

# INFRASTRUCTURE INVESTMENTS – REALIZING ADVANTAGES THROUGH MULTI-MANAGER SOLUTIONS



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## Management summary

- Infrastructure investments offer attractive opportunities for investors with a long-term focus
- High diversification potential for the entire portfolio and within the asset class, as well as individual designs, enable stable and predictable cash flows, which offer an interesting alternative in the existing low-interest-rate environment, especially for institutional and professional investors
- Unlisted infrastructure investments are characterised by a low correlation to other asset classes and have a high resistance to crises
- The market for infrastructure investments is extremely complex and characterised by high barriers to market entry, which makes a specialised investment team with a high level of expertise and experience indispensable
- Multi-Manager solutions open up access and thus participation in the asset class to many market participants
- The additional fee of Multi-Manager funds is offset by many advantages and is usually significantly overcompensated
- Multi-Manager funds offer cost-efficient and valuable market access, especially to smaller, new and also large market participants without the appropriate staff resources

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## 1. Economic conditions strengthen demand for alternative investment opportunities

According to surveys among investors, diversification is the main incentive for investing in alternative investments. Before all other asset classes, 70 percent of investors cite diversification as the main driver for infrastructure investments.<sup>1</sup> In addition to this incentive, it is becoming increasingly difficult for institutional and professional investors to meet their yield targets in the existing interest rate environment and almost impossible to achieve in the bond market. Under the current conditions, the behaviour of different asset classes during a crisis is also coming back into focus, while volatility has returned to the stock markets.

Infrastructure investments offer good prospects for the future, as the trends digitalisation, energy transition and new mobility concepts are at the centre of attention. The enormous need for investment in these areas will open up a multitude of opportunities.

Alternative investments in the infrastructure segment offer attractive opportunities. However, there are many special features to consider when setting up infrastructure allocations. The comprehensive investment universe, the complexity of which is growing increasingly due to the ever-increasing number of providers, presents investors with major challenges.

The focus here is on overcoming high market entry barriers, market screening, fund selection, implementation in IT-systems and monitoring. In this context, the expertise of an experienced, specialized investment team is essential.

In addition to building up their own capacities, the advantages of outsourcing should be considered. Multi-Manager solutions – outsourcing portfolio construction and managing to an external provider – offer a valuable alternative in many cases.

Multi-Manager solutions offer many convincing advantages and open up very good and cost-efficient alternatives for a wide range of investors to participate in the development of the infrastructure segment.

## 2. Differentiation of possibilities in the infrastructure segment according to relevant parameters

Infrastructure includes all physical and organizational facilities that are of essential importance for modern economies in terms of operations and growth, for example, roads and bridges, but also schools and hospitals. Traditionally, their provision has been seen as a predominantly public task, but privatisation and the resulting access to private capital are playing an increasingly important role in view of the productivity of capital, strained national budgets and an enormous need for renewal investments.

It's debatable whether infrastructure should be regarded as a single asset class given the heterogeneous range of opportunities available to investors. The segment covers a wide range of investment opportunities. Starting with the choice of investment type, through economic or social infrastructure projects to the remuneration structure, there are numerous differences and special features. Depending on the risk/return profile of the investor, the asset class offers possibilities for tailor-made solutions as well as valuable additions at portfolio level.

### 2.1 Types of participation

Basically, it is possible to participate directly or indirectly in infrastructure projects through equity or debt capital. Direct debt capital engagements relate often to project-based and asset-based financing, which is usually based on bonds issued. Indirect participation in infrastructure bond funds is possible.

Debt capital investments often have fixed coupon payments and lead to direct, current income. Due to the ranking within the capital structure debt investments have a lower risk of loss. However, the prospects for returns are lower, and participation in the performance of the investments as well as a direct relation to the real economy are very limited. These potentials can be exploited via equity capital at the expense of higher risk. Opportunities for direct equity investments arise from privatisations (e.g. takeover of a state-owned energy supplier), public-private partnerships (PPP) (e.g. construction and operation of state-owned toll roads) and purely private investments (e.g. construction and operation of a wind farm). Since direct equity investments often require considerable capital and severely limit the diversification potential of most investors, fund-based indirect forms of investment are of crucial importance.

