Transforming Business – Season 2, Episode 3:
Funding infrastructure to stimulate growth

Infrastructure projects can accelerate Australia’s economic recovery – but where will the investment come from to fuel that?

Hello, and welcome to our podcast …

Transforming business with MinterEllison: ideas and challenges that are shaping our future.

Construction is a bell-weather for Australia's economic condition.

Continued investment in residential, industrial and commercial property – and major infrastructure projects – keeps the industry moving and Australia prosperous.

In the midst of COVID-19, state and federal governments are seeking to fast-track and fund infrastructure projects and help steer the nation towards economic recovery.

But in this time of high government debt, there’s a clear and pressing need to attract private investment.

To find out how Australia might secure that investment, Minter Ellison partner and Infrastructure Industry Leader Nicole Green caught up IFM Investors’ Chief Executive Officer, David Neal, for a virtual chat.

Nicole Green

After almost 13 years as CEO of the Future Fund, David, you've started with IMF Investors in quarter one of 2020, which coincided with Australia's response to COVID. Can you reflect on some of the challenges that that timing brought to what must have been a most unusual time to take the reins at IFM Investors?

David Neal

Yeah, thanks Nicki. It's lovely to be here and chatting with you. Clearly it was an unusual time and it's been an interesting transition. So, I sit here as we speak now, I'm just about to come up to six months in the role. I've spent all of that time working from home, most of it from the corner of my bedroom. So, it is an odd way to get to start running a global business and of course the environment we're in has added a lot of challenges to that. Actually, before I talk about the challenges though, I might just reflect on the opportunity from a personal perspective, when you're in the cauldron of dealing with a crisis as we were, in those early days of a very severe sort of health crisis and then the challenge of moving everybody to working from home.

The challenge we had of dealing with assets and all those things. When everybody is busy and focused and having to work together as a team. Really having to come together as a team. It's actually a fantastic opportunity for me to see the team in action, to be integrated into that team in action. So, in some ways it's a fantastic transition, from that perspective. But, to get to your question on the challenges, the key is staff wellbeing of course. We moved to 500 offices from our normal nine global offices as everybody is suddenly working from home. You've got the practical challenges of that we've all dealt with I'm sure, of technology and everything else, which all went actually remarkably smoothly. And then you have the, sort of, psychological, personal challenges that everybody has, and everybody has their own context. But dealing with, suddenly, spending 24 hours at your workplace; I think I did hear someone say: it's not working from home, it's living at work.

It's really important that we try and protect our staff from feeling like that and we need to give them the guidance and the coaching and the tools to be able to deal with that. Because none of us have been through that process, day after day after day, of being where your work is all of the time, is not something that we're trained to deal with – most of us, anyway.

So, the challenge, the key challenge is helping our staff through that. Helping them understand how to cope with that. What are the tools, what are the challenges, what are the strategies that they should deploy? How do you create the boundary between home and work, which is normally defined by a commute? And when that isn't there, how do you create that boundary and if you don't, people just get exhausted and they get stressed by everything else that's going on around them. So, we've done a lot there I think, to help, that's been the key challenge. But of course we run large portfolios of assets all round the world and those assets, some of them have been clearly massively impacted by the COVID environment. Watching the team that I have come to join, watching them set about their work, firstly making sure that the staff in those assets were looked after and then thinking about how to make the asset as resilient as possible. How to keep the essential services that they offer running, clearly that's critical. Them going about that work in an incredibly professional and diligent way. I was very impressed with that.

So that, would be clearly an immense challenge. You don't typically build a team to deal with every single one of your assets. Having a major issue at the same time, all at the same time. I know the whole world was dealing with similar issues, but you can imagine the strain that that puts on a team, when you have to cope with that. So, that's clearly been interesting as we've navigated through that sort of environment. And then the other challenge has been thinking about the external environment, the economy that we're a part of. And thinking about, so what can we do to be a part of the recovery from that? And so this is clearly, a major challenge that our economy is dealing with, and what can we do to be a part of the solution. So, it's been interesting.

