Quarterly valuation update for the energy and infrastructure sector

Q4 2023 update and spotlight on platform investments

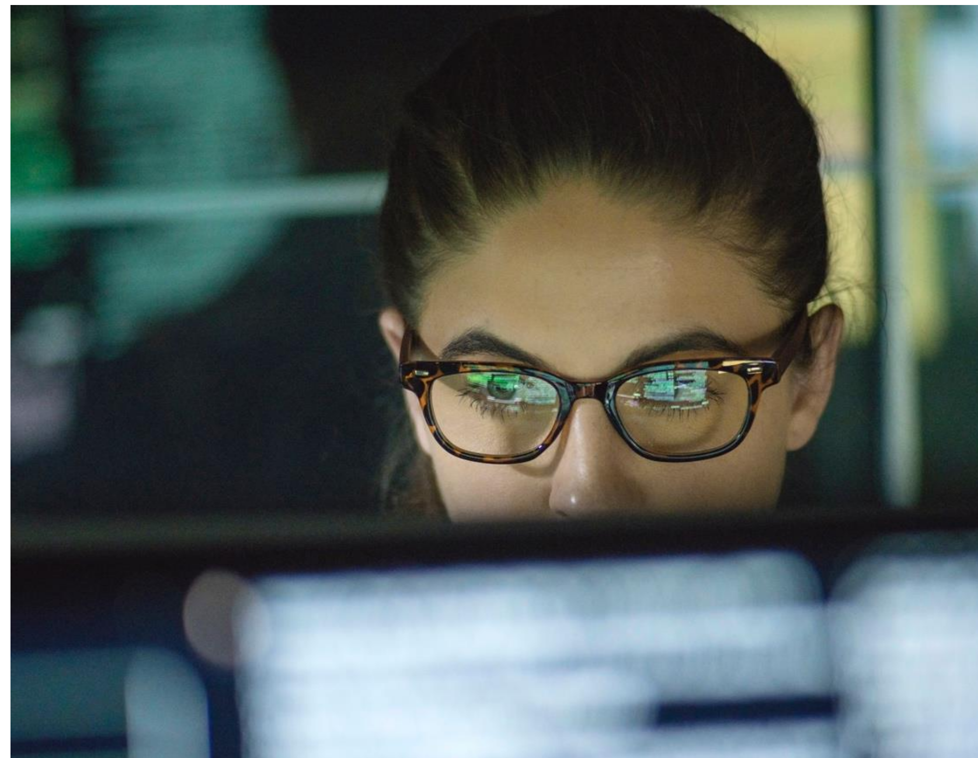
mazars

Quarterly valuation update
Introduction

Welcome to the Q4 2023 edition of our quarterly valuation update, which provides a snapshot of some of the main publicly available valuation trends across the energy and infrastructure sector, covering both debt and equity metrics.

This quarter we continue to look at trends in debt and equity metrics relying primarily on publicly available information. In relation to the equity trends, we use the Mazars indices of listed infrastructure funds and listed renewable energy funds, compiled on the basis set out in Appendix 1 to this update.

In addition, this quarter we have included a spotlight on the challenges of valuing platform investments.