<sup>1</sup> Preqin Investor Interviews, November 2019

## 2.2 Classification of infrastructure areas

Indirect infrastructure investments can be realised through investments in listed or non-listed infrastructure funds. Listed funds have high liquidity, but are also subject to the fluctuations of the stock exchange. Non-listed infrastructure funds offer considerable diversification potential for portfolios due to their low correlation to other asset classes. However, they are characterised by high illiquidity, which is, however, mitigated by a growing secondary market. Nevertheless, a resulting illiquidity premium and the specific characteristics offer attractive opportunities for investors with a long-term investment horizon, through stable distributions that can be planned over the long term. These characteristics make them increasingly interesting for institutional and professional investors who, in the current market environment, are looking for profitable projects with long-term payouts.

Infrastructure is a central element of modern economies. Economic infrastructure facilities are responsible for the transport, exchange of goods, communication and supply of the essential needs of water and energy. Social infrastructure refers to areas that are of direct social importance, such as hospitals and schools.

Table 1 illustrates the range of services over which the infrastructure areas are spread. These penetrate into almost every area of daily life. High market entry barriers and partly monopolistic market positions determine the type and extent of state involvement.

**Table 1: Infrastructure classification**

Economic infrastructure				Social infrastructure
Transport	Energy	Utilities and waste disposal	Communication systems	
Bridges/Tunnels	Wind energy	Power distribution	Satellites	Hospitals
Toll roads	Photovoltaics	Gas distribution	Broadcasting systems	Sports facilities
Railways / Public transport	Hydropower	Water distribution and treatment	Fibre optics and other networks	Schools / Universities
Air- and Seaports	Energy storage	Waste disposal and recycling	Data centres	Public administration buildings

## 2.3 Remuneration systems

Infrastructure investments differ in particular in the design of the remuneration system based on how an investor is remunerated (from fully contractually agreed and use-independent to demand-based). These different remuneration systems offer complex possibilities for infrastructure investments to meet individual requirements. Depending on the risk/return profile of the investor, different designs are possible, depending on the infrastructure project and the respective state participation.

Figure 1 illustrates the designs that must be fundamentally differentiated in the infrastructure segment. Starting from fixed to variable payment depending on use, offer a wide variety of variants, hybrid forms and combinations – based on the investor’s assumption of risk.

**Figure 1: Risk-return-profile based on remuneration<sup>2</sup>**



\* Availability-model

<sup>2</sup> Aquila Capital (illustrative)

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Availability-based public-private partnerships have the lowest risk, as the infrastructure measures financed are usually public goods. Their provision, financing and maintenance is partly outsourced by the state to the private sector. In this case, tasks that are sovereign to the state, such as the provision of schools, for example, are outsourced to private investors. They are made available for public use through long-term contracts - comparable to rental or lease agreements. In this case, infrastructure investors act more or less as service providers. Risks are minimized by the absence of credit risk due to the participation of the state, as well as cash flows that have already been secured in advance. However, the low risk results in a reduced risk premium.

Monopolistic market positions, which in certain areas of supply are accompanied by privatisation measures, are regulated by the state. Due to the monopoly position of, in particular, grid-bound infrastructure, such as electricity, gas and to some extent water networks, pricing cannot be set by a market mechanism. Instead of being fixed by contract or law, prices are set according to the calculation methods of state regulatory authorities. Within this procedure, the specific plant characteristics are taken into account. These are usually characterised by very long use periods and the associated investment costs as well as maintenance and expansion investments. The aim is to strike a balance between the interests of consumers (infrastructure that is functional and cost-effective in the long term) and the interests of suppliers (reliable framework conditions for investment and ongoing operation) and to create appropriate incentive mechanisms for investors. As a result, due to the relatively inelastic demand in this area, it is also possible to achieve payment flows that can be planned in the long term and are subject to minor fluctuations.

