How investing in infrastructure can increase UK productivity and generate positive returns

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Climate change is clearly one of the greatest challenges facing humanity today. In order to avoid its harshest effects, communities around the world need to find sustainable and resilient infrastructure. As a result, there is a large and ever-growing need for investment in this sector.

Indeed, according to the Organisation for Economic Co-Operation and Development (OECD)[1], no less than $6.9 trillion will be needed every year until 2050 to invest in the infrastructure required to meet the United Nations (UN) Sustainable Development Goals by 2030 and to achieve net zero by 2050.

However, as the UN goes on to say, "there is currently a multi-trillion dollar gap in these required investments, and evidence shows that the majority of investments continue to go into 'business-as-usual' infrastructure."

Filling that funding gap is another critical challenge facing our society, and unless we do find that funding, our global futures look uncertain as carrying on as normal is no longer an option.

Who will fill the funding gap and support the infrastructure we need?

Experience has shown that the majority of central governments seem largely unable to fill it themselves. Obviously, very few individuals have access to the huge amounts of capital required to make a meaningful difference on a global scale, which leaves institutions such as the LGPS community.

LGPS has a major role to play

LGPS has enormous investment power, with holdings of almost £350 billion currently in the UK alone. This gives the sector huge potential leverage, with growing support to use that leverage, too.

Indeed, the UK government has recently[2] been urging local government pension fund managers to play a more active and meaningful role in funding UK infrastructure if the UK is to achieve net zero by 2050.

In its Levelling Up White Paper[3] published in February 2022, the government made a direct request:

"The UK Government is asking LGPS funds, working with the LGPS asset pools, to publish plans for increasing local investment, including setting an ambition of up to 5% of assets to be invested in projects which support local areas."

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Environmental, social and governance (ESG) factors may be considered when determining assets worthy of investment

It has also been established[2] that LGPS funds may consider environmental, social and governance (ESG) factors when making investment decisions. "While pursuit of a financial return should be their predominant concern, they may take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to believe that scheme members would support their decision."

This global and national environment creates a genuine opportunity for pension funds who wish to support infrastructure, maintain their ESG focus and deliver significant returns to their policyholders.

Which sectors are investible?

Historically, infrastructure investment has focused on areas such as toll-roads, airports and the old energy sector. The areas that now need funding include businesses focused on the transition to clean renewable energy, the expansion of digital technology, building the electricity grid of the future, battery charging and the optical fibre broadband network.

A potential threefold return?

Investments in these sectors have the potential to bring a threefold return. This works in terms of generating:

1) Financial returns to investors

2) A return in terms of helping improve productivity across the economy by making it easier for people to work wherever they need to, whenever they want to

3) and of course, a return in terms of abating carbon emissions and bringing the UK closer to achieving net zero.

Where can opportunities be found?

Many of the investment opportunities come in the form of companies in the small- to mid-market space who are looking to expand. These often seem to have more flexible options available in their toolkits to insulate them to a degree from the kind of macro risks that affect bigger businesses.

How can risk be mitigated?

The value creation initiatives being developed by mid-market companies often feature elements that mitigate the early-stage development risk. These include platform expansions, asset roll ups/aggregations, or build versus buy-on projects. This risk mitigation may also make them more attractive to institutional investors.

What are the risks?

Infrastructure investments are complex investments subject to significant risks, including the risk of illiquidity. These investments are not suitable for investors in need of liquidity and are subject to the risk of capital loss. They should only be considered by sophisticated investors with a long-term investment horizon and a higher risk appetite.

A hands-on approach to management

Investing in mid-market firms also provides an opportunity for the funder's team to stay involved with the management of the businesses involved. This means investors are better placed to help management grow the business while meeting clear ESG and financial objectives.

New money for new projects

From an investor's point of view, the opportunities typically come in the form of injections of new capital into the business in order to fund new plans or projects. So, they are being used for something more purposeful than buying stock in an existing company.

Downside risk reduction built in

Infrastructure projects such as solar renewable generation typically are covered by long-term contracts from partners who commit to offtake their electricity which offer protection against inflation.

Potential for significant returns

Investment in sustainable infrastructure has been generating extremely valuable returns over the past few years, even in a culture of very low interest rates. In fact. returns in the mid-teens are far from unusual from ICG's own Infra fund, which was set up in 2013 to help investors benefit from the returns they need through our experienced team's investments in assets across the sector.

It is estimated[4] that 79% of society's carbon emissions comes from the infrastructure sector. We must work together to abate those emissions if we are to address climate change. Investing in green infrastructure gives LGPS members the opportunity to play their part in the green infrastructure transition, while also helping to make our economy more productive and generating valuable return on investment.

1. https://www.unep.org/explore-topics/green-economy/what-we-do/sustainable-infrastructure-investment
2. https://commonslibrary.parliament.uk/research-briefings/cbp-7309/
3. https://www.gov.uk/government/publications/levelling-up-the-united-kingdom
4. https://www.unep.org/news-and-stories/press-release/new-report-reveals-how-infrastructure-defines-our-climate#:~:text=The%20findings%20highlight%20that%20infrastructure,and%20the%20Sustainable%20Development%20Goals.