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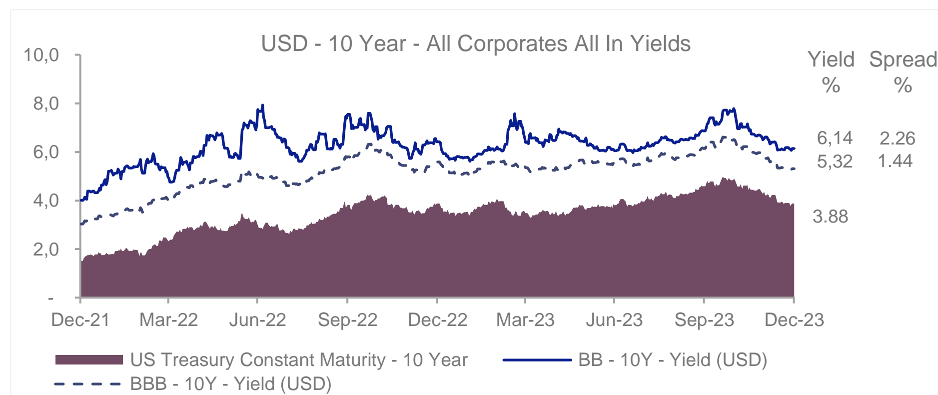
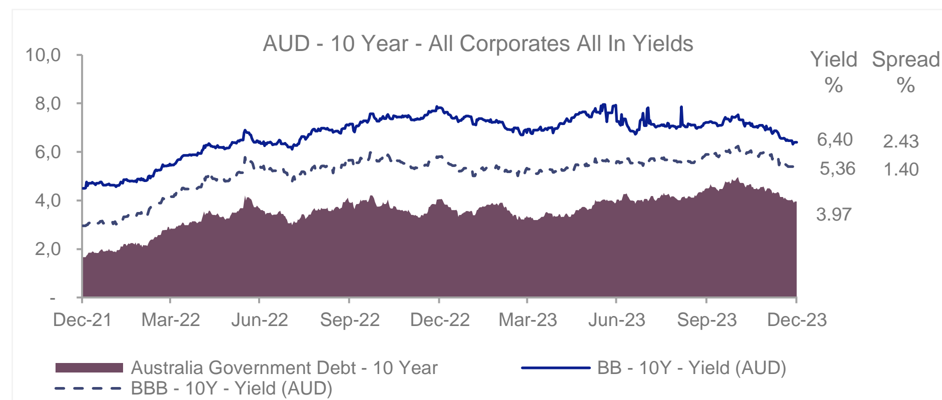
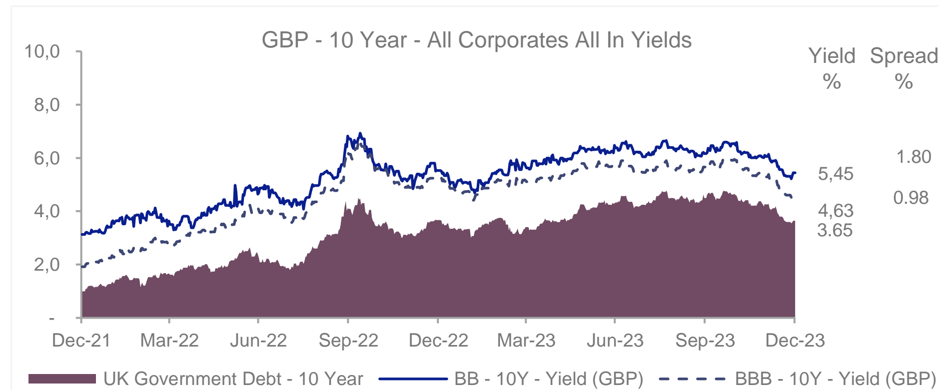
Quarterly valuation update
Debt valuation trends

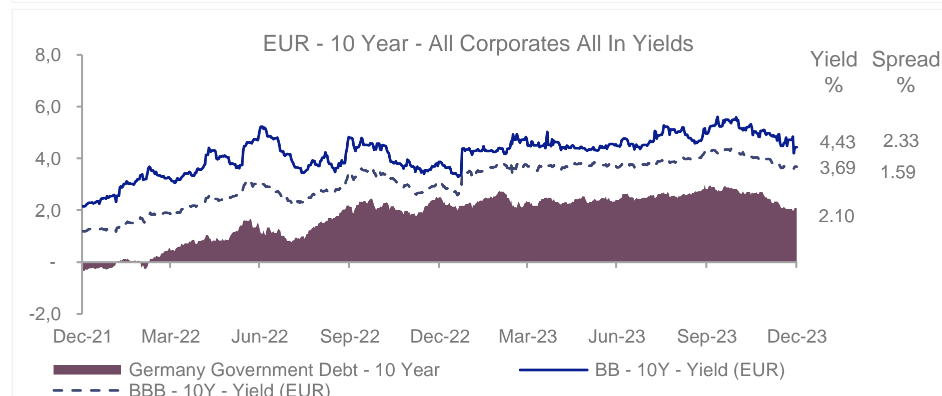
A decline in the cost of debt across the markets as inflationary pressures ease

