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Opportunities arising across the infrastructure spectrum

Asset class has proven its value over multiple economic cycles

By Paul Mackintosh

Infrastructure has long been one of the ideal asset classes for institutional investors with long-term obligations – in principle.

There has in fact been a very slight uptick in allocation to the asset class. According to data on the unlisted infrastructure equity allocation of about 80 large pension funds from the Organisation for Economic Cooperation and Development (OECD) in a May 2017 report, the share of total assets allocated rose from 2.8% in 2010 to 3.5% in 2014.

The question is, what limits investment in such an ostensibly attractive asset, and what are its real merits.

Infrastructure assets

Infrastructure is a very diverse proposition. Ralph Witt, co-head of real assets at Barings' Funds & Co-Investments, notes that "the infrastructure asset class comprises many of the essential facilities that support economic activity", including transportation, power generation, energy, telecommunications and social infrastructure.

"As such, infrastructure assets are inherently tied to global demographic and GDP (gross domestic product) trends, inflation and other macroeconomic drivers," he says.

According to Oliver Goetz, head of transport and infrastructure at Rothschild Global Advisory, a key feature of infrastructure assets is the ability to generate stable and predictable cashflow over a long period.

"Infrastructure assets are often monopolies, have regulated income streams, operate in a stable legal and regulatory environment, own long-term customer contracts with offtake agreements, or more generally have a strong and secured market position," he says.

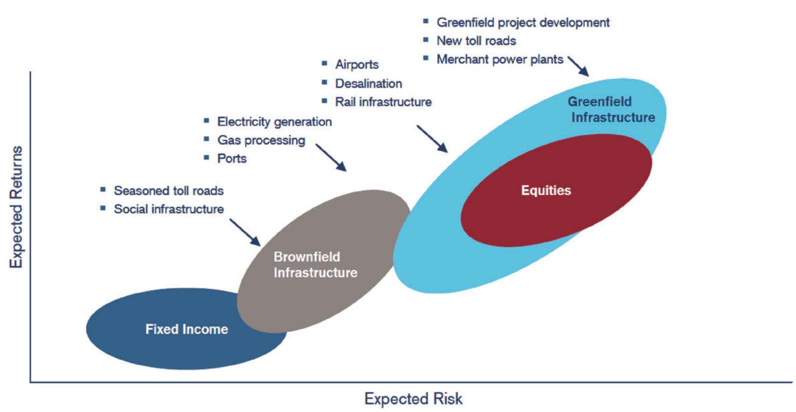
Mr. Witt lists several characteristics of infrastructure assets. They are long-lived, physical assets that provide essential services to the real economy; have predictable cash flows that are either regulated or contracted; have inflation protection through contractual agreements; and enjoy competitive advantages through regulatory protections.

But as Mr. Goetz points out, there is a spectrum within the infrastructure space that ranges from "core infrastructure" to "core-plus infrastructure".

Revenues in core infrastructure are de-risked, which means limited or no market risk associated with revenue generation. Examples are social infrastructure such as schools, prisons, regulated utilities, major airports and major ports.

Revenues in core-plus infrastructure are exposed to more market risk, both in price and volume. Examples here

Infrastructure as an Asset Class - Hypothesis



Source: Credit Suisse Asset Management

Ralph Witt

Oliver Goetz

include toll roads, storage terminals, pipelines, and telecommunication towers.

Typical investors

Given the returns characteristics, infrastructure investments may appeal to some investors more than others.

"Investors have steadily increased their private infrastructure allocations over the past two decades," Mr. Witt says, adding that "participants in the asset class include every type of investor across the globe".

Still, as Mr. Goetz notes, the "typical infrastructure investors" include pension funds and sovereign wealth funds.

Mr. Witt links investor appetite to "the asset class proving its value over multiple economic cycles by providing reliable long-term total returns, inflation protection and portfolio diversification".

The particular attractions he sees include income yield at a time when global central banks have driven interest rates to historically low levels; the opportunity to capitalise on long-term, structural demand trends for critical infrastructure assets; a hedge against unexpected inflation in an easy monetary policy environment; capital preservation in an uncertain global environment; and portfolio diversification.

He says "the unique attributes of the infrastructure asset class underpin every investor decision".

According to Mr. Goetz, the typical infrastructure investors are more conservative and have lower risk appetites, and therefore lower return expectations compared to private equity investors. In many cases, they also have a requirement for regular cash yields.

Investment options

Mr. Witt says there are "various structures and investment types, each of which offers different advantages and disadvantages that are geared to various levels of firm sophistication and size".

They include unlisted infrastructure funds, co-investments alongside fund managers, separately managed accounts (SMAs), direct investments in underlying assets, and investments in publicly-listed vehicles.

Mr. Goetz notes that traditionally, pension funds have invested indirectly via infrastructure funds, but that in recent years, "more sophisticated funds have increasingly engaged in direct investments".

A direct investment strategy gives an infrastructure investor "the highest degree of investment flexibility and the ability to construct a bespoke investment portfolio", Mr. Witt says.

As for co-investments, "key advantages include the ability to lower the fund investment's overall fee structure as co-investments are typically offered on a reduced fee basis, and the discretion to add exposure to targeted sectors or companies on a selective basis", he adds.

However, he cautions that co-investment "requires a team with deep industry knowledge and a well-defined investment process in order to successfully execute on opportunities".

According to Mr. Goetz, although investors may avoid management fees through direct investments, the fact that infrastructure investment requires specialised knowledge and experience demands greater in-house expertise.

"An alternative strategy to gain infrastructure exposure is to invest in publicly-listed vehicles, which include listed-infrastructure, master limited partnerships (MLPs) and yield-focused entities called YieldCos," Mr. Witt says.

"MLP investments typically target the US energy midstream sector and benefit from a pass-through structure for tax purposes. YieldCos invest in contracted assets that generate stable distributions, typically in the power generation sector," he adds. "Listed investments can offer broad infrastructure diversification and provide an investor with superior liquidity, but are exposed to the volatility of public equities and, in some cases, the risk of strategy drift, where definitions of infrastructure can differ greatly."

Asian hotspots

Where, then, should investors look for the most attractive infrastructure prospects, in Asia and beyond?

According to Mr. Witt, the key macro themes driving infrastructure investment globally are changing demographics, greater market access, and rapid technological changes.

"These themes are creating opportunities across the infrastructure spectrum, driven by higher demand for transportation and fuels, greater access to data/telecommunications and newer and better technologies," he says.

He likes the power sector in OECD and non-OECD countries in Asia and elsewhere, where high population growth is driving the need for more power, creating investment opportunities.

"Investment opportunities exist globally; however, emerging markets will lead the growth in the future," Mr. Witt says.

He sees similar prospects in petrochemicals and transportation infrastructure, and toll roads and bridges.

"From a geographical perspective, lower risk opportunities in Asia usually exist in more mature markets like Japan and Korea with lower but stable GDP growth and a stable regulatory environment," Mr. Goetz says. "Generally, returns in emerging markets should be higher as investors often take greenfield/construction risk and more regulatory risk compared to developed countries."