Even without state participation, it is possible in some areas in the private sector to achieve availability-based remuneration models through contracting. In the renewable energy sector, for example, the market for private power purchase agreements (PPAs) is experiencing enormous growth. Long-term contracts for the purchase of electricity produced from renewable sources offer secure and predictable conditions for both investors and customers thanks to fixed prices. Furthermore, in the private sector, it is possible, for example, to market only part of the electricity via PPAs. As a result, downside risks are limited by a PPA, while upside potential remains available via market prices. The risk premium is based on the creditworthiness of the corresponding customer.

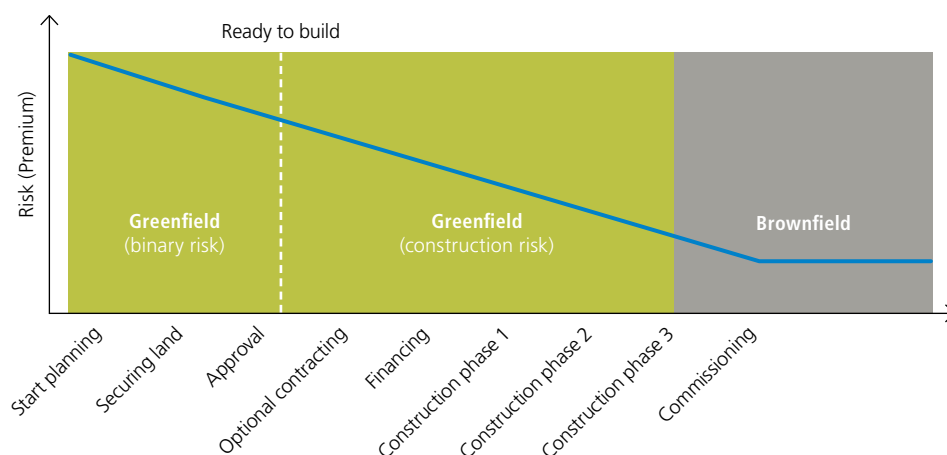
Infrastructure projects with demand-based remuneration models are more volatile. Examples of these models include sea- and airports as well as toll roads. Broad access to this infrastructure is essential, but they show a high correlation with the general economic conditions. High potential in growth phases is offset by corresponding risks in crises and downturns. Correspondingly, equity investors require the highest risk premium in this sector.

## 2.4 Project maturity - Greenfield and Brownfield

Another dimension of differentiation within the infrastructure universe is due to the maturity of the projects. Basically, a distinction is made between greenfield and brownfield projects. Concerning the

assumption of risks arising from the development of projects, the expected risk premium varies. Depending on the expectations and the risk appetite of the investor, gradations are possible. Figure 2 illustrates – in an illustrative and simplified way – this relationship.

Figure 2: Risk development with construction progress<sup>3</sup>



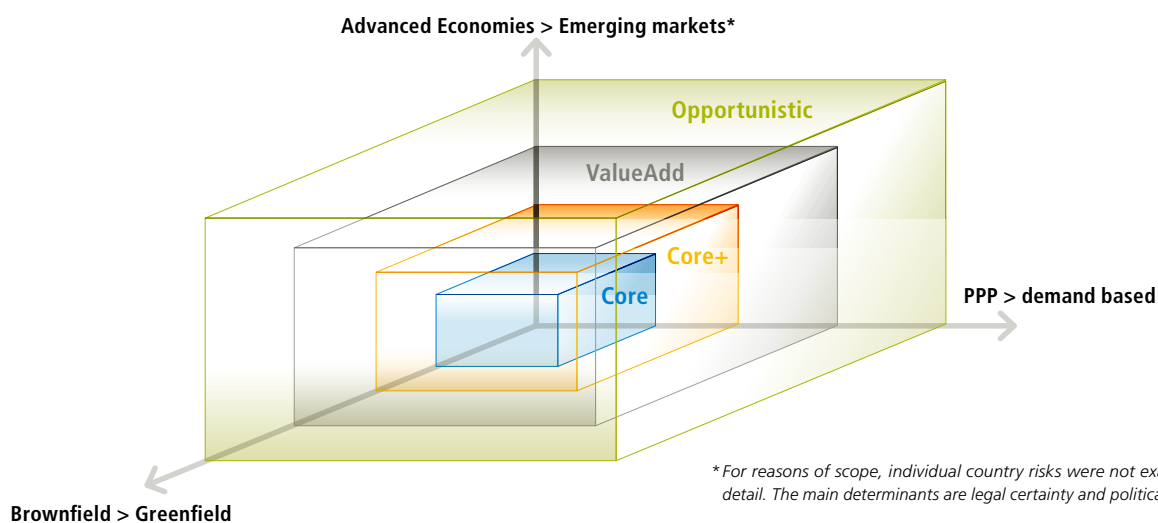
As construction progresses, the risk to be assumed for the investment decreases and the resulting risk premium develops in parallel. The market for infrastructure funds offers opportunities to invest in different phases.

