Infrastructure: dispelling the myths

Infrastructure as an asset class – where are we now?

Chairman: Focusing first on the definition of infrastructure, I think we are all guilty of talking about it as if it were just one asset class, so we need to think about how we can change that so it is more apparent to investors that infrastructure covers so many different things, each with its own investment characteristics.

Secondly, there is no doubt that there is growing institutional interest in this sector, as pension funds and other institutions become more and more disenchanted with bonds, equities and private equity. However, some institutions are uncomfortable with the perceived illiquidity of the asset class, but if you are a long-term investor with long-term liabilities, the fact that you can’t get your money out tomorrow or even in ten years’ time should be irrelevant, shouldn’t it? Provided it is generating a healthy return.

Hale: I would agree that people talk about infrastructure as if it were a homogenous asset class, which is wrong as there is a definitely a spectrum of risk and return out there. One of the things we like to talk about at Towers Watson is core infrastructure – the type of things that are lower risk; and opportunistic infrastructure, the kind of assets that would compete with private equity and opportunistic real estate for capital, looking at generating alpha through private markets.

Latham: I have been in the sector for over 16 years and there are a lot of similarities to the evolution of other asset classes. For example, real estate and private equity started with the “balanced” option prior to being differentiated by style and/or risk. In Australia in the mid-1990s infrastructure funds often commingled greenfield and developed or operating assets. We are now seeing segmentation by sector, geography and style or risk characteristics.

What we are seeing now, just to take real estate as an example, is your value-added, your core, your opportunistic investment strategies. As the sectors evolve we expect there will be more segmentation around strategies and managers.

Over the last five years, the infrastructure market in Europe has been at an embryonic stage and it has had its teething problems. What we are starting to see now, though, are much tighter investment strategies within funds, less style drift in the underlying products and it is all about delivering what it says on the tin rather than drifting off into unexpected directions.

Chairman: Why did infrastructure as an asset class grow so quickly in the Australian market?

Latham: In the mid-1990s there was a congruence of factors from both a demand and supply perspective. A system of mandated pension fund contributions was introduced in Australia to promote self funded retirement which resulted in an aggregation on the wealth management side. There was also a strong affinity with real asset investing in both property and resources and therefore investors were very comfortable in that non-traditional asset space. Around the same time governments started to move towards a zero net debt paradigm, which resulted in the privatisation of government assets and private sector finance for new projects such as toll roads.

So, the supply of assets combined with a supply of money through the desire for more diverse asset allocation strategies brought the infrastructure industry into play at that point.

Transparency

Michaels: At LCP our main focus has been on core infrastructure, helping our clients to diversify away from equities. Increasingly, we are also looking at the lower risk end of the infrastructure spectrum, the social infrastructure or ‘PFI’ type projects, as a way of getting a higher return than index-linked gilts, rather than looking at infrastructure as a diversifier for equities.

An issue I would like to raise is the transparency of managers’ returns. This is one of the only major asset classes where managers don’t
Chair for the day: Andrew Chapman, investment manager, John Lewis Pension Fund
In 2003, Andrew was appointed as the first in-house pension investment manager for the John Lewis Partnership. He is also a member of the Investment Advisory Committees at Collar Capital and Pantheon Ventures and sits on the Advisory Board for the Pension Fund Investment Forum and is a member of the Investment Council of the UK’s National Association of Pension Funds (NAPF).

Duncan Hale, senior investment consultant, Towers Watson
Duncan is a member of Towers Watson’s infrastructure research team and has nine years experience researching infrastructure managers, having started his career in the firm’s Australian investment practice in 2001. He was involved in developing the firm’s infrastructure capability in that market before transferring to the UK in 2005. He is also involved in providing consulting advice to large defined contribution and defined benefit schemes.

Andrew Jones, managing director, infrastructure debt, AMP Capital Investors
Andrew is responsible for leading AMP Capital’s infrastructure debt activities globally. He has over 22 years of experience in the industry, and joined the investment team in January 2000. For AMP Capital’s infrastructure equity investments, he is the director of a student accommodation business, the director of an aged care services business and has also been a member of AMP Capital’s Infrastructure Investment Committee since 2004.

