Infrastructure in a post-COVID-19 world

Partners from DLA Piper's global infrastructure team consider the future of infrastructure after the COVID-19 crisis

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Infrastructure is famously prized by investors for stability and predictability – COVID-19 has turned this on its head in the short term and undoubtedly will have a huge impact on the sector in the longer term. At the same time, it will create significant opportunities for investors and other stakeholders. Attitudes to risk and how it is shared may well have changed due to COVID-19 and its impact, but in reality will investors and lenders turn their backs on infrastructure as an asset class? Unlikely.

It remains too early to say with confidence how and when economies will return to normal and what that new normal will look like. Despite the uncertainties, it is possible to make some tentative predictions about longer term implications for the sector (recognising that different types of assets will be impacted in different ways) - and the respective roles of governments, investors and corporates.

The role of governments

Governments as providers of last resort: The crisis has emphasised that, ultimately, only governments have the powers and resources to ensure that essential infrastructure continues to operate in the face of catastrophic disruption. But this does not mean that governments need to own and operate that infrastructure.

Globally, governments and private sector operators are cooperating to ensure that essential infrastructure continues to operate in the face of drastically reduced volumes. This has led to interventions such as the UK government's support for its rail and bus operations, and the Australian government continuing to pay for service levels it is not currently utilising. In each case, this aims to ensure continuity of service both during the crisis and thereafter.

Even where governments have the right to terminate existing arrangements, for insolvency or failure to hit financial or performance targets, many governments consider this is not the best response in a crisis, especially where the private sector is not to blame - political drivers are to help companies survive and keep people in employment where possible.

In relation to aviation, approaches have been patchy with, for example, the UK government applying a case by case approach, rather than adopting an industry-wide package. Governments may favour supporting flag carrier airlines, and major city airports look set to fare better than some regional airports. Who takes the risk in the speed and level of recovery of passenger revenues is likely to depend upon how the lockdown is "released" and other government policies to mitigate the risks in what many believe will be a staged transition back to the pre-crisis volumes of traffic.

Longer term, it seems likely that there will be some rebalancing of risk in public-private arrangements, recognising the role of governments as the guarantor of last resort and limits on the risks that the private sector can in practice absorb.

Greater state aid flexibility: In recovery, governments will still have to provide some level of support where necessary. In the EU, where national subsidies require EU approval, the usual state aid rules have already been relaxed to give greater flexibility.[1] This need for flexibility is likely to extend for some time as companies will continue to face reduced revenues and will continue to be financially weakened. An additional complication in the UK with Brexit means a tailored approach will be required to achieve the same objectives.

Government stimulus packages: Governments will be eager to boost their economies post-crisis, and infrastructure spending is an obvious and necessary stimulus area. Some spending will be post-crisis related, such as health and social care projects, as well as digital infrastructure to build greater capacity and resilience.

For example, in China, the government is actively promoting large scale infrastructure projects to reduce the unemployment rate with a particular emphasis on public health related infrastructure development. In Canada and the US, it is anticipated that there will be major infrastructure stimulus packages. It seems likely that the initial focus will be on projects where construction activities can be commenced quickly. Shovel-ready projects are at a particular premium, as witnessed by the UK government confirming that the UK's HS2 Stage 1 is to proceed even during lockdown.

A boost to public – private partnerships?: How will these stimulus packages be funded? While the crisis has highlighted the fundamental role of governments, ironically it seems likely to give a boost to greater private sector involvement in the recovery. Governments have been able to borrow very cheaply and so had become sceptical about the benefits of public-private partnerships ("PPPs") – even the UK, which pioneered them, abandoned them in 2018 saying the Public Finance Initiatives did not provide good value.

But all governments are now facing huge deficits and will be less likely to borrow cheaply, so there is a need to re-assess the cost-benefit analysis and seek to explore new models where private funds are used to support public outputs. This suggests some kind of PPP model or management contracts for the delivery of services will come to the fore again, favouring investment funds and banks, and operators who are focused on providing public services efficiently and cost effectively without taking unnecessarily high levels of volume risk.

Speeding up procurement and delivery of major projects: Governments will need to look at ways of speeding up their procurement processed and delivery of projects to support their stimulus packages. This should involve shortening and simplifying procurement, planning and consenting processes. Measures are also needed to preserve existing consents. The crisis has demonstrated how quickly governments can move (even if imperfectly) when they need to and this trait needs to continue.