## 2.5 Complexity in the infrastructure segment

The number of specific sectors, as well as the variable possibilities of design, lead to a high degree of complexity within the infrastructure segment. Due to this complexity, there is enormous diversification potential. Individual requirements can be met with numerous

tailor-made solutions. Figure 3 illustrates the dimensions of risk assumption, according to which classification can be made into the risk categories from core (low risk) to opportunistic (high risk).

Figure 3: Risk dimensions in the infrastructure segment<sup>4</sup>



*\*For reasons of scope, individual country risks were not examined in detail. The main determinants are legal certainty and political stability.*

<sup>3</sup> Aquila Capital (illustrative)

<sup>4</sup> Aquila Capital (illustrative)

### 3.1 Impact of the pandemic on various sectors of infrastructure

Depending on the return requirements and the risk appetite of the investor, there are numerous combinations of portfolio allocations. The complexity of the asset class is both opportunity and risk. Expertise, experience and in particular the manager’s access to the market are of decisive importance.

Typically, closed-end funds, i.e. with a fixed fund term (on average 10-15 years), assume higher risks. In analogy to private equity approaches, the fee structure of these funds is increasingly geared to overall performance. Funds with unlimited duration, so-called evergreens, as well as very long-term fund structures (>20 years) usually pursue more defensive strategies. The fees of these funds are more asset-based and focus on long-term, stable payouts. This makes them particularly interesting for conservatively acting institutional and professional investors.

### 3. Behaviour in the event of market fluctuations

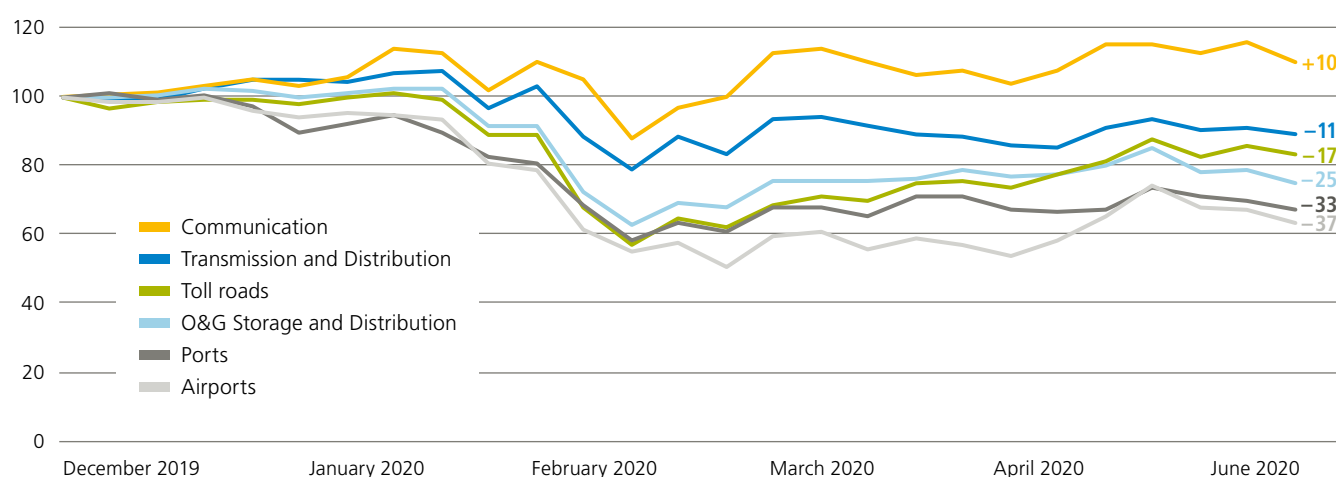
The current crisis has led to considerable distortions on the financial markets. While the announcement of enormous economic stimulus packages by governments around the world provided a partial recovery, the final economic effects of the corona pandemic are not yet foreseeable. In particular, volatility on the stock markets returned after a prolonged bull market.

