Building a balanced infrastructure portfolio

Infrastructure can offer investors a broad opportunity set. **Martin Lennon** looks at how schemes can build a diversified portfolio to reduce risks and generate both yield and capital growth

AT A GLANCE

- Schemes are increasing target allocations to infrastructure
- But choosing when to invest during an asset's life cycle is key
- Diversification can help mitigate risks and change return profiles

The potential for new infrastructure development across Europe today is vast, providing pension funds with an increasingly attractive investment opportunity. With assets typically generating long-term, contractual and inflation-linked income in excess of corporate bonds, it is unsurprising that schemes have been raising their target allocations to the asset class recently.

Infrastructure offers a broad opportunity set, with return profiles varying considerably by sector and development stage. For investors opting to achieve ownership participation in infrastructure assets, choosing at what point during an asset's life cycle to invest influences the level of risk and returns on offer.

Greenfield vs brownfield

Infrastructure assets typically fall into two broad categories, greenfield and brownfield, which refer to different stages in an asset's lifecycle. Pension funds invest in both but for different reasons.

Brownfield assets are already operational and cash-flow generative, offering stable, long-term income, with double digit internal rates of return (IRRs) available and high single digit yields.

Greenfield, however can mean different things to different investors. These are new projects that require planning, design and construction before they become operational. Pension fund investments in projects – such as Gigaclear, which is building and expanding new full fibre networks – offer an earlier entry point to ownership of infrastructure. In contrast to brownfield, greenfield projects may not be cashflow generative until they become operational. While there is clear risk at the development stage, for example where a greenfield project requires planning permission, investing at the shovel-ready construction stage where construction risk is readily managed still brings expectations of increased returns, with IRRs at a meaningful premium to brownfield. Both approaches have the potential to enjoy capital gains.

The pension fund challenge

The risk return profiles of both infrastructure types align well with the needs of UK pension funds able to give up some liquidity. Contracts, often exceeding 25 years, underpin the longevity and predictability of investment cashflows, which usually include some inflation protection, making them well-suited for meeting pension fund long-term commitments.

Investments can also be considered as defensive in nature. Underlying assets typically have long economic lives, low risk of obsolescence, low operating costs and high barriers to entry. Moreover, infrastructure assets typically provide essential services, such as energy, experiencing relatively consistent demand, throughout the economic cycle.

This combination of inelastic demand, stable and reliable revenues and low ongoing capital expenditure means infrastructure can offer the lower volatility and lower correlations of returns with other asset classes that are attractive to pension funds.

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Minimising risk

One of the key challenges facing the sector is the increasing volume of institutional demand placing upward pricing pressure on larger, trophy assets. However, in order to find value, asset managers with strong relationship networks can sidestep many of the most competed assets by exploring the mid-market for assets that are too small or complex to attract large-scale investors.

These deals often take place off-market, and sometimes require separation from a parent company, but offer greater scope for value creation through active asset management. In addition to visible market presence and access to deal flow, managers also require a rigorous process of internal review to ensure they are selecting the best assets for their clients' needs.

Other risks include impacts of political or regulatory change particularly given the public service nature of infrastructure. Investors also need to accept illiquidity risk in any investment, and potentially, currency risk if a transaction is not domestic. However, risks can be minimised through rigorous asset selection processes, appropriate project structuring, contract negotiations and working with experienced construction counterparties.

In greenfield projects, risk can be reduced by investing later in the construction phase rather than at the earlier, planning and design stages. This can create an attractive balance of risk and reward with expected returns only marginally lower than those available at riskier pre-construction entry points.

Institutional quality portfolios

Portfolio diversification is vital to reduce risk and provide investors with both yield and capital growth. By combining assets such as utilities (consistent income streams with low correlation to GDP growth) with energy (high growth potential but less inflation linkage) and transport (strongly correlated with economic growth and a high level of inflation linkage), a carefully diversified portfolio can be created in order to deliver the stable and predictable cashflows that pension funds seek.

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