MEKETA
INVESTMENT GROUP

100 Lowder Brook Drive
Suite 1100
Westwood, MA 02090

781.471.3500
Meketa.com

MEMORANDUM

TO: Meketa Clients
FROM: Private Markets Infrastructure Team
DATE: March 27, 2020
RE: COVID-19 Update: Effects on Private Infrastructure, Post #1

Infrastructure portfolios are by definition and design intended to take advantage of the defensive attributes of the asset class: broadly being essential to producing and delivering goods and services critical to the global economy; and therefore, generally commanding inelastic demand, contracted revenues, and predictable cash flows, among other attributes. We are about to see how resilient infrastructure is under the extreme public health threat and consequent economic activity disruption wrought by the novel coronavirus and its illness COVID-19.

These are the types of investments involved:

Transportation	Energy/Utilities	Social	Communications
Toll Roads, Bridges, Tunnels	Midstream	Hospitals & Medical Facilities	Cable Networks
Airports	Transmission & Distribution Systems	Education Facilities	Communication Towers
Seaports, Container Terminals	Storage Facilities	Police & Military Facilities	Fiber
Commercial Railroads	Power Generation	Court Houses	Spectrum
Mass Transit	Renewable Power	Public Arenas/Recreation	Satellite Systems
Parking Facilities	Water Conveyance & Distribution	Student Housing	Wireless
Logistics	Water/Wastewater Treatment		
	Waste Treatment		

Overall, in a traditional downturn, we would expect the asset class to hold up well on a relative basis; however, the economic damage caused by the pandemic threatens such assumptions. There will no doubt be losses in value in the near term, and it is conceivable that some of those will not be recoverable. The duration and depth of the decline will depend on when it is safe to resume our economic lives and the extent to which government and financial institutions can provide support and relief between now and then. In the US, the $2.2 trillion stimulus package approved on March 27 includes $650 billion aimed at helping individuals and families, $1.1 trillion aimed at helping business and the public sector, and $504 billion for grants and loans to large businesses (including airline and defense industries specifically, and likely other infrastructure businesses as well) and local governments. To put this in context, total federal spending in 2019 was $4.45 trillion, including $676 billion in defense spending.[1]

[1] Source: Washington Post, March 25, 2020.

Below are some initial observations and examples across three dimensions of infrastructure investments: risk/return profile; sector; and geography.

Risk/Return

Core – These strategies should be the least impacted as they generally provide critical functions and services under contracted revenue agreements and derive most of their value from cash yield. However, some managers with core and core-plus strategies have invested in what are ordinarily considered essential assets but that have GDP links and volume exposures, including airports, ports, and rail, that have already been significantly impacted.

Value-Add – We expect to see mixed levels of impact, depending on the type of value-add strategy executed and how much control the owner has over expenditures relative to costs. For some investments, ongoing construction projects could be slowed or delayed, with contract provisions that make the owner economically whole. Other businesses that are depending on facility expansion, market share growth, or business optimization will be forced to match pace with their respective economic watershed. Value-add strategies typically have long hold periods already contemplated and should have opportunities to recover value post-recovery.

Opportunistic – As with value-add, the impact depends on the nature of the opportunism. For example, a P3 strategy involved in project development and construction will benefit from standard EPC/design-build contract terms, including force majeure, which could lengthen the hold/realization of the investment, with a lower IRR but higher multiple return. Alternatively, a manager operating in emerging markets will be impacted consistent with interruptions and stoppages in the respective service area or affected counterparty. There is also the issue of getting ex-pats home when local health care services are a concern. One manager reports that supply chain and staffing disruptions are causing construction delays, but existing operations are experiencing only limited disruptions. This same manager's stress testing for three- and six-month stoppages showed ultimately lower fund-level IRRs.

A note on leverage – The amount of debt managers place on infrastructure investments is typically directly related to the level and security of the revenue streams. As such, core strategies will usually have the highest leverage (e.g., 40% to 50% at the fund level, and up to 80% or 90% for individual investments with solid cash flows). At the opposite end of the risk spectrum, opportunistic strategies will typically use little to no debt, but may use construction loans that are drawn on as needed but not payable until completion. Value-add strategies sit in between, often having little to no leverage at entry when revenues and any loans are used for growth plans, facility expansions, and business optimization projects. As value-add investments are de-risked and more cash is available for debt service, managers may increase leverage commensurately. Between government relief and lender grace, we would expect that troubled investments could receive waivers or assistance to tide them over, at least for some period of time.