- Government bond yields are relevant to valuations because they are often used to inform the risk-free rate and also influence the cost of debt.
- The big picture is that the cost of debt has increased significantly in all markets over the past two years and this has led to discount rate increases also. However, Q4 2023 did see a general reduction in bond yields, reversing some of the more recent rise in cost, back to levels seen towards the start of 2023.
- Yield curves are partly inverted with the cost of debt highest for short-term durations, at their lowest for 5-yr debt, and then rising again for longer durations.





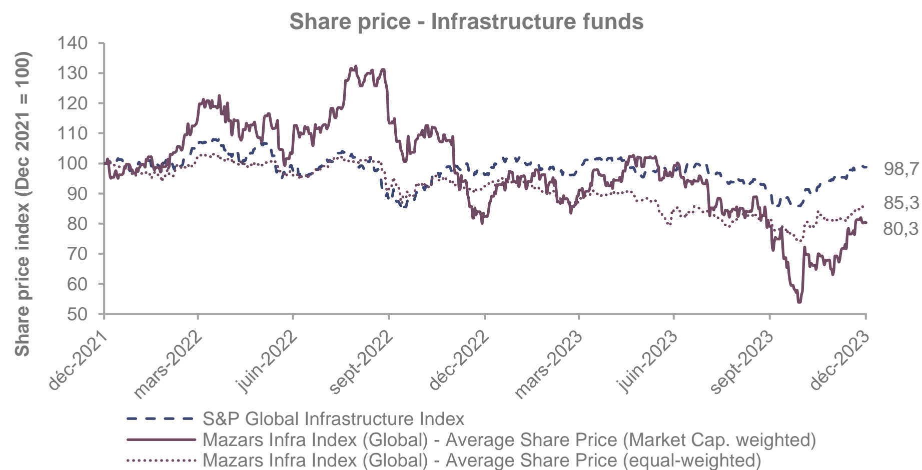




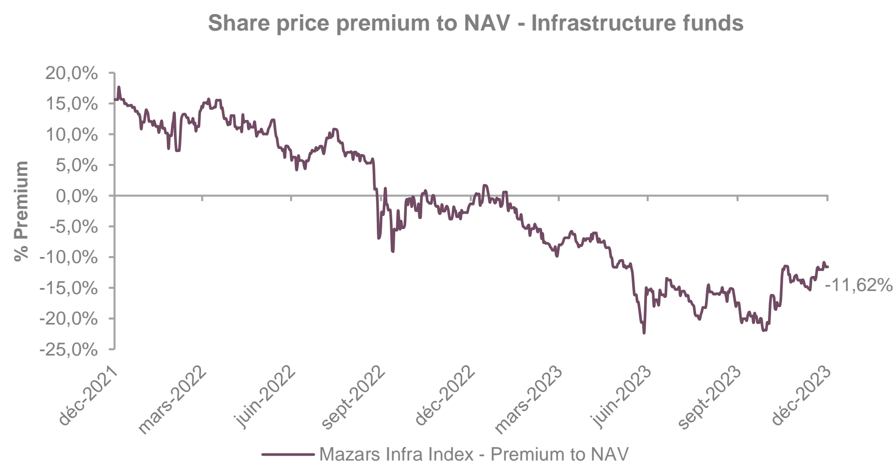
Source: Capital IQ, Mazars analysis

Quarterly valuation update
Equity valuation trends – infrastructure funds

Q4 saw a reduced discount to NAV for listed infrastructure funds as share prices increased