A look at the infrastructure sectors shows that they are affected very differently. In particular, the focus is on the respective remuneration structure. The market for alternative infrastructure investments, i.e. unlisted investments, is not transparent due to the lack of publicly available data. For this reason, indices of listed infrastructure companies are used as a guide to the development of the individual infrastructure sectors. In the next chapter, however, the differences to unlisted investments that need to be taken into account are discussed.

Figure 4 shows the performance of listed infrastructure companies based on their quotation at the end of 2019.

In line with expectations, the telecommunications industry is emerging as the winner of the crisis. After a 10% loss compared to the previous year’s close at the beginning of the lockdown restrictions, home-office-solutions and the enormous expansion of digital media gave a boost to stocks in this segment. The telecommunications industry is the only sector to show a positive development in the comparison considered here.

Figure 4: Performance of listed infrastructure companies by sector in the first half of 2020<sup>5</sup>



<sup>5</sup> Aquila Capital, own calculation, based on Bloomberg data

It is followed in second place by the network operators and utility sector. Despite the provision-dependent and government-regulated fee structure, the index shows a decline of more than 10% compared to the end of 2019. Irrespective of the fundamental resistance to the crisis, the cyclical nature of the stock markets is clearly evident. Listed infrastructure companies show a high correlation to the stock markets and panic on the stock exchanges leads almost immediately and across sectors to significant losses.

However, the demand-dependent sectors in particular, which generally have highly cyclical compensation, have suffered significant losses. Restrictions to contain the virus, such as curfews or school closures, significantly intensified these effects. As a result, share prices of infrastructure companies in the transport sector recorded slumps of up to 40% and more. Whilst the easing of restrictions led to a slight recovery, uncertainty remains at a high level. The long-term consequences are not yet foreseeable.

The lockdown also had a strong impact on the energy sector. Amplified by politically induced increases in supply (oil price war, gas transit) and mild weather conditions in winter, the global slump in demand led to significant price declines for oil and gas. In the USA, the price even fell into negative range due to storage facilities being too scarce. As a result of significant price declines in raw materials and a demand shock, electricity prices also fell to very low levels, placing a significant burden on power plant operators. In the renewable energy sector, however, state subsidies on the one hand and the PPAs on the other cushioned the impact considerably. Moreover, a recovery already emerging in electricity price futures is keeping expectations very optimistic.

In part, the crisis should have had a positive impact on companies focusing on social infrastructure. The provision-dependent remuneration of government agencies and the central importance that hospitals, for example, play in the crisis ensure a high degree of resilience of these infrastructure facilities in the crisis.

