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Economic shocks are worsening the bankability of infrastructure deals – here are 8 ways to keep capital flowing and get projects off the ground

The global economy has been shaken by exceptional shocks in the 2020s, and infrastructure development is suffering. Simultaneously, ambitious plans like the US Bipartisan Infrastructure deal, the Infrastructure Investment and Jobs Act, call for much more new infrastructure to be built. We need to invest close to USD7 trillion in infrastructure to support sustainable and equitable development, climate change mitigation, and climate adaptation. Government budgets are at their limits, and so governments have redoubled their efforts to mobilise private capital. These efforts have paid off in record levels of private capital commitments to infrastructure – but actual investment has remained stagnant due to investor concerns about the financial feasibility (i.e. bankability) of projects. In this article, I review five economic shocks that are worsening the bankability of new infrastructure projects, and eight approaches to improve bankability and get projects off the ground.

Multiple economic shocks are affecting new infrastructure development

Although infrastructure assets that are operational have been relatively resilient to economic shocks, the bankability of new infrastructure deals is deteriorating with increasing inflation and interest rates, and the construction of new infrastructure is plagued by supply chain, labour market, and inflation issues.

Five economic shocks are worsening the bankability of new infrastructure:

1. **The tight labour market is increasing labour costs.** Lockdowns and restrictions during the pandemic reduced work opportunities, and then the great wave of resignations hit. Construction employment in the OECD countries dropped from 45 million people in 2019 to 4

jobs among young people.

2. **Supply chains weakened by the pandemic and geopolitical conflict are increasing the cost to transport materials.** The availability and costs of most commodities are being disrupted by supply chain disruptions that began during the pandemic and worsened as a result of the war in Ukraine and China's extended lockdowns. Supply chains are showing signs of easing (the global average freight rate for a 40-foot shipping container was down to about USD2k in February 2023 compared to USD11k in September 2021), but construction materials have lower value-to-weight ratios. This means price hikes and supply lags will be more prolonged for infrastructure development.

3. **Rapid inflation is escalating material costs.** Higher construction costs have become the number one challenge for contractors globally, whereas they were in twelfth place in 2020. The US Bureau of Labor Statistics reports that the producer price index for construction materials is up from 236 in March 2020 to 331 in February 2023. Steel, cement, and non-metallic minerals are used in large quantities for infrastructure creation. Extraction rates for non-metallic minerals are rapidly exceeding natural replenishment rates. The US producer price index for non-metallic minerals shows prices increased consistently from March 2018 to March 2020, then rose sharply by February 2023. Price hikes result not only in less construction work, but also in more cost overruns, more project delays and cancellations, and more disputes. Price hikes and volatility in most material prices appear to be easing in 2023, but they remain a big challenge.

4. **Rapid and sharp spikes in interest rates have unexpectedly increased the cost of capital and reduced potential returns.** The proportion of investors citing interest rates as a key challenge for return generation increased from 12% in 2020 to 56% in 2022, according to the Preqin Global Infrastructure Report 2023. Infrastructure projects are usually highly leveraged, with debt:equity ratios between 80:20 and 60:40. High interest rates have increased debt payments for financing of new projects or refinancing of existing projects. With higher interest rates, the required equity returns and overall cost of capital also increase. EDHECinfra data show that the median required equity return for global infrastructure increased from 8.1% over the past five years to 9.3% over the past six quarters, and the median weighted average cost of capital (WACC) for global infrastructure companies increased from 4.9% to 5.9% over the same time period, as of 30 September 2022 (the most recent data available). Higher financing costs can be the difference that makes some new infrastructure uninvestable.

5. **Uncertainty about the global economy is paralysing development of new projects.** The IMF World Economic Outlook 2023 predicts that global inflation could drop to 4.3% by 2024, still above the pre-pandemic (2017-19) levels of about 3.5% and with numerous downside risks including persistent inflation, sudden financial market repricing, geopolitical fragmentation. Some upside risks are pent-up demand boost and faster disinflation. These uncertainties require flexibility from all stakeholders to avoid a standstill in deal flow.