Danny Latham, head of infrastructure investments, Europe, First State Investments
Danny was appointed Head of Infrastructure Investments, Europe in November 2007. He has overall responsibility for the European infrastructure business, with a primary focus on origination, execution and management of infrastructure assets, portfolio management and client interface for the European Infrastructure fund and client mandates. In his prior role he was a Director of RREEF Infrastructure based in London.

Martin Lennon, head of Infracapital, M&G Investments
Martin Lennon has been the Head of Infracapital since its inception in 2005. He has over 20 years of infrastructure, project finance and investment experience gained in the corporate and financial sectors. Before focusing on Infracapital, Martin lead the Project & Infrastructure Finance business at M&G having joined the company in 1998, developing a diversified business investing in infrastructure across a wide range of financial instruments.

Adam Michaels, partner, LCP
Adam joined LCP in February 2004, and became a partner in the investment department in 2009. Adam provides advice to a wide range of pension schemes and companies, with a particular focus on investment strategy. He previously worked as a pensions actuary at the Government Actuary’s Department. He is part of the LCP Alternative Assets Panel, and leads LCP’s research into tactical asset allocation and infrastructure investment.

Brendan Walshe, Senior Consultant, Aon Hewitt
Brendan is a qualified actuary and joined Hewitt’s Investment Practice in November 2005. Prior to joining Hewitt, Brendan worked with PricewaterhouseCoopers for over eight years. He has been involved in advising pension scheme clients on all aspects of their investment requirements over many years, including strategy reviews, asset transfers, manager assessment and selection, performance monitoring and trustee training.
publish their returns in a transparent way, so for investors trying to assess what they can expect from this sector, albeit that there is only five years of track record to go on, we don’t have any published track records of managers to help trustees know what to expect.

Clearly we, as consultants, can get more visibility than the average investor, but what I would like to see the industry move towards is the publication of returns as a matter of course and a move towards, perhaps, peer group infrastructure benchmarks. Often when I am talking to clients they have only heard the scare stories, and without having any data from the industry as a whole they are not getting a balanced picture.

**Lennon:** I have been involved in the infrastructure space for more than twenty years now, and I think that transparency will come. We have to face facts that infrastructure, as an asset class in its own right, is still fairly young and many of the main body of funds that we see on the landscape today are only halfway through their own lifecycle. So performance data remains incomplete as many of these funds have not yet had significant realisations. As this progresses through its natural evolution, greater transparency will come.

Also, as we have already identified, there are different strategies at play in the infrastructure space. There has been tremendous success in the “PPP” model and there is evidence and track record of that; the core infrastructure market is still developing; and some people have taken strategies which are more private equity in nature, as opposed to some with a more core utilities or transport focus. What this means is that when more data does become available as I predict it will, that when you are comparing performances, you have to be careful that you are comparing like with like.

**Latham:** In Australia, one of the asset consultants has created an index of five unlisted funds in Australia going back over the last 15 years, so I think the industry has to move towards a system whereby it is either transparent by fund or it is transparent relative to an index, and there needs to be a body that aggregates that data. Who that body is, we don’t know yet.

**Lennon:** I think the index is likely to happen quicker than full transparency of funds because a lot of these structures are private structures that just don’t lend themselves neatly to the sort of data sharing that you might otherwise see.

**Jones:** I think a key point is that there are quite significant pockets of disappointed investors who have embraced the fundamental characteristics of infrastructure, but because of reasons like style drift, they have ended up experiencing much more volatility than they expected to have. So it is really about being very transparent in the risk appetite that you have got in a particular strategy.

From our perspective, we focus on subordinated debt but have a range of different styles across high growth, Asian-focused opportunities to yield focussed debt plays, but if you aren’t very clear about what investors should expect out of those strategies, you can get the sort of disappointment that we are seeing today.

**Chairman:** So it is all the fault of the consultants for not guiding their clients?

**Walshe:** When I hear about investors being disappointed at how infrastructure has performed, I tell them to look at how some of the other assets in their portfolio have performed through a very serious financial crisis.

But it seems that infrastructure, because we are dealing with tangible assets, tends to come in for far more criticism from investors than other asset classes and that’s because they have been through an airport, they have been through a port and they see the activity and they can then empathise more with how the asset class is doing, so they can have very active views.

More generally, it has been an evolutionary industry, it has gone through a lot of change and it will continue to change.