Nicole Green	Those are some wonderful reflections and terrific to hear you talking about people first because I think it really is a people challenge, but obviously your investments and the future economy are also quite significant. Perhaps if we could turn to your investments, as you said, IFM has a very significant asset portfolio and I know you have a number of airport assets, which as we all know have been hugely impacted by the health crisis, but also the government's various responses to that crisis. Do you think as a result of COVID that IMF Investors will change your approach to investment in projects going forward and the types of assets that you will invest in?.
David Neal	At a high level, no I don't Nicky. I don't think we will because if you think about what we are doing, we're aiming to construct diversified portfolios. We're aiming to construct, well we're aiming to understand long term cash flows that we can put a value on, long term dependable cash flows. Those cash flows are dependable typically in our space, the infrastructure space, because of their essential service – the monopolistic, or close to monopolistic characteristic that they have, those things don't change. Now, clearly there is probably going to be some disruption to that for some time, it's going to take a while for people to be traveling again in the way that they were before. It's very uncertain what the propensity to travel will look like. How quickly will that recover? That will depend obviously on how the health crisis unfolds, and if we find vaccines. It might depend a lot on government policy, things like testing regimes at airports. You know there's much we can do that I'm confident that we – that the world – will do to either solve or help manage this crisis. And that's just sort of the way of things: you buy assets and some of them are impacted by something that you didn't foresee or couldn't foresee and you manage your way out of that the best way possible, but that's why we construct diverse portfolios. What will be the next major crisis to hit? Well, maybe that's something that will impact other sorts of investments. At a high level, the way to think of our portfolio, I think through this crisis, has been, if you're moving people around you've had a problem. If you're moving goods around you've had less of a problem. So, yes, the economy has been impacted, but clearly there's still a lot of trade. Certainly, my family seems to be keeping the postal delivery service pretty busy, we're getting parcels delivered every other day. So, clearly there's goods still moving around and so the port has been a lot less impacted than the airport. And if you own a utility then largely that's gone unscathed. So, at a high level you've just got to keep trying to anticipate the risks that might beset particular assets and you've got to build diverse portfolios and so, no I don't really see that changing..
Nicole Green	Okay. Thank you. You mentioned both your portfolio and then you also mentioned the economy, I know there's a lot of discussion about infrastructure investment and procurement being our silver bullet on the road to economic recovery. It would be great to hear your thoughts on what you think our governments at various levels should be doing to help facilitate that. And perhaps, if we could break it down into two sub questions. One is, the types of projects that you think could help get the economy ticking along quickly and secondly, are there any other regulatory or policy reforms that government could look to, to really improve investment and certainty in that pipeline and the benefits of investments for investors, such as yourself?
David Neal	Clearly there is a great opportunity, as you've mentioned for infrastructure to play a role in the recovery. It seems sort of self-evident that if we can move quickly to build assets which improve the productivity and the economy, but at the same time obviously create lots of jobs to build them in the first place, that's something we should be really working hard at and it's obviously something that governments around the world have been talking about. So, I think that is clear and is why we are so engaged on this question. We feel like we have a responsibility here to be a part of the conversation. To be a part of the solution.

