A challenging and volatile environment... is this the time for a fresh look at infrastructure as an asset class?

ALEXANDRA NOBLE OF ALLENBRIDGEEPIC EXAMINES THE CURRENT SITUATION FOR INFRASTRUCTURE AND WHAT THE OPPORTUNITIES MAY BE

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As we are all aware, the investment environment has and continues to be highly challenging and volatile. Over the past 20 years we have seen sharp declines in long term bond yields across the globe, from around 8% twenty years ago to 4% ten years ago, and they currently languish in the region of 2%.

With central bank monetary easing policies in the developed world, many investors are still concerned about the debt crisis and potential erosion of returns with inflation hovering on the horizon. More recently, there have been disappointing returns from traditional growth assets, all of which has added to the present value of liabilities being driven upwards. A tough challenge for pension fund investors who, as a result, are looking for investments which may be counter cyclical and provide long term growth prospects with limited downside. However, I would caution investors to undertake careful due diligence to ensure success in this asset class; infrastructure investment can involve complex structures and may also require specific execution capabilities.

There has been a growing interest in infrastructure as an asset class, and I believe that it is likely to play an increasingly important part in both debt and equity portfolios over the next few years. It is estimated that US$585 billion per annum will be required for average annual global investments between now and 2030. In the *Prequin Quarterly update*, they advise that a total of $15.4 billion in institutional investor capital was secured by unlisted infrastructure fund managers in H1 2013, which is a significant 88% increase on the $8.2 billion raised during the same period last year.

In general terms, infrastructure investment can provide long term asset-backed securities which have stable and secure cash flows which are often inflation linked. Another factor to take into account is the illiquidity premia that is particularly attractive for long term investors. For certain investors there are also socially responsible investing characteristics which are attractive.

However, there still remain communication issues between the infrastructure participants and pension funds. Having spoken to a number of people involved in this area over the last 18 months or so, I believe that there is a clear desire by participants to bridge the gap and try to speak the same language. The challenge for pension fund trustees wanting to embrace infrastructure in their strategic asset allocations is the need for clearly-written objectives, an understanding of the impact for them on expected returns, and their risk and liquidity appetite. Finally they need to be agile and ready to respond quickly to opportunities.

From the asset managers' perspective there is a real interest in making these assets more available, and a number of new products have been launched in the past year.

What qualifies as infrastructure for institutional investors?

The term infrastructure has a wide variety of definitions and interpretations, but infrastructure is defined by the OECD as the system of public works in a country, state or region, including roads, utility lines and public buildings.

The list of core infrastructure sectors includes:

- **Public buildings...** hospitals, schools, prisons
- **Transportation...** road, rail, airports

- **Utilities…** water, gas, electricity, waste
- **Communications…** fibre, mobile towers, satellite
- **Energy…** solar, bio-mass, hydro, nuclear, wind

What are the investment characteristics of infrastructure?

Long term, asset-backed
Infrastructure investments have underlying assets which may have a term of up to 30 years.

Stable and secure cash flows
Contractual agreements may be up to 30 years and this provides infrastructure assets to deliver stable and long term income streams. The nature of these assets means that they tend to benefit from sustained user demand even in times of economic crisis. Additionally, the default rate on infrastructure is very low.

Inflation-linked revenues
The revenues of many projects are often or partially inflation-linked, and this is particularly attractive for investors who need assets that will provide cash flows when their liabilities become due, thereby reducing the risk of a liability funding shortfall. Inflation-linked returns can also be incorporated in a Liability Driven Investment (LDI) programme.

Diversification
Significant diversification can be achieved through a variety of vehicles – single sector or multi-sector. Additionally, this can be achieved through investing across countries and investing at different phases of a project – at the construction or operating phase. Furthermore, infrastructure assets are generally not correlated with other asset classes.

Illiquidity premia
Whilst there are some downsides to investing in illiquid assets (and they may not be suitable for all investors), the resultant illiquidity premia may boost the long term returns of a fund.

