Morgan Stanley

INVESTMENT MANAGEMENT

KEYNOTE INTERVIEW

The future is digital

Digital infrastructure has earned its stripes as an essential service during the pandemic. That will have significant implications for the future of the asset class, say Morgan Stanley Infrastructure Partners' Yacine Saidji and John Watson

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Q How has covid impacted the growth trajectory of digital infrastructure?

John Watson: When you look at the impact covid has had on consumer and enterprise behaviour, it's become abundantly clear how reliant we are on digital infrastructure in our everyday lives. Initially, the increase in traffic as a result of lockdowns placed a strain on networks. That was followed by a wave of announcements heralding new investment in that infrastructure.

Long term, however, the impact will be an acceleration of the digitalisation that was already underpinning the broader digital infrastructure thesis. Trends such as cloud migration, investment in the wireless ecosystem and the emergence of 5G, which were already underway, are becoming an increasing priority, both for customers and the enterprises enabling those technologies.

Q And how is that translating into attractive investment opportunities?

Yacine Saidji: Two important trends have come together to create exciting opportunities in this space. First, the demand growth is undeniable. Second, integrated telecoms operators are looking to hand these assets over to specialists, like us, in order to optimise the investment required to scale the infrastructure of the future, which is creating a surge of dealflow.

JW: I'd add that digital infrastructure offers both attractive incremental unit economics and, importantly, resilience. The criticality of these assets has been absolutely proven during the pandemic and their resilience in the face of turbulent markets has been demonstrated in spades.

YS: Even just a few years ago, there were questions as to which of these assets really represented infrastructure. We believe the higher quality assets have demonstrated that they have earned the label.

Q Digital infrastructure is a clear 'covid winner' and prices have climbed. How can you compete without overpaying?

YS: You need to interface well with the telecoms operators themselves, because when you become owners of the infrastructure, those operators will typically become your clients. They're therefore highly focused on what life will be like once the asset is under your control. The engineers may not be benefiting directly from the monetisation, but they do want to make sure they can continue providing a high service to customers. The price paid is not the only element of winning a deal in this sector. Earning trust is crucially important.

JW: A lot also comes down to understanding the local market environment. While we may have a broad view on the long-term tailwinds behind a particular component of the digital ecosystem, the study of individual assets is always very local, and needs to include an analysis of the local demand, competitive environment and moats around the business. Picking apart the nuances and complexities of that is a major part of the job and is almost entirely a function of having the right set of local partners, experienced in the local economies. That's another area where we feel we can gain an edge.

Q What's your formula for value creation?

YS: There's no simple formula because every situation is different, but there are some common principles. More often than not, we'll be extracting assets from integrated operators. Prior to the transaction, those assets will have had only one client. Part of our value creation will be making that asset available to whoever wants to use it. The asset will typically also have been viewed as a cost centre within the integrated operator. We look to transform the entire culture of the team from cost centre to profit centre, and from managers of a small division within a giant organisation to CEOs of a single company with a single purpose – to be the best at whatever it does.

In addition, as part of the integrated operator, the management team may have had difficulty accessing capital. With us, as long as the return is attractive, the capital is there, which allows them to take appropriate risk and invest for the long term. We explain that we're looking to achieve an exit in a five- or six-year horizon and while what happens to the P&L in the meantime is not unimportant, what's really critical is the ultimate destination. Finally, we spend a lot of time identifying and attracting

Q Where next for digital infrastructure?

JW: The 5G build-out will significantly increase bandwidth capacity to mobile devices and enable very low-latency products and services. The bandwidth gains are likely to be driven by a combination of additional spectrum availability, network densification and improved radio access network technology, while much of the latency gains will be a function of more localised compute. Taken together with continued migration to the cloud, we'll see a greater focus on the edge ecosystem and we're cautiously optimistic that this will evolve into an investable proposition going forward.