	In terms of the types of projects, the sorts of projects that you can move the fastest are those in the existing assets and where ourselves and industry super funds and other long term investors more generally, have been deploying substantial capital already and over the years, continuing to reinvest. And there are many further invest opportunities in the assets that we own. So, there's opportunities for new terminals and new runways and things like that, which will be required for our growing population. The key around a lot of those and obviously it's difficult, a lot of the CAPEX has been deferred, as cash flows have sort of dried up and the focus is elsewhere, but if we can get people moving around through airports again and we can get the cash flow moving then that sort of investment can move very quickly.
Nicole Green	How can government help?
David Neal	Well, approvals could be fast tracked. So often these things take years to get from the start to actually commencing, putting the mythical shovel in the ground. So, fast tracking those sorts of approvals would be helpful. But more broadly, and incidentally there's plenty that we're doing there, but one of the really interesting broader themes here that I know has been talked about a fair bit, is the idea of building back better. Can we build back at a more environmentally responsible way, low emissions, that sort of stuff and so lots of our investments that we've been doing have been in things like solar farms, behind the meter of our airports. Airports have the characteristic of usually having lots of land, so plenty of places to put solar panels and that's an extremely reliable and value adding, but also obviously environmentally advantageous set of investments to do. And I imagine that we'll continue to do those sorts of things. What we don't do really, is sit and analyse the national economy and figure out where the bigger infrastructure needs are. There are all sorts of bodies already established for government at state and federal level advising government on all of that. What we really need is for government to just make the decisions – what is that pipeline? So, one of the critically important things that the government can do, is to make the decisions about what are the critical pieces of infrastructure that they believe are required. What are they going to prioritise and therefore what's the pipeline of projects that we're going to see? And then we can start doing our work on what is of interest to us and how we might want to be a part of those projects and those solutions. I think that clarity and that leadership from government, state and federal would be a hugely valuable thing that they could do. And then we've been talking about how you then get from that pipeline of projects to an actual project that's off and running, capital supported and planned, and we've been observing that for many of these sort of greenfield projects, long term equity capital tends not to be a part of the solution.
Nicole Green	This is probably an opportune time to talk about the model that IFM Investors has proposed to solve that issue.
David Neal	Yes, so the lack of long-term equity capital, when you think about it is a third of a puzzle in terms of supporting new greenfield projects, why is that not the case? We've got this substantial pool of superannuation savings in the country that is very keen to find appropriately returning investments in this country. The multiple wins that come with projects that create returns, as well as jobs, as well as a more productive future economy, particularly at this moment in time. This is something that ought to be the perfect place for long term equity capital to play a role and yet it's not in greenfield typically. It buys up the existing assets, it buys up the brownfield, but it's not been involved. And the reason for that, we think, is the way that they're procured. The constructor-led bid into a PPP kind of project or something similar is incentivising highly levered structures where there is very little equity, it incentivises the constructor to make a construction margin because that's what they do, over a three to four-year period.

It is less about what the 40-year cash flow stream looks like and how well is that asset going to perform over that 40-year period. It's less about how is that asset going to meet the needs of the community around it over a long period of time. So, we kind of think, how can we get superannuation capital involved and our suggestion is, that it needs to be on a much more partnership base with government – that the government brings in an equity partner, that they together work through how best to allocate the various risks in a project across different parties. Risk sharing is a key downfall of the current model. The government thinks it has offloaded risk to someone and that they are unable to bear it. And of course, then the risk comes straight back to government because there's nowhere else for it to go.

Whereas if you share risk with a long-term equity partner that can offset risk over a 40-year cash flow period, well they've got a much bigger ability to absorb, and the taxpayer, I think, gets a much better outcome as a result. So, we think that working with an equity partner to design up these projects and how they are managed and governed has that advantage. The other advantage it has is that it means you are not reliant on one large constructor. You can break the project up into small pieces, you don't have to have the entire project planned out and scoped and costed before you start. You can actually get moving on it. You can also parcel it out to smaller constructors. We can have more small and mid-sized Australian domestic firms involved in the process than we perhaps currently do. Which, we think is also good, obviously for strengthening and deepening the Australian economy. So, I think there are lots of advantages to this approach, but it requires a different mindset from government, it requires them to be confident enough and comfortable working as a partner with equity capital, such as a superannuation fund, but not necessarily a superannuation fund, any long-term investor could, with the appropriate skills obviously, could play this role and IFM certainly would like to play a part in that.

Nicole Green

You raised an interesting topic there, which is the risk sharing. We've obviously seen projects where government has thought that those risks have been passed onto the private sector, only for them to come back because you can never really contract out the government ultimate risk, in that they will be the ultimate concessionaire, et cetera. In your model would you be re-looking at the way that risk has been shared between government and the private sector to try and re-visit that sharing and for some of those that have traditionally been passed on to be considered in a different way?

