

Hard assets

Infrastructure investing is a long-term commitment. That makes it a good match for pension schemes, finds **Andrew Sheen**

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Toll roads, hospitals and airports might not be the most glamorous of opportunities, but investing in such essential 'infrastructure' projects could suit pension schemes. It works well as a long-term asset and can also yield good returns – providing trustees select the right projects.

According to the Organisation for Economic Co-operation and Development (OECD), the developed world needs to invest over \$2trn a year in infrastructure over the next 20 years, while political think-tank Policy Exchange estimates the UK alone needs to find £500bn of new investment in the next decade.

Cash-strapped governments – which would have traditionally funded such projects – are struggling to cope with the after-effects of the recession and unable to meet this need. That is where private investors, such as pension schemes, could step in.

While investing in infrastructure has been a well understood and popular option for Australian and Canadian funds for many years – with many operating their own multi-billion dollar in-house investment teams in areas as diverse as satellite broadcasting, nuclear power generation and oil pipelines – many UK schemes are only just beginning to put their toes in the water.

But interest in infrastructure is growing, driven in part by the alignment of interests that exists between the financial needs of trustees and their schemes and the opportunities infrastructure represents.

RISK CONTROL

For Danny Latham, head of infrastructure investments, Europe, at First State Investments, which manages €1.6bn of infrastructure assets, the case for pension schemes investing in infrastructure is clear. "It offers stable, predictable earnings with some inflation protection and long life assets," he says.

Infrastructure investments fall into three broad categories:

- Greenfield projects, which are essentially new builds, where the investor participates from the initial stage of the project

- Brownfield infrastructure, or existing assets which are already operational and generating income
- Public Finance Initiative (PFI) assets, which are public sector assets, such as hospitals, funded and usually operated by private investors but falling under public-body supervision

Greenfield investments are seen as being riskier than taking on existing assets, due to the relative uncertainty over cost overruns and falling behind schedule. However each type of investment has its own particular attributes and suitability for pension schemes.

Duncan Hale, senior investment consultant with Towers Watson, says: "We think PFI is a very good asset – it seems to match what pension funds are trying to achieve. But it's a relatively small marketplace and it can be difficult to make significant investments. The majority of pension schemes are invested in brownfield assets. As a young asset class, there are questions about whether greenfield risk is being appropriately priced."

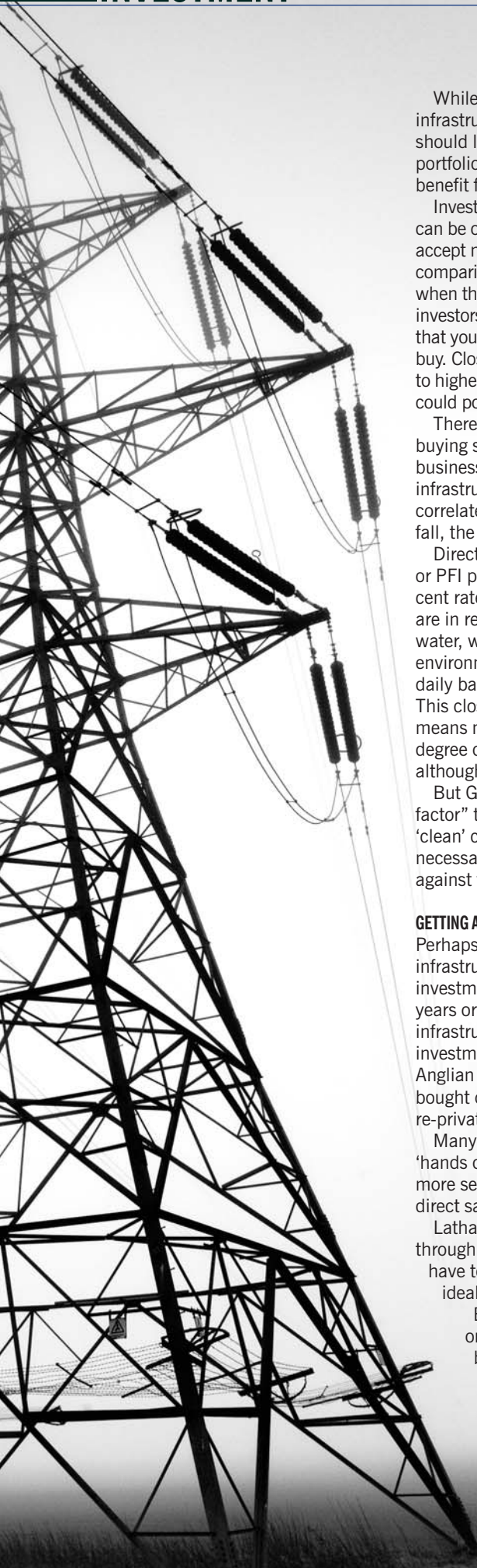
Many managers establishing greenfield projects try to remove as many of the risks as possible, such as agreeing contracts with the construction company to avoid extra costs that delays can bring or contracting out facilities management to remove operational risks.