The increase in available licensed spectrum, such as C-band (3.7 and 4.2 GHz spectrum repurposed from satellite use in 2021), and unlicensed spectrum, such as Citizens Broadband Radio Service (3.5 to 3.7 GHz, repurposed from US military use in 2020), will create a new opportunity to invest in the infrastructure that enables the most efficient deployment of those frequencies, including in-building wireless network solutions. Further into the future, a vast amount of investment will be required to fund space-based broadband, and while I don't think that represents an investable opportunity for the infrastructure community today, it's something we'll continue to monitor closely.

At the end of the day, it comes down to those unit economics, contracted cashflows and resilience of the developing business models. There will likely be new technologies that fit that bill down the line.

YS: The future that consumers are demanding is even more digital than today, even more connected, more global and more intelligent. In order to achieve that future, we need to invest more in digital infrastructure, whether that is storage, compute, transmission or radio. There needs to be more of it, and it needs to be open access. That's a future we can really contribute to.

the best talent in the industry. There used to be a maxim among managers that infrastructure assets looked after themselves. That's absolutely not the case in digital. Bringing together the right management teams, structuring their incentives and then backing them to take the initiative with value creation concepts is critical.

Q Which areas within digital infrastructure do you consider to be most attractive right now?

JW: There are not many secular trends across TMT that don't lend themselves to the criticality of fibre – whether that's cloud migration, mobile network densification or the continued proliferation of streaming content and gaming. Covid has only intensified the importance of fibre-to-the-home solutions and I've no doubt fibre will remain an area where we spend a lot of time. But it ultimately comes down to understanding the local market opportunity and then the dynamics of each individual business.

In terms of data centres, we find the North American competitive landscape challenging. We believe there will be more opportunities in Europe and Asia. We continue to have a great deal of confidence in wireless infrastructure, but again we see less opportunity in the US, given the amount of consolidation that's taken place and where assets are trading.

Small cell densification and in-building wireless solutions will become big themes as 5G proliferates and the new licensed and unlicensed spectrum are deployed. Those are the areas where we see near-term opportunities.

Q How do you deal with the technology risk inherent in digital infrastructure investment?

YS: Before you get to technology risk, you first need to deal with valuation risk. Can you find the right opportunities at the right price? That requires a great deal of discipline, negotiation skills and a willingness to walk away. Technology risk is also important and very much depends on the sector. We feel that fibre is future-proofed in terms of potential substitution. But in other sectors, you do need to consider whether an inability to migrate from a 4G protocol to 5G, for example, could render an asset obsolete. That risk needs to be managed.

> *"Digital infrastructure offers both attractive incremental unit economics and, importantly, resilience"*
>
> JOHN WATSON

JW: While TMT is a fast-paced industry, we focus on owning the infrastructure assets that enable that technology disruption, while not being subject to it themselves. For example, the proliferation of high-quality connectivity that fibre enables will facilitate widespread disruption, but we don't believe fibre is especially subject to disruption. That being said, we monitor very closely emerging communications technologies to ensure our views reflect the ever-evolving landscape.

> *"The future that consumers and enterprises are demanding is even more digital than today"*
>
> YACINE SAIDJI

Q And what about regulatory risk?

YS: Regulatory risk effects every infrastructure sector. Our approach is to try and understand the regulatory objectives – what it is that the regulator is trying to achieve. Typically, that's the provision of essential services on a cost-effective basis. Our strategy supports those objectives because we take infrastructure out of an integrated operator and open it up to other customers. That makes it more efficient and aligned with regulatory objectives.

However, as our assets become increasingly recognised as hyper-essential, it seems inevitable that they'll attract increased regulatory attention, particularly if some owners don't act in the best interests of the community. We've not seen it to date, but I'm sure it is coming, and it's vital, therefore, that we remain good custodians of these assets.

Q The ESG implications of digital infrastructure are coming under increased scrutiny. How should the industry respond?

JW: More and more of the investment focus will be on technology sustainability. From a communications perspective this topic will manifest itself in a number of ways. One obvious example is a greater focus on the technologies and infrastructure that enable more energy-efficient compute deployment, which has clear implications for the data centre ecosystem. While digital infrastructure tends to have a favourable ESG profile, there are ways to continue to improve that profile to the benefit of the communities and the customers we serve. ■

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