David Neal

Yes, I think that's by its nature that's how this would work. The key is, you get a much more engaged, collaborative conversation about each risk – who is best to bear it. And that's a sort of, not just a level of risk, but a value equation for the taxpayer in going through that conversation. How much does it cost to lay off this risk to the private sector? Are we prepared to bear that risk? Are we the best people to bear that risk? The government is in a much better position to bear regulatory risk than the private sector. They're in control of whether that's going to change. There are obvious conversations that can be had, which lead to a much more optimal allocation of the risks. That's really all it is. So, there's no single answer here. There's no: this is the way you do it. Every project has its own context and is complex in its own many ways. So, that's why the idea of having a collaborative partnership enables you to flex around that context and get to a more optimal solution.

That's our view anyway, but it requires a different mindset and it requires probably different skills within government and arguably within the private sector as well. But we think those skills exist and that shouldn't stop us moving forward with this sort of model. And there are others around the world who have used a model like this and apparently with great success.

Nicole Green	Yeah, the model would certainly have a lot of merit in terms of opening up your contractual options and re-managing risk and I think any project that you guys invest in, is going to be significant, and looking at each project on its own merits and where the risks for each project are allocated is absolutely the way forward. I'm interested also to understand on that basis where you would have multiple contractors and whether you have thought through this, as yet or whether it will be managed on a project by project basis, but that is gives rise to a number of interfaces and potential interface risk. How will that be managed with the multiple contractor situation?
David Neal	Well, I think you need an appropriate delivery partner that is skilled in that space. Those interfaces exist anyway, in any major project, they already exist really, it's just about the level of involvement. I think the key difference is the amount of involvement that equity capital has in the management of those interfaces. And the point about bringing the equity capital into the management of those interfaces is that you are bringing in the entity that is most aligned for the long term. So that management is occurring with the lens of what's the best long-term outcome here, rather than, how do I maximize my three-year margin for building this thing. I don't think that the interfaces particularly are that much more complex than they would be. It's not the what really, it's the how is this being done with what alignment, with what mindset is this being done?
Nicole Green	It's interesting because the whole model goes to fostering investment, and we spoke about pipeline, and if we could get certainty of pipeline that would help. Are there any other things that Australia can do to really help create Australia being a destination for what are massive capital flows all around the world?
David Neal	I think whenever you speak to any long term investor they will say, well you'd need policy and regulatory certainty. Wherever you go in the world, if you're making a long term investment, that's what you're looking for and the less of that there is, then the more expensive that project is to get off the ground, or the higher the return that the investor requires given the risk. Australia has historically been very strong on this. It is a very attractive destination, typically on the infrastructure side, but I think as a country generally. We've generally been pretty good with a dependable regulatory environment and policy settings, stable rule of law, stable government, that sort of stuff. It's important that we hold onto that. I think there are some risks that we begin to lose that and it's as if, as you've alluded to in your question, it's a highly competitive environment now. The governments all around the world are competing for the investor dollar and needing to be as attractive as they possibly can be to bring that capital in. Dollars are instantly globally mobile these days and so it's important that the government has that in mind and resists the temptation to tweak and tinker with settings that are important to long-term investors.
Nicole Green	Do you have any views as to whether some of the recent legislative changes will benefit local superannuation funds and investors because the internationals will be more sceptical about their opportunity to invest?
David Neal	I think whenever there's a change made which creates uncertainty for the foreign investor, more uncertainty, then clearly that's going to create an advantage for the domestic investor and so yes, I'm sure that is the case. Interestingly we face a similar concern as Australian investors when we go offshore, because most countries now are looking at tightening their foreign investor rules, worried about national security type risks in particular. The whole sort of context of that change, risks the less efficient movement of capital around the world and that's obviously not good for any of us. I think it's important that the governments find a way to balance these sorts of considerations as effectively as they can. One of the things that we would like to see is obviously, sort of pre-clearance or at least understanding, what are the criteria you're going to use in making your decision? And how consistent have you been in applying those criteria? How consistent and transparent have those decisions been? That's what we're thinking about when we're investing in other countries and I'm pretty sure that's what the foreign investors will be looking for in an Australian context and the less consistency they see, the less clarity over the criteria, the harder it will be for them to commit to these sorts of investments.