Chris Gill, chief executive of HSBC Specialist Investments, says: "We try to identify risk in every way we can and pass that off in a way to those best suited to hold it. If you can do that, it gives you an even more predictable cash flow."

Making sure the manager has removed or minimised as many risks as possible is an important consideration for investors looking to access any category of infrastructure assets. Dylan Foo, an investment specialist with AMP Capital Investors, which manages CLH, a Spanish petro-gas distribution company, says one of the top concerns was to remove the uncertainty over the price of petrol and gas from the performance of the investment. "We don't want to think about or care about price risk. The investment has no link to the price of petrol," he says.

KEY POINTS FOR INFRASTRUCTURE INVESTMENT

- There is a massive demand for infrastructure investment, which has driven up fees
- Infrastructure can be used as an inflation-linked investment – within reason
- Trustees should consider an investment in infrastructure of not less than 2 to 3 per cent of their portfolio to reap the benefits



While there is no set or common allocation to infrastructure for schemes, Gill says most trustees should look to invest at least 2 to 3 per cent of their portfolio – any less and the scheme would not see any benefit from the investment.

Investments are typically structured via a fund, which can be open or closed-ended. An open-ended fund will accept new investment over the course of its lifetime. In comparison, a closed-ended fund will gather investments when the fund starts up and then accept no further investors until it matures. Hale says: “What’s important is that you match the vehicle to the assets you’re trying to buy. Closed-ended structures are seen to lend themselves to higher risk [assets] whereas at the lower risk end, you could potentially see open-ended structures.”

There is also listed infrastructure, which involves buying shares in companies involved in infrastructure business (such as construction companies). Listed infrastructure is tradable on exchanges, but is closely correlated to equities, meaning that when stock markets fall, the infrastructure fund will usually suffer as well.

Direct infrastructure investments – such as greenfield or PFI projects – typically offer investors a 12 to 14 per cent rate of return over the life of the asset. Many assets are in regulated sectors – utilities such as power, gas or water, which have strictly regulated operating environments – and, given that everyone uses them on a daily basis, are able to generate very stable incomes. This close relationship between assets and regulation means many infrastructure investments offer some degree of inflation-linked income, which is closely, although often not exactly, correlated to inflation.

But Gill warns that despite being an “interesting factor” the inflation-linked nature of revenues is “not a ‘clean’ correlation”, meaning schemes should not necessarily count on infrastructure to protect them against the impact of inflation.

GETTING ACTIVE

Perhaps of greater interest is the very long time horizon infrastructure assets operate over. Unlike private equity investments, where managers buy and hold assets for five years or so, before selling on to other parties, infrastructure managers tend to buy and hold their investments. In some cases, such as the purchase of Anglian Water by First State Investors, assets may be bought outright and taken off listed markets, essentially re-privatising what were publicly quoted companies.

Many infrastructure managers also take an active, ‘hands on’ approach to managing assets, with one or more seats on the company board of directors and a direct say in the management of the business.

Latham explains: “Clients expect us to add value through active management and sitting on boards. You have to have a board seat to have an influence, and ideally, we prefer a couple of seats.”

But the issue of debt and the amount of leverage, or borrowing, used by asset managers when buying assets in the credit-fuelled decade before the crash, has been a cause for concern. With funding tight and credit hard to come by, managers have had to turn to other sources to raise funding, notably through institutional investors such as pension schemes.

Because of this, Hale says there has been “significant movement” on fees, since “the pricing power is with investors, not the manager”.

CASE STUDY: USS

The £28bn Universities Superannuation Scheme, which provides pensions to university lecturers and staff in the higher education sector, was an early adopter and advocate of investing in infrastructure. As of March 2009, it had over £600m invested in the asset class, which accounted for approximately a third of its alternative investment portfolio.

Fraser Booth, a portfolio manager in the alternative investments team at USS, says despite the recession, which has affected returns, the scheme remains committed to the asset class.

“Infrastructure assets remain very attractive to pension fund investors such as ourselves, who have inflation-linked liabilities. The underlying stable, index-linked, cash flow characteristics of infrastructure are suitable for matching some of these liabilities and offer more value than alternatives such as index-linked gilts,” he says.

As a larger investor, with more resources to manage assets in-house, USS is able to invest directly alongside managers outside of their funds, although this route is suitable only for larger schemes which have the ability to build up their own in-house capabilities.

Booth says: “We have built a concentrated portfolio of a few managers who can offer co-investment in transactions alongside their funds, allowing the scheme to reduce the fee burden, escape the restrictions of the fixed term limited partnership model and enabling us to tactically upsize transactions that better fit our liabilities.”

Fee structures, which were copied from the private equity model of charging in the region of 2 per cent of assets under management and 20 per cent of profits, have been criticised as not being properly aligned with investor interests. But the drying up of credit and changing investor sentiment has forced the industry to change its practices. Latham says the ‘2+20’ model “didn’t work” on assets with the moderate returns of infrastructure and prompted some larger investors to take their infrastructure investments in-house, while others have put pressure on managers to change.

“We’re seeing that fees are moving more towards a real estate-like model [charging a fee of 0.5 per cent to 1 per cent], depending on the strategy,” he says. ■

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