Infrastructure Investing in practice

Barry White

Killin Consultancy Ltd

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What are Infrastructure Assets ?

Infrastructure assets are the facilities and structures essential for the orderly operations of the economy

Examples include:

- Transportation networks
- Utility & Energy distribution systems
- Communications infrastructure
- Social infrastructure

All providing essential services to communities

What are Infrastructure Assets ?

Examples of infrastructure assets include:

- **Transportation assets** – toll roads, airports, bridges, tunnels
- **Utility and Energy assets –** water, power generation, electricity & gas networks, and fuel storage facilities
- **Communications infrastructure** – transmission towers
- **Social infrastructure** – education, recreation, waste management and healthcare facilities

What are the main investment characteristics ?

Infrastructure as an Asset Class

- Defensive investments, attractive risk-adjusted returns
- Low correlation with traditional investments
- Relatively high and predictable cash yields
- Sector growth potential

How does infrastructure fit into a portfolio?

	Similarities	Differences
Private Equity	• Management control over investments • Converging investment techniques	• Different risk-return objective; low exposure to economic cycle • Longer investment horizon; return less driven by exit strategy • Strong cash yield / lower capital growth
Real Estate	• Cash yield is significant part of return • Absolute return objective focus • Importance of location	• Control over operating companies • Barriers to entry; less exposure to valuation cycles • Longer cash-flow predictability; higher gearing • Normally larger individual asset size
Equities	• Equity ownership • Upside return potential	• Lower level of securitization / liquidity • Lower correlation with business cycle • Relatively predictable and high cash yield
Fixed Income	• Long-term, predictable cash yield • Long duration asset • Low market risk	• Asset ownership • Growth / upside potential • Inflation hedge features • Indirect exposure to interest risk

What are the Risks?

Patronage and Demand Risk

Transport assets like toll roads, ports and airports are exposed to usage or patronage risks which vary between assets and over time

Regulatory and Sovereign Risk

Often regulated by Government either through a regime set by a regulator (Water Companies in the U.K.) or through long-term concession agreements

Contractual and Credit Risk

Long-term contracts expose counterparties to credit risk

Operational and Construction Risk

Infrastructure assets involve operational risk and greenfield projects involve construction risks

Financing and Inflation Risk

High leverage used in financing infrastructure assets exposes investors to the cost of debt and refinancing risk. Value of cash flows may be impacted by inflation.

Are LGPS Funds committed to invest in this Asset Class ?

- Asset inflows into infrastructure increased by £995m to £1.4Bn in year ended March 2013 (data from Mandate Wire)

- The average investment made by a UK pension scheme in 2011/12 was **£27m**, in 2012/13 **£126m**

- Public & private pension schemes have 1.2% of assets invested in infrastructure (NAPF 2012 annual survey). The same survey in 2007 had the level at 0.5%

- UK corporate DB schemes have grasped the need to use this asset class by moving significantly into this area but Public sector schemes investment has stalled

Why should LGPS Funds invest in this Asset Class ?

- HM Government wants you to – but is that a good reason?
- In March 2013 the Department for Communities & Local Government lifted the maximum limit for limited partnership investments from 15% to 30% of schemes' total assets
- This enabling legislation is meant to encourage larger LGPS schemes to invest in the Pension Infrastructure Platform (PIP)
- The question I pose to you is: Do you think your local "Trustees" believe that they should invest
- Will LGPS Funds be happy to take on the risk of being a "developer" of a greenfield project

Infrastructure headlines from a leading Pensions magazine

- 25 Feb 13 “LPFA chief: local authorities circling infrastructure”
- 15 April 13 “Pip members wrangle over fund structure”
- 8 May 13 “Schemes hold off infra investment while Pip develops”
- 29 May 13 “Pip battles into infra market to drive down fees“

Investing in Infrastructure

Investment in infrastructure can generally be made in five broad forms :

1. Fund of Funds
2. Listed Funds
3. Listed stocks
4. Unlisted Funds
5. Direct investment

Type of Investment

1. **Fund of Funds**
    - Invests in a diverse portfolio of infrastructure funds
    - FoF manager receives management fee for:- vetting fund managers; making the initial fund investment; providing ongoing monitoring of funds and reporting
    - FoF approach provides limited partners with fund diversification and reduced exposure to any one fund manager
    - Adds extra layer of fees
    - Could be replicated by investing in single fund managers selected by the investor

Type of Investment

2. Listed Funds

- Invest in direct infrastructure, listed infrastructure or both; usually externally managed

- Primary advantage – normally exchange traded, liquid and provide financial reporting in accordance with relevant listing exchange

- In UK dominated by listed PPP investment funds which provide yield and some inflation linkage; generally lower returns than unlisted funds

- May offer investors more liquidity than unlisted but the frequent illiquidity of the stocks inhibits investors being able to buy/sell large holdings

Type of Investment

3. Listed Stocks

- Large universe of listed stocks including utilities

- Examples are companies with large market capitalisations:

UK Water Companies - Severn Trent, Pennon Group

Infrastructure Companies - **Abertis** (owns Luton Airport), **Ferrovial** (owns Heathrow Airport), **Duet Group** (owner of regulated energy utility infrastructure business in Australia)

UK Investment Trusts – John Laing Infrastructure, 3i Infrastructure, HICL Infrastructure, GCP Infrastructure Investments

Type of Investment

4. **Unlisted Stocks**
   - Invests directly in infrastructure on behalf of limited partners
   - Now largest segment of this asset class through which pension funds invest
   - Pools capital from multiple limited partners enabling a more diverse portfolio of assets with smaller capital commitment per investor
   - Individual fund investors pay a management fee to support the investment team
   - Fund manager normally provides administration, legal, accounting services acting as the General Partner

Type of Investment

5. Direct Investment

- Only accessible to very large Funds e.g. Calpers, Ontario Teachers, Australian Future Fund and Sovereign Wealth Funds

- Need teams of staff doing due diligence and having operational capability

- Current trend looking at working together with large funds globally

  e.g. Universities Superannuation Scheme (UK) in partnership with Borealis (Canadian infrastructure investor) and the Kuwait Investment Office had a bid of £5.3Bn rebuffed by Severn Trent

Finally a few personal observations

- Devon in 2007 committed 1% of it’s fund (£25m/$50m) to a global unlisted limited partnership
- The Fund raised $1.5Bn commitments: 15 year life + 5 year extension option
- After 6 years it is 90% invested in 5 portfolio companies with over 40 assets in 12 countries
- Forecast fund life IRR 9.3% : cumulative IRR to date 9.1%
- Like many other LGPS schemes Devon did not continue to invest: but is now looking to do so

Contact Details

Barry White

Killin Consultancy Ltd

t: 01392 469115

m: 07905 089962

e: killinconsultancyltd@virginmedia.com