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

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
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.

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.

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.
Any views and opinions provided are those of Yacine Saidji and John Watson and are subject to change at any time due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring. The views expressed do not reflect the opinions of all portfolio managers at Morgan Stanley Investment Management or the views of the Morgan Stanley as a whole, and may not be reflected in all the strategies and products that Morgan Stanley offers.

The material contained in this article is current as of the publication date of the article, is intended for informational purposes only and does not purport to address the financial objectives, situation or specific needs of any individual reader. It has been obtained from sources believed to reliable, but Morgan Stanley cannot guarantee its accuracy or completeness. The use of this article is not a solicitation, or an offer to buy or sell any security or investment product. Moreover, the opinions expressed in this article are not necessarily those of Morgan Stanley or its employees.