It would have been much better for the industry, of course, if we hadn’t had some of the scare stories of the last few years. But it is a tremendous asset class with great potential and, for a consultant, the ideal scenario is to work with some very large investors because then you can start to build a true infrastructure portfolio across the opportunity set.

What has also happened, because of the nature of the pensions industry,
is that investors’ acceptance of alternatives has only begun to increase in the last seven to ten years. Ultimately infrastructure is just one small part of the alternatives portfolio where investors have had to get up to speed. That’s why the typical entry point for many investors has been something more tangible like core infrastructure.

However, there is no doubt, that there is a very wide and rich tapestry of opportunities, across a range of sectors and niches. In practice, as people become more familiar with the asset class it is easier to look at broader opportunities like primary (compared to secondary) and so on.

Chairman: If you have a client investing in this sector, how do you address the issue of illiquidity. Are you comfortable with illiquidity or is it down to the specific investor? And how do you calm those concerns?

Walshe: I always describe this as a long-term asset class which is illiquid. The issue is that a lot of investors tend to have short-term memories, and when you have a scenario like we had in 2008/9 when funding levels dropped dramatically, the focus on liquid versus illiquid became much more tangible. That has changed the mindset to a certain extent. Those investors who were reconciled in their own minds that this is a long-term, illiquid asset class suddenly found that, as part of their overall portfolio, the level of actual illiquids held was too high.

For example, they may have had property in their portfolios which they couldn’t get out of, or found that their hedge funds were gated. On top of that you had a number of companies which were going through corporate transactions and restructurings that consequently needed greater liquidity. So, the challenge was what to sell?

Going forward, though, I think it is all about education and once you start getting the cash-flows off some of these assets, which for very valid reasons have been lower than people expected over the last 18 months, things will improve.

Hale: But as you said, with infrastructure we are looking at around 5-10% of the assets in the portfolio, and there are a number of other very good asset classes too, and that has to be taken into consideration when you are thinking about making an allocation to something like infrastructure.

Secondary market
Chairman: Have you seen much evidence of the development of a secondary market? Has that developed for example in Australia where this market is more mature?

Latham: It has in two forms, albeit a little different than in the traditional secondary market as exists in private equity. Firstly in terms of liquidity at the asset level and, secondly, at the fund level.

In Australia, like Canada, various segments of the market preferred to buy direct stakes in assets rather than getting their exposure via pooled funds. Therefore to achieve liquidity they had to divest the equity stakes. My experience over the last ten years or so, is that when stakes have come up in these assets, the existing investors have tended to pre-empt, or if someone wants to get out they generally sell to their fellow shareholder. Therefore we have started to see a secondary market developing in the underlying stakes in the companies themselves.

At the fund level, investment vehicles in Australia generally tend to be open-ended, which give investors the ability to redeem out of the funds – so the need to go out and have a secondary sale of units has been less prevalent.

Lennon: But in terms of the liquidity of the underlying asset class, liquidity is pretty good. For a good quality infrastructure asset there is capital that will be interested so that’s not really the issue. The real question relates to the Limited Partnership (LP) structures employed by a significant number of funds available to institutional investors. These structures do have mechanisms that permit LPs to move on but they tend not to be very flexible (for perfectly good and acceptable reasons).

Hale: The other reality, though, is that liquidity only matters in certain situations and in those situations it is typically very difficult to trade these assets because everyone else is also worried about liquidity. We are, as I am sure others around this table are, fully aware that when you invest in this type of asset, it is a very long-term illiquid asset and I think that should be embraced as we are long-term investors in the pension industry.

Buyout
Michaels: Another issue in the current climate is that a large proportion of corporate pension schemes are thinking about buy-out, or they at least have to accept that a new owner make take over in five years’ time with a completely different view. So, whilst there are some good reasons for looking at infrastructure as part of your portfolio, you need to be a bit cautious about what the future plans are for the pension scheme.

Walshe: That is an interesting
challenge but I think it also misses one of the fundamental points – this is a long-term investment, which can match long-term liabilities, so if the asset is suitable for matching long-term liabilities then it can be equally suitable to a new investor coming in, for example, following a buyout in future years. So then it comes down to the quality of the infrastructure fund management and about having something within your universe of infrastructure that is going to be more acceptable to someone new coming in.