### 3.2 Unlisted infrastructure investments benefit from low correlation with other asset classes

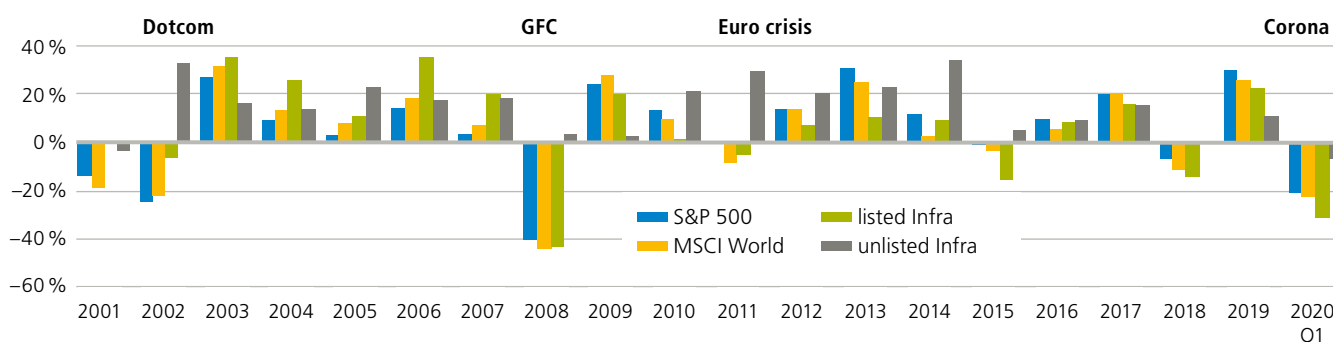
Compared to listed infrastructure companies, non-listed infrastructure companies – based on often contractually fixed cash flows – have a significantly higher resistance to crises. Furthermore, they are not exposed to the high volatility created by market players on the stock exchange.

The graph shows the development of the asset classes over the past 20 years, in which four major crises have been experienced. In line with the low correlation to other asset classes, it becomes clear that unlisted infrastructure investments were not subject to fluctuations comparable to those of the equity markets during the crises. A marginal decline was recorded after the bursting of the “dotcom bubble”. In contrast to the distortions on the stock market, however, this loss was more than compensated for in the following year. While the global financial crisis and the subsequent euro crisis did not lead to any losses, the most serious crisis of the still young millennium saw a comparatively small decline of only 6.3%. Significant effects on the demand-dependent sectors are decisive.

Due to the low correlation to other asset classes, non-listed infrastructure investments have a high potential to improve portfolio diversification. In contrast to listed infrastructure companies, however, the segment is characterised by high barriers to market entry due to the volumes and minimum capital requirements. As a diversified strategy is also essential within the segment, it is challenging for many investors to build up infrastructure investments. However, institutional investors with a long-term investment horizon, in particular, could benefit greatly from the advantages. The selection of managers and access to opportunities also represent a high hurdle.

**Multi-manager approaches can help here.**

Figure 5: Comparison of asset class behaviour<sup>6</sup>



<sup>6</sup> Bloomberg (2020)



#### 4. Advantages provided by Multi-Manager solutions

By bundling capital via investors, Multi-Manager solutions achieve a second level of intermediation. Outsourcing of investments also has a whole range of other positive effects:

##### Lot size transformation

Especially in the infrastructure segment, which is often characterized by very large-volume projects, lot size transformation creates the possibility of overcoming access restrictions. This allows investors to participate in the development of the infrastructure sector.

##### Diversification

Diversification is at the heart of a Multi-Manager approach. Investments, especially in unlisted infrastructure projects, reduce the volatility of the overall portfolio. A diversification effect can also be achieved within the infrastructure class, resulting from the distribution across different projects within the infrastructure universe. Multi-Manager solutions provide the necessary market access. In addition to investments in diversified funds, they also allow investments in specialised individual funds. Spreading the invested capital across different managers and investment strategies also make a significant contribution to reducing the volatility of returns due to different applied processes and decision-making parameters. In addition, further diversification effects can also be achieved by investing in infrastructure assets with different remuneration structures.

##### Significant cost savings

Due to their market access and investment amounts, Multi-Managers can often benefit from discounts on the management fees of the target funds. Generally, investment funds offer discounts for multiple subscribers, early subscribers or when certain subscription volumes are exceeded. Besides, a significant cost saving advantage can be achieved by using economies of scale.

##### Win-win situation

Investments in funds with different investment objectives make it possible, on the one hand, to limit the downside risks through defensively oriented projects. On the other hand, upside potential can be preserved by investing in funds geared to growth. Adding direct investments, secondary-market transactions and debt capital investments also open up a way to avoid the negative effects of an initial J curve<sup>7</sup>.

##### Expertise

Investors gain access to specialized investment teams. Their expertise is a key success factor in selecting suitable target funds. The competence of the investment team also provides access to

opportunities that cannot be reached by any other means, which are not only subject to minimum capital requirements but also result from previous cooperation and corresponding experience.