Nicole Green	I think you're 100% right, particularly when one considers the big cost involved in a number of these projects – getting most of the way through it and not knowing you're going to get knocked out, unrelated to price or how beautiful your effort is going to look – is pretty important. Picking up from the critical assets and investment into Australia, one of the interesting things through COVID is our ability as an Australian nation to be self-sufficient, particularly when it comes to critical assets of which you invest in, such as our electricity assets or our Telco assets. Do you think investors will start looking at supply chain as a key risk now and what do you think will be appetite for re-establishing certain manufacturing plants in Australia for those key components that mean we keep our critical assets functioning?
David Neal	Your first part of the question, will investors look at the, essentially, the resilience of the supply chain? Of course, absolutely. I think that we've learnt very clear lessons about the importance not to concentrate too much on any one source of goods. Does it make sense, and will we bring everything onshore? That feels like that's probably going too far, but there's clearly, when you bring a new risk factor in to the decision and give it a higher weight than it had before, then we're going to get different answers and so yeah, I think there's very likely to be a pretty substantial amount of re-onshoring if you like of all sorts of things including in the manufacturing space. But, exactly how much that is, I think again depends on how we progress with the health crisis, managing the health crisis, as much as anything else. There's a difference between – you can diversify a supply chain by saying, well, we don't want to be so reliant on country X, we're now going to make sure that our supply chain comes from X, Y and Z. What you can't diversify is your border, so if the risk is, I might not be able to bring something in across the border then you have no choice. You have to onshore. If you're concerned about concentration risk then you can diversify and so I think the actors in the economy are making decisions about which one of those it is, that we're particularly worried about. I would like to think that we can overcome the border issue, that we are not going to see our borders shut too often and that really, this is actually more about diversification and so maybe a lot of this supply chain resilience will come from just moving our suppliers to other jurisdictions.
Nicole Green	That's an interesting concept around the border, I would have also thought that as technology improves, we could become again a nation that takes a greater interest in manufacturing. I think the whole discussion around technology, digitization and decarbonization is a really current one and an absolutely critical one. I note that IFM Investors cut carbon emissions in 2019 from a range of your investments by more than 8%. Can you talk to us about the focus on the decarbonisation? I was listening to a conference recently where it was stated it's not really a choice anymore it's just part of what we have to do, both in the procurement, but also the operation of infrastructure efforts.
David Neal	It absolutely is, we've moved, by we, I really mean the industry, but IFM is aiming to be a leader in this. We're moving so quickly from… the way investments were thought about was… the way ESG was thought about, was like a risk-based approach where you would bring ESG risk, climate risk into the devaluation of the asset, when you were thinking about buying it. You would look at, well how at risk are these cash flows from environmental impact, whether that's a carbon price coming on and getting larger or whether that's a physical risk. But you would do a risk-based assessment; is that asset going to get stranded? You put a value on it and if you could buy it for less than that, then it was a good investment. You were bringing the climate risk in. We are moving so rapidly past that now to the much more sophisticated approach which is; actually, our responsibility is to transition this asset. So, what we are now doing is, we're having to project a plan. We're having to project the transition plan for how the emissions in the asset will fall over time and obviously different investors can set whatever target that is they looking for. We will be aiming for Paris Agreement consistency.

We've got to work through the complexity of what that means. What does it mean to be consistent with the Paris Agreement for the way that this toll-road needs to change through time? What does it mean for this pipeline? What does it mean for this airport, in this context? That's tough, you're projecting the business forward over decades and you've got to do that in the context of not really knowing what the technology will be. Of course, not knowing what the technology will be to help you with this in five, 10, 15, 20 years' time. But that's the job that we're doing now. That's the job that we have to do, and I think that all responsible investors have to do. It's not just about putting a value on a series of cash flows today, it's about designing and executing a transition plan over the next decades.

Nicole Green There is a lot of work to do in retro fitting existing assets and I think historically in the built environment, we've always thought about the asset's impact on the environment and a lot of our planning thinks about that, but I think now we're now at a point where we have to think, in addition to that, what is the environment impact on the asset, rather than the asset's impact on the environment and how do we build assets that are resilient to the future? Do you think there's an opportunity in the procurement of infrastructure as well, not just the retro fit, to start building into these scopes of work that have to be delivered, that resilience?