For example, if you have something like emerging market infrastructure, that may be problematic, but if you have something like core PFI, which is generating a healthy yield and is correlated to inflation, it is hard to see why an incoming insurance company or buyout firm would find that unacceptable.

Latham: Are the consultants around the table seeing a trend away from alpha generation and more towards absolute return / asset liability matching as the role of infrastructure, particularly core infrastructure?

Hale: I think we are seeing that more generally. Our positive view on infrastructure is less focused on liability matching. We think there are elements of liability matching, but they are muted and we view it more as a return-seeking asset class.

Michaels: Yes, particularly the core infrastructure funds. One of the great advantages of infrastructure for a pension scheme investor are the long-term inflation-linked cash-flows – inflation-linkage being particularly attractive in the current environment. But infrastructure investments do not mark to market: the way the infrastructure fund is valued tends not to use a break-even inflation in the same way that your pension liabilities are valued by the actuary. So it might work as a long-term investment, it might provide you with some protection against inflation over the long term, but you are not going to see that come through in reducing the impact of changes in expected future inflation on your Scheme’s funding level from one valuation to the next.

Jones: The other observation that I would make is that, as the sector becomes more segmented, we are starting to see opportunities to access infrastructure exposure with an expanded range of attractive investment characteristics.

These include options with high levels of liquidity with a number of listed funds starting up and a range of new offerings focussed on debt strategies. I would imagine, therefore, that it will attract a broader range of investors going forward, not just those with very long-dated liabilities that they are trying to match who have been attracted to traditional long dated equity focussed funds.

Hale: I think it comes back to the point that we made at the very start – infrastructure is not all things to all people, and it is a requirement of everyone around this table that when we are talking to our clients, we have got to explain exactly what you are going to achieve if you invest in a certain way. Things like liquidity, liability matching etc are all very important considerations to make when you are making allocations to infrastructure.

Latham: I think you are right. At the top of the cycle, when it became rather faddish to be looking at the infrastructure funds, the promoters of some of these funds got a bit carried away and tried to turn what is effectively a reasonably boring asset into something that it is not, and that is either through fund structures, or gearing strategies, or gearing upon gearing at fund level and that has led to some of the disappointment in the marketplace.

Infrastructure allocation
Chairman: Can I ask the consultants, in terms of advising your clients as to where they should fund potentially any infrastructure investment, which asset class do you tend to encourage?

Waishe: We would typically recommend to our clients that they fund from equity because, fundamentally, it is an equity investment and it has equity-like risk. It may have less volatility than a listed equity due to the underlying cash-flows of some of the assets, but in practice it is a method of diversifying equity risk. So ultimately it is an equity, which can be actively managed and hopefully deliver additional value through the manager’s skill-set over the long-term.

Hale: We would of course look at this on a case-by-case basis, but our general view is that this is a return-seeking asset that offers you diversification benefits to equities, so largely we would see it as a replacement to equities.

Chairman: Despite the fact that it is such a broad class. For example, is PFI really an equity play?

Michaels: More recently we have seen clients concerned about the very low yields on index-linked gilts, looking to get more inflation protection in the portfolio, and therefore...
looking at things like PFI projects, perhaps long-lease property and those sorts of real assets as a replacement for those bonds. But that has been a more recent development and the general trend has been for schemes to build up their bond holdings rather than reduce them.

Lennon: I think over the years some institutions have actually struggled to know where to put infrastructure – I have visited countless institutional investors over the years and have met people from the private equity side, from the fixed income side, and the real estate side. I probably agree with those around the table in terms of where it has got to now, i.e. leaning towards the equities camp, but it is not clear cut and there are still many institutions that are undecided.

Jones: I think it gets compounded even more when you start to look at high growth infrastructure strategies, particularly when you are bundling them up in the same pot as a core strategy. I believe it is more appropriate to consider a high growth emerging market offering alongside of private equity type funds rather than core or debt strategies. High growth strategies obviously have very different risk profile and payoffs than core or debt funds, potentially undermining the consistency of performance clients are expecting from their infrastructure bucket.

Chairman: Looking at the experience of Australia, what can Europe expect next from this sector?

Latham: Leaving PFI out of it (as that is a fifteen year game in Europe), where we see innovation happening is around the product side. In Europe it started with the private equity style structure, so the ten-year closed ended fund, with fee structures comparable to that (the two and twenties, for example).

