Real Assets: Do Infrastructure Investments Cater to the Requirements of Global Institutional Investors?

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The authors examine whether infrastructure investments can serve as a viable alternative for institutional investors hoping to achieve higher risk-adjusted returns.

Economic developments both in the United States and Europe will likely be characterized by moderate growth rates and considerable uncertainty for the near future. As a result, a growing number of global institutional investors may feel hesitant to explore alternative investments. Although government and corporate bonds—with their sometimes deceptively high ratings—can seem attractive in this economic climate, they might not prove fruitful when future payment and pension obligations are taken into account. A negative return after inflation will not, for example, feed considerable retirement obligations built up over several decades. Can infrastructure investments serve as a viable alternative for institutional investors hoping to achieve higher risk-adjusted returns?

As the global population rises, mainly in cities in the developing world, a vast amount of infrastructure must be built and retrofitted in the coming decades. Infrastructure (maintenance) in developed countries has to be brought to an acceptable level and new technology, such as low-carbon energy and transport systems and state-of-the-art water systems, requires new infrastructure.

What are some considerations for an institutional investor courageous enough to explore these kinds of "alternative investments"?

Advantages

Relatively High Returns

Markets for infrastructure services are often characterized by oligopolies because of heavy government regulation and a limited number of concessions. Unlisted infrastructure funds generally target a net internal rate of return of between 10 to 20%. Preqin, the UK research provider, analyzed 104 infrastructure funds launched in 1993–1999 and 2000–2004. On an average, these funds performed far better than private equity, venture capital and property funds of the same vintage years. It should be noted, however, that the funds launched in/after 2000 performed significantly better than those launched in/after 1993.

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One reason for this is higher leverage used for the investments of the second fund generation.

Relatively Low Risks

The performance of infrastructure facilities is exposed only to moderate economic fluctuations. Restricted competition and a lack of elasticity in demand are two reasons for this manageable risk profile. Among infrastructure investments, greenfields, i.e., project developments, bear a potentially higher risk than brownfields, i.e., existing facilities.

Steady Cash-Flows

The profiles of most infrastructure assets are dominated by operating assets with distributable cash-flows. The volatility in cash-flows is relatively low due to fixed prices and the fact that infrastructure customers generally have little or no bargaining power. Usage does not decline significantly with price increases or during recession periods. Predictable cash-flows may effectively help to achieve high credit ratings that can translate into relatively low borrowing costs.

Little Correlation with Other Asset Classes

A portfolio of infrastructure assets generally has low correlation to other major asset classes. Depending on the unlisted infrastructure strategy, the correlation to other major asset classes can be lower than that of listed infrastructure vehicles.

Disadvantages

Of course, there are a number of potential downsides too:

Likely No Hedge Against Inflation

In cases where the cash-flow stream of infrastructure assets is linked to price level indices, there might be a stronger inflation linkage. This, however, does not hold true for the infrastructure asset class as a whole.

Moderate Liquidity

Closed-ended infrastructure funds confront the investor with lockup periods of 10–12 years with only a few options for secondary sales of fund interests. Open-ended funds, which are common in Australia, for instance, will allow for redemptions, generally on a daily basis.

Lack of Transparency

Fund managers have to establish a consistent, independent and transparent valuation process to gain credibility. A common valuation standard for infrastructure investments is not currently available, but it is a mid-term task for a global infrastructure investment association.

Solvency II

If infrastructure investments are categorized as “private equity,” European Solvency II regulations for insurance companies will require an excessive amount of capital to cover the moderate risk of the related infrastructure investment. If infrastructure investments, however, are structured and classified similarly to high-quality bonds, the level of solvency capital required would be more acceptable. A formal credit rating and a bank guarantee would likely help to reduce the amount of capital required as “back up” for the investment product.

Suitable Investment Structures

An institutional investor willing to accept the aforementioned restrictions that come along with real assets to achieve the generally attractive risk-adjusted returns has a number of structural options when it comes to infrastructure investments:

Direct Investments

Direct investments can save costs on management and performance fees and increase insight and control. This, of course, requires dedicated internal capabilities and resources. It requires solid working relationships with municipalities, utilities, construction companies, etc. The fact that overall infrastructure allocations are and will likely remain to be relatively small also has to be taken into account.

A high number of sovereign wealth funds gain some exposure to infrastructure through debt and equity investments that were made to aid the development of their home economies.

Listed Infrastructure Funds and Bonds

Listed infrastructure funds offer daily liquidity, generally lower fees, lower leverage and more transparency. But a January 2012 Preqin survey revealed that 81% of infrastructure investors are seeking unlisted investment opportunities, and 31% want to pursue direct investments, whereas only 9% were interested in listed infrastructure investments. Apparently, listed infrastructure funds are an option primarily attractive to retail investors. The Canadian bond market for PPPs debt has developed rapidly in recent years, with bonds issued in the record amount of C$1.47 billion in 2010. High ratings were achieved through simple projects with top contractors, large amounts of collateral and a good liquidity profile.

Private Funds

On November 11, 2010, the EU Parliament approved the Alternative Investment Fund Managers Directive ("AIFMD"), which will come into force in the EU member states on July 22, 2013. AIFMD will, for the first time, subject managers of alternative investment funds to EU compulsory regulation. In certain infrastructure arrangements, e.g., those involving consortia, it will become a difficult task even to determine who the AIFM will be. AIFMD will require a system for the management of conflicts of interests. This becomes relevant when affiliated parties are to receive varied types of remuneration such as management fees, project management fees, carried interest, concession contracts, etc.

Irrespective of these basic structural options, the institutional investor should be aware of the fact that infrastructure investments can qualify as, e.g., private equity, real estate or fixed income, and may therefore be placed in the respective "bucket" of a portfolio.