Source: Capital IQ, Mazars analysis



Source: Capital IQ, Reports from Funds, Mazars analysis

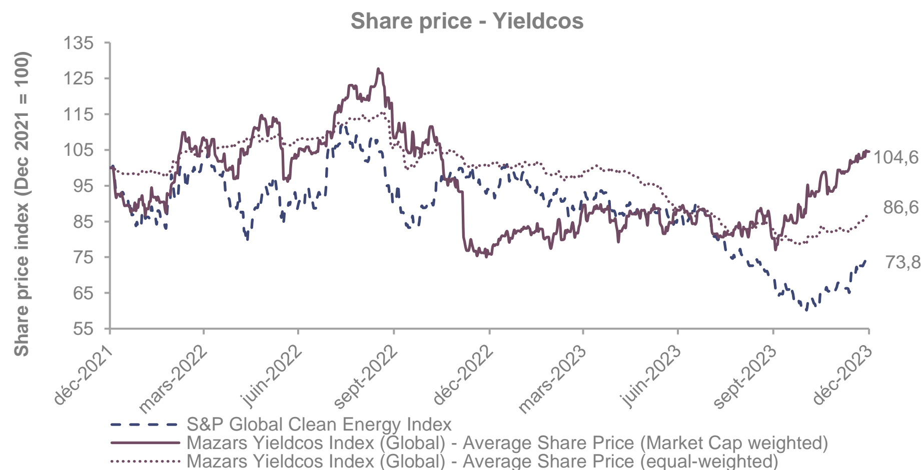
- Graphs indicate that share prices have increased over the quarter, with an overall improvement in investor sentiment this quarter, perhaps linked to the reducing cost of debt in that period.
- NAVs have not changed significantly, so the overall impact of higher share prices is reduced discounts to NAV.
- Some listed funds continued to report higher equity discount rates but are also noting a recovery in transactional activity at valuations that support carrying values.
- The reduction in gilt yields this quarter, if sustained, may start to feed through to a halt in discount rate increases and potentially to lower discount rates later this year.

"There was an increase in the transactional activity within the core infrastructure sector in the period. This reflects signs of converging views between buyers and sellers over asset pricing, driven by medium-term interest rate expectations. Buyers with capital, predominantly unlisted participants, continue to be able to transact in the market." – HICL (Interim Results Report, released in Q4 2023)

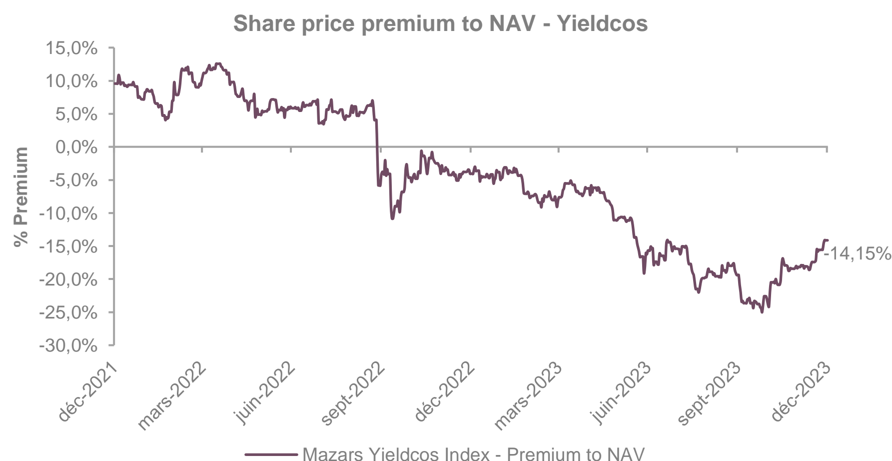
Quarterly valuation update

Equity valuation trends – renewable energy funds

Discounts to NAVs narrow; NAVs have been under pressure from rising discount rates in the sector.