Risk versus returns
Clearly there are a number of factors to be considered, and different infrastructure projects provide different risk factors, such as construction-phase investing versus operating-phase investing, government stability, and regulatory framework issues. The potential sources of risk are much greater than for traditional investments and require specialist oversight.

The situation in the UK

According to the National Infrastructure Plan, £400 billion needs to be invested in the UK's infrastructure in the next ten years if the country wants to remain competitive in a global market. The Treasury has identified a pipeline of over 500 projects and programmes worth over £250 billion, and they expect that more than two thirds of this investment will be privately funded. In this "Age of Austerity" and with a huge budget deficit, the Government is in no position to provide the funding necessary. Furthermore, the banks are no longer willing to lend on a long-term basis, as shrinking balance sheets and new legislation will increase their need for liquid assets. This should provide new and interesting opportunities for long-term investors such as pension funds. The credit crisis has led to a shortage of private finance for infrastructure projects from the banks and, as a result, this change in the supply and demand dynamics has provided the infrastructure industry with a variety of vehicles for investment.

Increased pressure by Government to control public spending and the further restrictions on the banks' ability and appetite for longer term investment suggest that there will be no shortage of opportunity to invest in infrastructure.

In July 2012, the UK government signed a Memorandum of Understanding with the National Association of Pension Funds (NAPF) and with the Pension Protection Fund to encourage pension funds to invest in this area. The plan is to attract £20 billion of pension fund capital to address the funding shortfall for the proposed projects over the next decade. In the short term there is an expectation that the NAPF will find appropriate investors for the Pensions Infrastructure Platform (PIP) to raise £2 billion and it is anticipated that the PIP will be launched this autumn.

Current levels of investment

The level of investment by UK pension funds is estimated to be in the region of 1-4% of total assets compared to 8-15% in Australia or Canada. The Canadian, Dutch and Australian pension funds have been investing in infrastructure for some time, even investing in the UK. For example, the Canada Pension Plan owns over 30% of Anglian Water and the Ontario Teachers Pension Plan bought Camelot, the National Lottery operator.

However, recent published figures show an increasing exposure by UK pension funds to infrastructure, and I believe that pension funds will continue to exploit their position as long-term investors in this sector. As further opportunities present themselves, exposure is expected to increase from the current level of around 5% of total assets under management to around 9%.

Investment opportunities

One of the major problems for institutional investors is not having direct access to individual infrastructure projects, nor having the necessary in-house skills to be able to assess the projects. However, an ageing infrastructure asset base in developed markets and the opportunities in emerging markets are providing a global flow of new investment opportunities, mainly as a result of banks being less able to provide longer-term funding for infrastructure projects. Currently most pension fund investments are through unlisted infrastructure funds (87%), both debt and equity, with a number of larger funds investing directly or co-investing with other funds.

The good news is that there are a number of fund managers who have brought new funds to the market, which demonstrates a real commitment to providing pension funds with a variety of opportunities:

- Unlisted infrastructure debt or equity funds (currently there are 142 funds seeking an aggregate $92 billion)
- Listed debt or equity funds
- PIP
- Direct investment
- Co-investment
- Secondaries
- Project finance
- Accessing inflation-linked cash flows via innovative swap structures

Some lawyers and consultants have been actively promoting infrastructure investment for some time. They are developing and road testing models, and creating legal structures to facilitate access to the UK infrastructure market. New ways of investing are emerging, different and flexible structures are evolving, and alternative sources of financing are being considered. Rather than as in the past, deals have been predominantly more like private equity deals, with pension funds beginning to look at investing in 100% of the full capital structure, and taking outright ownership of the asset or project and taking the associated benefits. This shows that pension funds are looking to invest directly in projects as well as through a fund or limited partnership. Clearly this is only appropriate for larger funds as direct investment requires considerable expertise and resources that may not always be available in house.

In conclusion I believe that infrastructure is an asset class that will provide a number of opportunities for long-term investors such as pension funds. There is a real commitment from the asset management industry to develop different structures for investors to take advantage of this global opportunity for diversification, and an opportunity to achieve the required returns.