Sectors

Transportation – This sector has been the most dramatically impacted in the near term and will feel the impacts of slowdowns and stoppages for some time. Passenger transportation companies have seen significant traffic reduction, while freight transportation is seeing less immediate impact. Simultaneously, government assistance packages are already targeting the airlines and other modes for record-setting support. One manager has already given early indications that its end of March asset valuations may be affected as follows: airports down 10% to 30%; toll roads down 5% to 10%; and ports down 5% to 10%. Another manager observes traffic in its ferry businesses is down 20% to 50% on cars, and is projecting further declines of 70%, while freight volume is so far down only 5% to 10%. Volume-GDP constructed revenue schemes will be significantly impacted in the near to medium term, consistent with the pace of recovery and normalization, while regulated and contracted schemes will hold up so long as counterparties are solvent or other assistance is available to tide asset owners and service providers over.

Communications – Most managers reporting are thus far optimistic about their investments' holding value and see new and expanded opportunities into and post-recovery. Where take-or-pay contracts exist and counterparties are sound or have financial backstopping, revenues should be stable. The crisis will likely impact/delay certain new investments over the near term. However, communications assets are mission critical for many counterparties and customers. A lot of work in the sector can be done remotely except for the physical installation and maintenance. Public equities in the sector have held up relatively well recently and managers point to relative sector stability during and coming out of the GFC. The coronavirus crisis has led to massive increases in internet, broadband, and wireless demand, some of which will translate into sustainable increases that will require investment above the scope and scale previously planned.

Energy/Power – This sector is coping with the twin hits of the oil price drop and the pandemic. Midstream assets in infrastructure portfolios tend to have take-or-pay long-term contracted revenues which offer protection, but counterparty risk still exists. In the US, shale production has a much steeper decline rate than traditional production. With new drilling being delayed in the current price environment, even with a price recovery, there will be a drop in volume going into 2021. In addition, some of these companies are publicly traded, and their stock prices have suffered. The Alerian MLP Index has seen dramatic declines in line with the drop in oil prices, even for assets with strong balance sheets and contracted cash flows. While midstream assets have been the most notably impacted, power investments, including renewables, with long-term government or commercial Power Purchase Agreements are likely to be more resilient. Power demand has dropped 5% to 10% across markets so far—workforce proximity rules and personal protection equipment availability will shape near-term levels of industrial and commercial power demand.

Utilities – Electricity, water, wastewater, waste, district heating, etc., all are essential services that will continue, albeit with a different demand/location of use and service (e.g., as offices close but more people are at home 24/7). Depending on whether the utility serves wholesale or retail customers, we would expect to see grace periods for payment and other types of assistance for business and residential customers who have had income reduced or nullified.

Social — Government facilities will still be operating, if not expanded, to serve crisis needs, and availability payments/leases should not be impacted. However, state and local governments are already facing some budget pressures as cumulative public health costs rise. Event-based assets, such as arenas, or anything that depends on human attendance or participation, will be relatively safe where revenues come from government availability payments but at risk where they are attendance/use-based. Student housing will be similarly affected in the near term with school closures—safer where universities make fixed payments, and at risk where owners bear lease risk.

Geographies

We have seen and will further expect to see the geographic dimensions of value and opportunity track the regional pattern of the pandemic, with respect to scope, scale, and timing. How this plays out will also depend on an asset's/company's revenue source from domestic, regional, or global actors. For example, a power plant serves its local market, a pipeline may serve a region, and a port can serve global container trade. While it is not too early to see which countries may have spared themselves the worst case, others are still in the middle of their outbreak with peak and duration yet to be determined, though some are clearly in severe distress.

Summary

We are cautiously optimistic about our infrastructure portfolios for the time being. There will certainly be some assets that are significantly impacted for at least a medium period. However, other investments should hold their own, and some are well positioned to participate in and support future recovery. Where revenue/service contracts exist, multiple provisions will explicitly or broadly cover situations where counterparty payments, debt service coverage, and asset availability/demand are interrupted, including force majeure provisions, which we have already seen invoked. Additionally, for investments in open-end core funds, there is no pressure to sell, and all the assets have long-term hold plans. For investments in closed-end funds, most have 12 to 15 year or longer terms, with provisions for extensions as needed. Hence, there should be little pressure to sell in a down market, except perhaps for those few funds that are at the end of their terms.

Disclaimers