Source: Capital IQ, Mazars analysis



Source: Capital IQ, Reports from Funds, Mazars analysis

- Overall, similar to infrastructure funds, listed renewable energy funds have seen a reduction in discounts to NAV during Q4, as the share prices increased over the quarter.
- But in contrast to infrastructure funds, NAVs have slightly decreased on average. This is partly a function of higher discount rates and reduced power prices, although partly offset by increased pricing for Renewable Energy Guarantees of Origin (REGOs) and higher inflation forecasts published by funds.
- Recent transactional experience has similarly suggested higher discount rates being applied by investors across geographies. In some cases, an expectation gap has opened up between what sellers believe they can get for assets and what buyers are willing to pay for them.
- The average premium to NAV trend hides large differences emerging between funds trading close to NAV levels and those trading at significant discounts, with a particular market focus on risks to dividend payments.

"Fear of prolonged high interest rates and resulting lower asset valuations is partly responsible for the discount to NAV at which the listed renewables infrastructure sector is trading"
– JLEN (Interim Results Report, released Q4 2023)

Quarterly valuation update
Spotlight on: the challenges of valuing a platform investment

When should companies in the energy and infrastructure sector be valued differently from the sum of their individual asset values?

What is the basic idea behind a platform premium?

- Many valuations in the energy and infrastructure sector focus on individual assets, applying a discounted cash flow analysis to a detailed, long-term financial model
- Often, the appropriate valuation of a portfolio of assets would simply be based on the sum of the parts, adding up the valuations of the individual assets in the portfolio. The valuation of a company holding a portfolio of assets may similarly be calculated in the same way, with an adjustment for company-level costs and taxes.
- **There may be reasons though to ascribe additional value to a company with a large portfolio of assets, above and beyond the tangible asset valuation.** The purpose of this "platform premium" is typically to recognise the **potential for growth** in that company, often linked to the **strength of a management team** and their access to opportunities. Sometime these opportunities may be identified (as with an early-stage development project pipeline), sometimes they may be more theoretical based on the broader market opportunity.
- In addition to pure growth potential, portfolio investment may also provide benefits from **scale and diversification** that may also push overall value beyond a pure sum of the parts analysis.

Approach and challenges

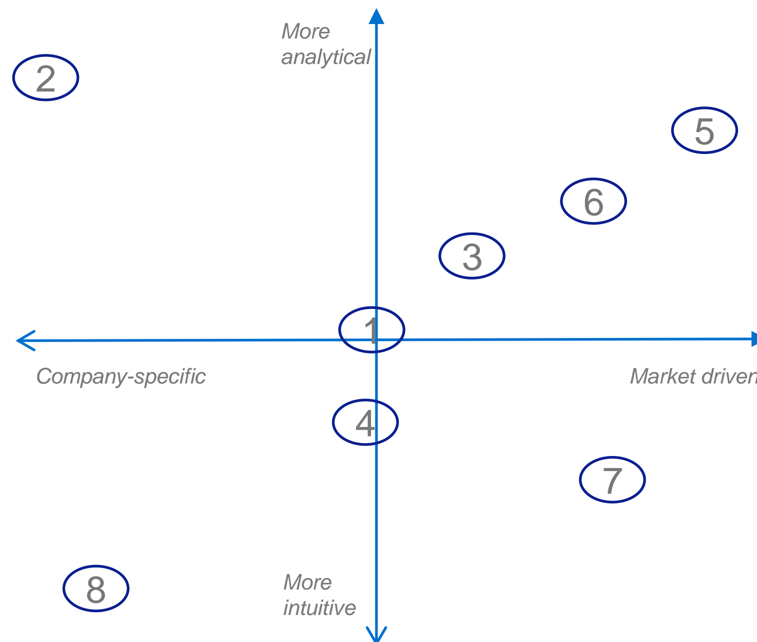
	Specific identified opportunities	Broader growth potential
Approach	Valuation of a specific forecast, linked to identified opportunities. Valuation of individual projects and/or specific opportunities Potential to weight pipeline where binary risks exist	Can involve broader assumptions around market growth, penetration of existing market, conversion rates of opportunities, as well as market benchmarking. Could simply reflect a judgement around the value of a management team (and access to opportunities) that is relatively subjective.
Challenges	Danger of false precision / false sense of science and accuracy in the valuation where apparently detailed numbers actually reflect very broad assumptions. Management teams may be overly optimistic about conversion rates of early stage projects so forecasts should be compared to historic conversion rates as a cross check.	Difficulty of proper comparability across companies / difficulty of applying even general benchmarks where the judgement is ultimately subjective. Market evidence for generic platform premiums can also be very variable and therefore difficult to apply.