##### Market screening and monitoring of target funds

Multi-managers undertake market screening and monitoring of the target funds. Experience in the market environment is of great importance in order to ensure optimal performance and to benefit from changes in the economic environment in accordance with strategic allocation decisions.

##### Reduction of complexity

By combining several professionally managed investment funds in the Multi-Manager structure, investors can invest in the parent fund rather than in several different individual funds. The investor therefore only has to make one investment decision. In addition, tax and legal audits, liquidity management of the individual target funds, checking the limits for each new investment and booking the returns as income or capital repayment are also handled by the Multi-Manager. The investor only receives an aggregated reporting system for all investments. Specific requirements (e.g. of investors with regulatory reporting requirements) can be taken into account and only need to be agreed once with the manager of the Multi-Manager solution.

#### 4.1 Additional diversification potential through Multi-Manager structure

By investing in selected target funds, Multi-Manager solutions enable further positive effects on the portfolio by exploiting diversification effects. The volatility of the return is only one of the options for measuring the risk of a portfolio. Taking into account the long-term time horizon and the illiquidity of unlisted infrastructure investments, the valuation of the assets and their volatility also plays a key role. Analogous to the stock market, there are positive and negative points in time for entering and exiting certain markets. This risk is known as “terminal wealth dispersion” and refers to the difference between the expected and actually realised result of an investment. This means that different managers who operate under the same conditions in similar asset classes may have identical yield volatility and yet a high degree of heterogeneity concerning the overall realised result. This risk is measured using the standard deviation of net asset values.

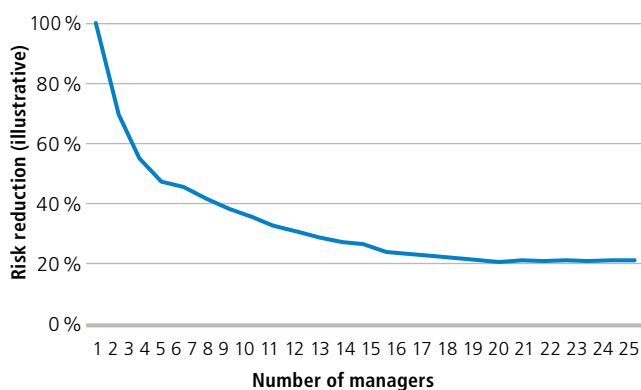
Within a Multi-Manager structure, the focus is on the selection of target funds. The allocation to different managers is reflected in the resulting distribution of capital across different processes, with a significant impact on the standard deviation of the terminal wealth.

<sup>7</sup> J-curve: Describes a phase-typical yield curve in which, due to acquisition costs or assets still under construction, a negative result is initially achieved in the first years before, in the later years, the income exceeds the costs and a positive yield is achieved.

Figure 6 illustrates the significant reduction in risk resulting from the allocation of capital to several managers. However, as can be seen from the curve, the benefit is defined by a positive but decreasing marginal utility. From a certain point on, an excessive distribution over a large number of managers makes monitoring more difficult and leads to a sharp increase in complexity. In this context, infrastructure investment offers an advantage over equity funds, as the size of the projects, unlike company shares, makes duplication of investment very unlikely or can be easily avoided by appropriate management. By avoiding these multiple investments in the same product, the potential is used efficiently.

Overall, it is clear that the use of diversification potential can generate advantages, but that a large number of factors influence these effects. Experienced and specialized providers can, especially through a Multi-Manager approach, efficiently exploit the entire potential and thus offer significant advantages for investors.

