. Then, under 'new normal' conditions, economic activity could more or less fully resume by the third quarter 2020 at which point serious demand side stimulus will be unleashed. Economic activity should over time return to, or close to, former levels. The length of time this takes will be a factor in whether the German GDP hit can be contained to single digit figures or not.

[2] ECB announced a € 750 billion additional bond purchasing programme on 18 March 2020.

F. What will the Future look like?

Attempting to predict the future rarely proves wise. Nevertheless, restricting myself to a view on the general direction of travel for German infrastructure and built on foundations of the above analysis, I would venture the prognosis that follows.

1. Short-term Cycle Effects

a) The financial market turbulence of late February 2020 marked the high-water mark of the current phase of the credit super cycle.

b) There will be a certain shake out and it will probably take longer than the financial markets currently seem to be pricing in for real economic activity to reach pre-Crisis levels.

c) Funds that deployed a lot of capital in the last few years and paid hefty premiums, especially on GDP sensitive assets including demand-based transportation assets, could struggle.

d) Some investors might need to rebalance their portfolios – assets could begin to come to market in the first quarter of 2021.

e) Equity risk premiums for many types of infrastructure assets will increase.

f) Valuations including premiums paid for availability payment-based assets, those subject to utility regulatory returns, and certain types of digital infrastructure could even increase.

g) Valuations including premiums paid for most demand-based infrastructure assets and those with a GDP sensitivity are likely to decline in the short term.

h) After fund managers get over their liquidity crisis' and stabilise cash flows, they will be looking to concentrate on portfolio enhancement, equity add-ons, and perhaps some bargain hunting.

i) Then, once the recovery trajectory becomes clearer and price discovery becomes possible, funds with dry powder will be well positioned to deploy into what could, in particular for GDP sensitive assets, have become a buyer's market.

2. Potential Structural Changes

The profound psychological effects of an invisible enemy causing on the one hand so much societal disruption and downright insecurity and yet, on the other hand, temporarily leading to clean air, clear skies, a return of nature, less noise, and more family time cannot be ignored.

True lasting behavioral and structural changes resulting from the Crisis are clearly very difficult to predict. However, such changes could conceivably include increased reliance on digital and communications infrastructure (the 4th utility?), less travel generally, more cycling, a shift from cash to contactless payments, a relative shift from retail to online consumption, more mobile working, and changing demands in terms of types of space and capacity on homes, offices and transport infrastructure. In some instances, there are opposing forces at work and it is difficult to see which will prevail. For example, less travel against the fact that people have felt safely socially distanced in their cars. It also seems to me, that if in the medium term more space and perhaps better healthcare cannot be made available when it counts to those living in congested cities, the calculation and attraction of living in such cities could change.

Governments are likely also to leverage and reinforce certain of the emotional effects and behavioral changes triggered by the Crisis to accelerate the transformational changes and spending required for the de-carbonisation of their economies.

3. Reinforcing Policy Measures

Even since before the Crisis, the political mood in Germany was turning towards substantially more action in the areas of infrastructure and climate change. The Climate Package (*Klimaschutzpaket*) and the recent call by the Association of German Industry (BDI), the main German business lobby, and the German Trade Unions Federation (DGB) for a large infrastructure and decarbonisation investment programme, are clear evidence of this. In addition, the active development and imminent announcement of a National Hydrogen Strategy (*Nationale Wasserstoffstrategie*) is highly indicative of an intended direction of travel.

In terms of directing the post-Crisis journey, it is reasonable to assume that the German government will grasp the opportunity presented by the Crisis to: (i) accelerate the energy transition (Energiewende) and associated efforts to decarbonise its economy; (ii) upgrade its social, digital, and transport infrastructure; (iii) increase efforts to become a world leader in the new technologies required for a transition to a hydrogen economy and for a ‘fourth industrial revolution’.

To this end additional investment programmes, subsidies, preferential regulatory treatment, and the streamlining of cumbersome planning procedures can all reasonably be expected from the German government.

If the EU’s stated aim of carbon neutrality by 2050 is to be successful it will require transformational shifts and unprecedented levels of investment. The Commission’s announced green investment drive including the potential easing of capital requirements on banks insofar as they lend to green investments is a small start. Further, if ultimately signed off by all EU member states, the deployment of the €500 billion EU recovery fund might also help a little. There are also changes afoot on the monetary policy side, the new ECB President, Christine Lagarde, is pushing for ‘climate change considerations’ to be included in the way the ECB conducts its monetary policy so as to direct capital towards ‘green’ investments. Such a change would be a profound and controversial shift in the use of monetary policy and, if enacted would lead to a dramatic relative shift towards ‘green’ and sustainable infrastructure investment.

Despite this potential new supporting role for monetary policy when it comes to green infrastructure, governments will of course still need prioritise spending taking into account their preferred trajectory. In the UK for example the relative prioritisation, if any, between HS2, a third Heathrow runway and/or full broadband will be hotly debated.

4. Macro Investment Outlook

a) Ultimately, fiscal and monetary policy will overwhelm deflation and above average inflation rates can be expected within 18-24 months of the end of the immediate Crisis.

b) The ECB will be successful in keeping real interest rates low and inflation rates above official target levels for quite some time.

c) Infrastructure assets will perform well in the expected reflationary times. Their ‘real asset’ attributes combined with stable inflation protected cash flows should be a winning formula.

d) The general supply of investable assets should increase over time.

e) Germany will retain and possibly enhance its status as a safe haven jurisdiction.

Many investors will also be re-evaluating their understanding of the concept of risk and how to effectively price it. Perhaps, in the medium term a new approach to evaluating long-term performance and value of particular infrastructure assets will be developed that will more strongly capture intangible values that do not easily feature in a traditional cost benefit analysis. A greater meaningful integration of environmental, social, and governance (ESG) criteria might be a start.

G. Concluding View – the Future is Green(er)

Germany will use the opportunity presented by the Crisis and its advantageous starting position to direct the post-Crisis journey driving the achievement of de-carbonisation targets whilst at the same time hoping to become a leader in the associated new technologies.

The Great Corona Reset as described in this note will be profound and a real boon to many infrastructure sub-sectors. Once the short-term disruption to the market has been navigated a new increasingly ‘green’ and sustainable era of infrastructure investing is will emerge. Benefiting subsectors will include renewable energy, digital and communications infrastructure, water, rail capacity and electrification, healthcare and social infrastructure, e-mobility generally including electrified bus fleets, logistics facilities, gas and electricity grid and storage upgrades, and industrial de-carbonisation projects.

As a firm, we treat infrastructure M&A, project finance, and project development as an integrated discipline. In this vein we constantly monitor subsidy programmes, regulatory changes, and upcoming government investment programmes with a view to identifying investment risks and opportunities for our clients.

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