Despite the current economy, there are some practices governments and industry can adopt to get infrastructure projects off the ground and keep capital flowing

It is good news that the public and private sectors are still aligned in intending to invest in infrastructure. Private capital raised for infrastructure investment reached a record level of USD173 billion in 2022, up from USD123 billion in 2019. This confidence is a direct result of the strong commitment demonstrated by governments, and the momentum their policies have generated.

To help close deals and keep capital flowing despite economic uncertainty, governments and industry can make policy reforms and apply innovative funding, financing, procurement methods. Below are a few examples.

1. **Cooperative approaches.** Although the exact set of crises facing the economy today is unique, best practice approaches to cooperative risk allocation, contingency assessment, and dispute resolution should continue to instil confidence in investors. An example is including a renegotiation element in infrastructure deals, to allow adjustments if there are deviations in key parameters like interest rates or inflation rates that extend beyond an agreed range. Such approaches can hugely help in closing deals and ensuring critical infrastructure projects move forward.

2. **Application of blended financing**. Blended finance uses catalytical capital from public or philanthropic sources to improve the financial feasibility of infrastructure projects. Use of blended financing needs to be scaled up (see page 48 at link).

3. **Bundling small projects into a larger program to achieve economies of scale**. Bundled procurement (see the case study on Pennsylvania 4,500 bridges project) can provide the scale necessary for smaller projects to be viably procured and financed by enabling bulk buying, bundled financing, and other cost saving measures. Renewable energy, water, waste, and social infrastructure projects are typically smaller in size than an average infrastructure project, so bundling could be particularly useful for these sectors

4. **Secure and ethical monetisation of data generated by infrastructure assets.** This is an underutilised revenue-generating opportunity that is particularly relevant now, given that several other forms of revenue from infrastructure (e.g. tax and user charges) are being impacted by the need to maintain affordability during inflation.

5. **Scaling up financial innovations**. Innovations like asset recycling[1] and securitization[2] can free up funds of governments and banks for investment into new infrastructure. This is important because recent Basel III reforms reduce the role of banks in infrastructure [illegible] time when accelerated infrastructure development is urgently needed. The infrastructure development phase (project preparation [illegible]) is

6. **More supportive travel and immigration policies**. Particularly in developed economies, more supportive policies can attract workers from countries with construction labour surpluses or unskilled labour willing to upskill with appropriate training and capacity building programs. It is essential that these programs be conducted ethically.

7. **Technology adoption.** An emphasis on accelerated adoption of the latest technologies will increase labour productivity and alleviate some labour demand pressure. The GI Hub has developed an entire blueprint for scaling up the adoption of infrastructure technology, which sets out policy, commercial, finance, and technology approaches at the portfolio and asset level.

8. **Circular solutions.** Price pressures that have arisen due to the global scarcity of construction materials (non-metallic minerals) coupled with weak supply chains, could be mitigated through accelerated adoption of circular economy solutions for infrastructure in local construction markets.

As the old adage goes, crisis is an opportunity in disguise, and it's time to adopt innovative policies and reforms to alleviate cost pressures, enhance returns, and raise the attractiveness of new infrastructure development – which is urgently needed to translate commitments on sustainable development and climate goals into actions.

Notes

[1] Asset recycling is the sale or lease of existing infrastructure assets to invest in new infrastructure.

[2] Securitisation refers to converting long term illiquid banks loans into highly liquid tradable securities.

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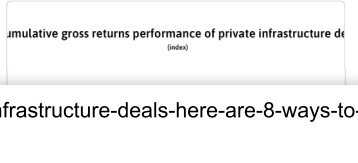

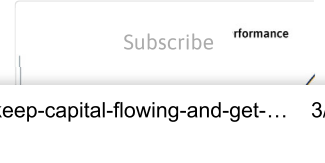

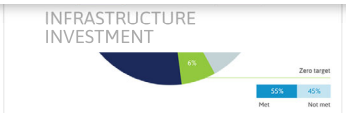

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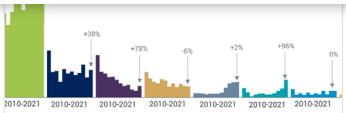

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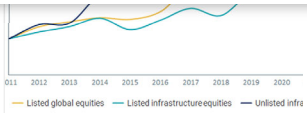

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