**Figure 6: Decline in terminal wealth standard deviation as a function of the number of managers<sup>8</sup>**

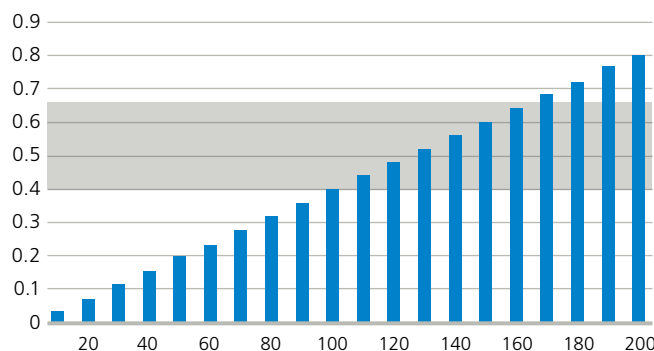


## 4.2 Implementation of a diversified infrastructure portfolio – make or buy?

Investors who want to make or expand investments in the infrastructure sector are faced with a classic “make or buy” situation. This means for investors: Do they build up their own personnel- and IT-capacities or do they invest in a Multi-Manager fund and bear the resulting fee?

Fund selection is at the heart of building a diversified infrastructure portfolio. A specialized investment team is essential for this. Ignoring additional costs and assuming that infrastructure experts can be found on the labour market, an initial consideration can be made based on salaries. According to a study by Banking Consult, a portfolio manager with seven years of professional experience currently earns up to EUR 160,000 a year. On top of this come bonuses of up to EUR 96,000 per year. A department head in fund management, on the other hand, earns up to EUR 400,000 a year, and even young professionals can expect to earn up to EUR 84,000. For a two-person, experienced investment team, a range of EUR 400,000 to EUR 656,000 can be expected. Figure 7 shows – based on a fee of 0.4 percent of the Multi-Manager fund – from which investment sum the costs of a Multi-Manager solution exceed the salaries.

**Figure 7: Fees according to investment amount and salary range of an investment team (in Mio. EUR)**



<sup>8</sup> Aquila Capital (illustrative), based on: O’Neal, „How Many Mutual Funds Constitute a Diversified Mutual Fund Portfolio?“, *Financial Analysts Journal* (March/April 1997)  
<sup>9</sup> <https://www.manager-magazin.de/finanzen/artikel/so-viel-verdienen-fondsmanager-in-deutschland-a-1227311.html>

The chart shows that this range is only touched from an investment amount of EUR 100 million upwards. From an investment volume of EUR 170 million, the fees are above the expected salary limit for the first time. However, it should still be noted that other costs are incurred in addition to salaries, such as the renting of office space, IT equipment and overhead costs of the fund management team. Furthermore, unlike an existing Multi-Manager fund, which has a historical performance and track-record, the process is subject to further uncertainties.

Besides, there is potential for savings in Multi-Manager solutions through, for example, discounts for high subscription sums, cooperation agreements, early subscriber bonuses and follow-up investments, which open up corresponding compensation potential. Multi-Manager funds offer new market participants and smaller investment-sums, in particular, the opportunity to efficiently participate in the infrastructure segment. However, the structures also offer a cost-efficient option for larger investors who lack the experience and specialized teams, as the additional fee is usually more than compensated by the result.

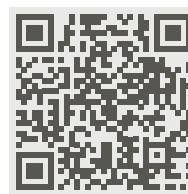
### 5. Conclusion

Multi-Manager solutions can create considerable added value. In addition to reducing volatility in several ways, they offer access to specialized managers and corresponding resources. This allows efficiency within the portfolio to be exploited to full effect. Diversification within the infrastructure segment is essential in this respect. Multi-Manager solutions provide the necessary market access and, in addition to investments in diversified funds, also allow investments in specialized individual funds. Market screening and the selection of target funds are of crucial importance here.

Overall, Multi-Manager solutions allow the construction of a balanced portfolio. This is otherwise only available to very large investors with the appropriate capital and staff resources. Particularly in the area of investment in non-listed funds - which represent an extremely advantageous addition to the overall portfolio due to their low correlation to other asset classes - there are high access restrictions. The balance between stable, long-term cash flows with limited downside risk and existing upside potential can be achieved without a doubt with a Multi-Manager approach. The advantages lead to significant overcompensation of additional fees and allow a large number of investors to participate cost-efficiently in the development of infrastructure portfolios. Especially following the investment pressure and diversification requirements of institutional investors, the expansion of investments in the infrastructure sector offers valuable alternatives.

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<https://www.aquila-capital.de/en/real-assets/infrastruktur>



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