Implications of changes to behaviour

Impact of changing patterns of behaviour: How people behave, whether by choice or compulsion, will have significant impacts on future use of infrastructure after the crisis abates.

Social distancing and restrictions on movement seem likely to apply for months, and as a result people are increasingly becoming used to new patterns of behaviour, such as working from home, reduced travel, home delivery and home entertainment. These new behavioural shifts have also reinforced pre-existing trends, such as technological advances and climate change concerns. Indeed, behavioural shifts have already given rise to profound implications for areas such as aviation, office occupancy, freight, commuter flows (for work, shopping and entertainment), ticketing and high street retail patterns, as well as the leisure, tourism and entertainment sectors. Businesses have rapidly adopted Zoom, Microsoft Teams and Skype and it seems overseas business travel is fast becoming a long distant memory. On a more positive note, will there be a real opportunity to drive new discussions on transport usage and climate change as people move away from their pre-outbreak travel patterns? Time will tell – our infrastructure needs to cater for all options.

Changing trade patterns: Learning the lessons from the crisis, companies and governments will need to review and shorten their supply chains, with a more defensive mindset, re-assessing dependence on other countries, including China. This will apply especially where the crisis highlights pre-existing political agendas, such as national security and sovereignty concerns and a populist stance on trade.

Infrastructure as an asset class

Changing attitudes to infrastructure risk: Clearly, COVID-19 has directly impacted many infrastructure projects and businesses, highlighting additional risk areas that few would have taken into account in the past when making investment and lending decisions. Will this reduce the attractiveness of infrastructure as an asset class to investors and lenders going forward? Here are a few tentative predictions:

- We expect more recognition for the role of governments in a crisis, potentially leading to a rebalancing of risks and reward and new contractual models.
- Sharply rising government deficits should result in opportunities for private debt and equity.
- Finance providers may become more cautious about volume and force majeure risks, but it seems unlikely that they will turn their back on the sector as more opportunities arise and the steps taken by governments have been shown to protect many projects/assets.
- The crisis may lead investors to re-assess (again) the balance of risk between GDP-related assets and regulated assets.
- Future projects (and their financing) may have to adopt more sophisticated regimes relating to payment structures, performance regimes, force majeure, delay and other relief regimes.
- New projects will need careful thought when justifying their promotion – what will the benefits of new capacity be in a post-COVID-19 world?
- Fibre, data and health/social care seem most likely to benefit from an increased emphasis on building future resilience and capacity.

Impact on M&A: In the short term, a number of transactions are reportedly being pushed back, for obvious reasons. The strong long-term factors supporting activity and opportunities in the sector may well offset any greater caution on the part of investors. Additional factors should support M&A activity; deals that have stalled are likely to seek to return to market, which should result in a short term surge, already being seen in Asia; and the need for governments and corporates to raise cash should create M&A opportunities. For a period there may be significant valuation differences as buyers focus on the post-pandemic world while sellers hark back to previous valuations, which - together with the general uncertain outlook - might depress M&A activity for a while as we transition from lock-down. Earn-outs and staggered payment mechanisms will likely be a focus of attention to help to bridge the gaps, and we'd expect to also see more focus on contractual termination rights.

Opportunities for financial investors: Financial investors face many negative impacts from this crisis. However, there will be opportunities, given the level of *dry powder* and access to capital, together with their operational expertise and experience of working with governments and corporates globally under various models. In addition to M&A opportunities, there is a real opportunity for them to engage proactively with governments and corporates globally to help them achieve their post-crisis objectives and potentially develop new models. Financial investors have a great opportunity to focus on their existing portfolios and show that, going forward, they are good and socially responsible custodians of the world's infrastructure in hard times. It is in times like these that reputations are created that establish the foundations for many years to come.

So what does this all mean?

COVID-19 has highlighted the critical importance of infrastructure to our economies and societies. After the crisis, there will clearly be major long-term impacts on the sector driven by many factors, including behavioural shifts, the exit strategy from lock-down, the pace and pattern of economic recovery, evolving attitudes to risk and increases to governments' deficits. The combination of all these things means we will see infrastructure opportunities for both financial investors and corporates who actively monitor the changing landscape and have the flexibility, financial standing and resources to adapt to a post COVID-19 world.

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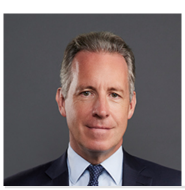
[1] *European Commission relaxes State aid rules to counter economic impact of COVID-19, DLA Piper, March 2020.*

AUTHORS



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