David Neal Yes. Yes of course. It would be nonsensical really for us to be building new investments that we didn't believe were resilient to climate change. That would make no sense, so if that's what you mean by that question, absolutely. I think that's absolutely critical.

Nicole Green The word resilience in infrastructure is also used in another way, which is looking at how you can repurpose assets. Do you think we need to be building assets with almost multi-purpose optionality or is that just going to blow out costs in a way that's not really feasible? Let me give you an example, talking to a couple of engineers the other day, they were saying, they are building car parks. That they'd been asked by the designer of the car park to have the car park built in a way where at some future point it can be converted into apartments. Now that has all sorts of really crazy engineering challenges because car parks have certain slopes, to build all of that. So how do you do that?

Even seen through COVID, the way we've repurposed various assets around the country to be become temporary hospitals or things like that, is that something we should be thinking about or is it just in the too hard basket and you deal with it as and when it arises?

David Neal Where you can and where that makes sense, absolutely you should. I don't think that we should lose sight though of the immense uncertainty that climate forecasting, climate projecting has and dealing with that as investors. Long term investing is tricky at the best of times, understanding what future cash flows will be and therefore what value you should put on them is hard anyway. Forecasting the future is not the easiest thing in the world. To overlay on top of that forecasting the exact way that climate change will play out in a particular country or in a particular region and what that means for the future asset needs, is really hard, and so whilst what you say has lots of attraction and where you can do it at an acceptable cost would make lots of sense, but I think it is important not to overpay for that. I think that we can't really be that sure as to what the future looks like. And you don't want to commit too much today's valuable capital to something you're not sure about.

There's plenty to spend our capital on that can be helping us become more climate resilient without, in some ways – it feels like you're almost speculating. I do remember on the board of one of the airports, we did have a think about exactly that point you talked about. Could we build this car park in a certain way that we could reuse it in the future, and it does dramatically increase the cost of building that car park and you're probably better off using that extra capital in another way.

Nicole Green	Well, while I've got the crystal ball out and asking you to foretell the future. I would be really interested on your thoughts on what Australia's economy in the next three to five years may or might look like?
David Neal	When, you've got such massive forces pushing against each other. This huge force of the health crisis and the economic crisis that it is spawning, pushing against this huge stimulus response that we've got, quite unusual stimulus response that we getting, and this is a local and global comment: It's very hard to know how the balance of those two incredibly strong forces will play out. It's just really difficult to know. It's easy to paint the story that we'll have a sort of depressionary, deflationary sort of environment. You could also say, well we’re going to drive out of this so hard, given this strong stimulus that we're going to have, before you know it’s an inflationary problem. You can actually paint both of those stories and so I think, trying to predict too much is hard. For our part we tend to think that it's going to be probably three years or so before the economy is back to 2019 kind of levels. One of the things that we worry about, we don't really have the answers to, but we worry about from the shape of the economy perspective is that we're entrenching the inequities even more. This is a so called, kind of Pink Recession. We've been talking about helping the recovery through construction, so women and also a lot of lower skilled people, they're generally the ones that have suffered through this, hospitality industry and so on. Creating a bunch of construction jobs will help the economy in aggregate, but it does probably deepen some of the inequities. So, that's a feature of the shape of the economy going forward that I think we need to think pretty hard about how we address. We've been stepping up our work to understand what some of the sort of procurement practices for services and things like that and our assets are, so that we can see whether there's things that we can do to help on that side, but that's something that I kind of worry a bit about.
Nicole Green	David, thank you so much for joining us today. We have covered a very vast array of topics all infrastructure related and we're most grateful for your thoughts and insights. And certainly, looking forward to seeing what we do in the next year, three years and five years and seeing how Australia goes from strength to strength, including our various entities, like IFM Investors. So, thank you.
David Neal	Thanks very much Nicky, it's been an absolute pleasure talking to you.

That was **David Neal** in conversation with MinterEllison’s **Nicole Green.**

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And goodbye for now.