What has started to evolve is the lengthening of the terms of these funds; the nature of them (in some cases open-ended versus closed ended); the lowering of fees – probably more towards real estate pricing rather than private equity type pricing.

If you step away from the products and look at the nature of the assets and the sourcing of the assets, the issues are much the same the world over. Governments have less money, corporates are changing their strategies and divesting non-core assets. The supply of opportunities is not changing, in fact it is increasing. The question is: what are the right products and structures to channel pension fund money into?

One of the other things we are seeing is that the Australian market has moved towards a dis-intermediated model and whereby you have the end investor wanting to have the asset allocation/investment decision, rather than give that decision to a manager, although they might still want a manager to manage the assets or to originate an asset for them. We have seen some of the big Dutch investors go down that path, the Canadians too.

Jones: From our perspective, notwithstanding the somewhat patchy experience that investors have had in this asset class, we believe that the characteristics which attracted investors to infrastructure in the first place remain in place and are actually more compelling than ever going forward. The appetite for risk generally has contracted, while a desire for capital stable yield-focussed opportunities is more relevant than ever. So in terms of the future of the asset class, we feel very positive. I think it is like any relatively young asset class, as more opportunities present themselves the benefits of the strategy get continually reinforced. While issues surrounding things like fund structures and pricing models have been a distraction, these get flushed out over time.

Michaels: I think going forward the fee issue is a really crucial one for us as we have clients looking at the asset class who find it hard to understand that, for a core infrastructure investors, how the current fee levels are justified compared with other active investments, such as equities say.

Hale: I think any structure that incentivises managers to take risk, particularly with core infrastructure, seems to be a complete misalignment with what people are after from the asset class.

Global opportunities

Chairman: Where do the opportunities lie today?

Latham: Booz Allen Hamilton recently put out a study that said there was some $40 odd trillion of investment requirement over the next twenty years. You then need to look market by market.

In terms of Europe, there is a capital shortage for the number of funds in the market. You can do pro-
prietary deals, you can have bi-lateral conversations and not all deals are going to tender, which is what happened at the top of the market.

You then go over to the US – which is arguably the gorilla in the closet when it comes to its potential – there is a huge investment need, but the mechanisms are not necessarily there to supply the opportunities. There is a lot of capital mobilising in that market, but there is probably a capital overhang. So on a supply and demand basis, I would say Continental Europe is, for a core/core plus strategy, probably the better value market.

Australia is in equilibrium – there are probably a lot of opportunities there but there is also a healthy supply of capital.

In terms of the developing markets? In my view, that is a private equity play.

Lennon: I have to agree with the European comment – the market is awash with opportunities across the Continent and the UK.

In terms of some of the themes we are seeing, we are seeing governments struggling with their own funding plans with the prospect of increasing privatisation but it is really a question of timeframe with regards to such opportunities. We are also seeing the corporate non-core asset disposals, particularly in utilities – which has been talked about a lot over the last five years – really starting to happen now.

The whole green agenda is also driving vast amounts of capital requirement both in the UK and abroad, and that is going to absorb a lot of capital potentially.

Then of course we have, over the next few years, the re-capitalisations/the re-financing requirements of the leverage excesses potentially of the last few years. So I think that there is going to be an enormous amount of investment opportunity. I think it is a very exciting time for those of us in the market.

Jones: One issue which is causing some investors to hesitate at the moment is the changing Sovereign Risk landscape, where even in countries with a history of a strong regulatory regime there is some fear that the pressure on government finances is increasing the regulatory risk significantly. This may well narrow the geographical focus for managers going forward.

Chairman: Can I ask the consultants, are you comfortable advising your clients to go into funds that invest overseas or is there still primarily a domestic bias?

Hale: I think generally at the core end and with the opportunistic stuff we see that as a global play. We think it is a way of increasing your diversity right across the globe. I think an area where you might want to focus on your home market is particularly the PPP/PFI space where you are looking for very strong inflation-linkages.

Walshe: Since we have been looking at the asset class we have taken a global approach to the opportunity set. Indeed we are probably quite fortunate being based in London because managers from across the globe come through all the time. However, at the end of the day, it goes back to what is appropriate for a particular client mandate at that time.

Michaels: Saying that, these are such long-term investments that you have to be very careful about investing in emerging markets, for example, where the political regimes seem to be less stable. So, global for us effectively means Europe and the US, and perhaps Australia, for the majority of schemes.