Quarterly valuation update
Spotlight on: the challenges of valuing a platform investment

It is common to apply a platform premium in some contexts, but it can be challenging to find an objective approach to this

Examples of valuation approaches to a platform premium

1. Use a Terminal Value growth (TVg) assumption as a proxy
2. DCF valuation of tangible growth opportunities, potentially probability-weighted
3. DCF valuation of broader market opportunity, making an assumption e.g. around number of assets added to the portfolio per year
4. In a valuation based on multiples capturing the growth through a higher multiple or a higher future earnings estimate
5. Reliance on broader comparable company benchmarks and the gap between underlying asset values and company values – use this to inform the size of a generic market premium
6. Comparison between the valuation of listed companies with different levels of growth potential (e.g. different sizes of development portfolios) – using this to derive company-specific premium
7. Applying a set level of premium as a matter of policy on the basis of scale and/or diversification (or conversely a negative premium for the opposite)
8. Particularly in the context of a transaction, a subjective assessment of a management team



Recent observations:

- *Up until mid-2022, there was clear evidence of a platform premium in the public markets, shown for instance by listed funds being valued at consistent premia to NAV and by listed IPPs being valued at a significant premium to the valuation of their operational and near term development assets.*
- *More recently though valuations have fallen back, making the public markets a more difficult source of data to drive analytical, market driven approaches to sizing platform premia. However, private transactions continue to demonstrate the value investors place on companies with a large portfolio of assets and access to further opportunities.*

Quarterly valuation update
Conclusions

Three key themes from Q4 2023:

Reduction in cost of debt this quarter	Following a lengthy period of rising gilt yields, Q4 saw a partial reversal with yields ending 2023 lower than they were a year previously in some markets. This increases the implied risk buffer on discount rates and may have started to lead to an increase in debt transactional activity.
As investor sentiment improves and share prices in the energy and infrastructure sectors rise, the discount to NAV reduces.	Share prices of listed funds started to respond to the reducing risk free rates. Listed funds continued to report increased discount rates used for valuation purposes but further reductions in the cost of debt may mean that these reported rates have now reached their peak for now.
The key reason for commanding a platform premium is the additional value that can be created for investors by the platform.	Investors typically value companies in the sector at a premium to underlying asset values to reflect the benefits of scale, diversification and access to growth opportunities, There are many available approaches to sizing this premium, but public market evidence is currently difficult to apply.

Appendix 1
Information about the Mazars indices

Infrastructure is an increasingly mature asset class, with an increasing number of listed and unlisted funds set up specifically to invest in and manage real assets across the infrastructure and energy sectors. For the purpose of our analysis, we have constructed two global indices that focus on listed funds, as follows:

- An index of infrastructure funds, currently including 8 funds with activities across 15 countries
- An index of renewable energy funds, currently including 19 funds with activities across 23 countries

While other infrastructure and energy company indices exist in the public domain, they tend to have a broader scope, including for instance construction companies, transport operators, concessionaires and utilities to gauge broad sentiment across the sector.

By focusing on pure asset owners, the Mazars indices aim to be more closely aligned with market sentiment on the valuation of these assets. This is reflected in this update and includes a number public statements from funds on how they are currently approaching their own valuations.

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