Walshe: That touches on an important point in that there are certain markets where there are inherent risks, but the devil is in the detail and it depends on the particular fund manager you are dealing with, their level of expertise or the partnership structure they have.

For example, we have seen a manager with some emerging market exposure which has local partners well aligned, so you really need to understand a particular manager and how you think that manager can add value and manage risks in that particular market.

Hale: Just touching on the point you made about the regulatory and political risks, I think that is one of
the reasons that we think diversification is very important – for example, in Australia, there have been some areas where some adverse political decisions have impacted returns, so we think diversifying both your political and regulatory risk is very important.

**Lennon:** I would echo that point about diversification. If you have a core/core-plus infrastructure strategy, which we do, the benefits that we have enjoyed over the last couple of years of having that diversification in our portfolio has been immense.

For example, we have seen value from having a mix of some assets which would have been more prone to GDP type drivers while others are not at all. You also need to think about broader geo-political issues.

**Chairman:** Do you think there are local sensitivities you also need to bear in mind?

**Lennon:** Yes – in the same way that you need to have people that understand particular sub-sectors and drivers of industry, you also need people who understand the local dynamics. The way that we would approach procuring an investment in one country could be materially different from that in another country.

**Closing comments**

**Chairman:** What are the key messages to take away from today?

**Walshe:** It is a tremendous asset class with tremendous potential. It has had a few teething problems but will continue to evolve. The universe of opportunities within the asset class is immense and there are a lot of dynamics which will drive it forward.

It would be unfortunate if some of the challenges of the last 18 months to two years destroyed these opportunities.

It will, of course, take some time to really know how this asset class is performing although a number of managers have already demonstrated strong performances (while others have come unstuck) but all in all, I think infrastructure has a very positive future.

**Jones:** I think the rationale for investor demand to target this space is stronger now than ever – the things that originally underpinned the asset class are still there: the essential nature of the assets and the earnings stability of the assets. The last few years – and notwithstanding some additional volatility over that period of time – will stand the industry in very good stead, as there have been a lot of lessons learned and the consistency of performance going forward will reflect the level of experience in managers.

So, a very positive outlook for the sector. I think one of the interesting opportunities for investors targeting the space is the fact that there is a broadening range of ways to access this opportunity whether it be through a listed strategies, debt strategies, growth strategies and so on. I think this will broaden the range of investors who are attracted to the space in the future.

**Lennon:** I think it is a very exciting time for infrastructure investing. I think infrastructure has emerged out of the last few years very strongly both on an absolute and a relative basis. There were a few problem cases out there, but if you analyse most of them they weren’t to do with the underlying assets themselves but more to do with gearing issues, for example.

I think the market is going to develop significantly. It will be interesting to see how the manager universe will develop as investors are much more understanding of the asset class now.

And if you actually think about it, as has been said, it is quite a boring space and the quicker we get back to making it a little more boring than it has been of late and actually enjoying the benefits that brings the better.

**Michaels:** I like a boring investment! Infrastructure has plenty of attractive characteristics for the long-term investor. Picking up a point made earlier, it will be interesting to see how buyout providers react when they are offered infrastructure assets or to what extent a functioning secondary market will develop in infrastructure funds.

A final point I would like to make is that, compared with a lot of asset classes, the range between a good and a bad infrastructure manager in terms of returns is very wide compared to, say, equity managers – so doing your due diligence is crucial.

**Latham:** I share the bullishness around the table on the sector. If we fast forward ten years and look back, I firmly believe that 2010-2012 will be very good vintage years. I think, from an investor perspective, whoever has the cash is king and they are in the negotiating seat to get very good terms for access to this sector at the moment.

**Hale:** I would like to echo the optimism around the table – one thing I would like to temper it with, though, is that we do need to see the structures evolve and structures that align what managers are doing with what investors are trying to achieve. I think maybe in the core space what we are after is boring, stable cashflows, a focus on yield, and less of a focus on performance fees.

**Chairman:** To conclude then, from a pension fund perspective, I still think it is too early to give an opinion on infrastructure as an asset class – we only made our first toe-hold in this sector two or three years ago and because of the nature of the sector being long-term, I don’t have the evidence. I wish I did.

You can ask me again in a few years!