FINANCING INFRASTRUCTURE

With governments strapped for cash and unable to support large-scale infrastructure projects, there is increasing opportunity for private-sector financing. Such infrastructure investments can provide attractive returns, portfolio diversification, and reduced volatility.

No one disputes the global demand for infrastructure — they just disagree over who will pay for it. “There is a clear need to reinvest in critical existing infrastructure, to build new infrastructure, and to bring existing infrastructure into the next century to foster economic development, bolster competitiveness, and enable technological and other types of growth,” says Graeme Conway, head of Macquarie Infrastructure & Real Assets (MIRA), Americas. While governments will continue to play a key role in accomplishing these projects, the need for private capital in investable infrastructure is growing, as are the opportunities.

Infrastructure investments have proven to provide attractive returns, portfolio diversification, and reduced volatility. In addition, they enable investors to have a significant impact on the communities in which they invest. “This provides a large and growing opportunity for institutional investors to play a part in this renaissance through the financial investments they manage,” Conway says.

Infrastructure investment growth has a number of key drivers. Over the last century, mature economies, like those of the U.S. and Western Europe, made substantial investments in key infrastructure that underpins their economies: roads, bridges, airports, ports, and more. Today’s acute need and investment opportunities in these countries stem from the lack of investment in the last 30–40 years, with current infrastructure in dire need of repair and updating. “Mature economies don’t just need new infrastructure, they also require the existing infrastructure to be brought up to standard, and the backlog is massive,” says Gershon Cohen, global head of Infrastructure Funds, Aberdeen Asset Management.

Global economic growth has been massive, as well, and bigger and faster economies need bigger and faster infrastructure: more transportation connections, bigger ports and airports, an efficient electrical grid, clean water, and more. “Many emerging markets have had great success, but if they’re going to continue, they need further investment for more of what they already have,” Gershon says. And developing countries, which need to connect with the global economy, need it all. To build large-scale projects, many governments are unable to raise enough capital — whether through bonds, taxes, or user charges — and have turned to the private sector.

Infrastructure is not homogenous as an asset class, and financing structures vary as widely as the types of projects. A concession between a government and a private-sector consortium to build and maintain a government facility has a very different risk and revenue profile than a merchant power plant built in an emerging market. The first has stable long-term fixed-income quality, perhaps financed largely with municipal bonds, while the second example, with more volatility and operational risk, would resemble private equity, and investors would have an ownership stake in the project.

“However, it’s important to recognize that infrastructure occupies a different risk-return space compared to more traditional
Building a well-balanced infrastructure portfolio

Interest in infrastructure as an asset class has grown significantly over the last 15 years, and the need for private capital continues to grow. Not only do infrastructure investments provide attractive returns, portfolio diversification, and reduced volatility, but they also enable investors to have a strong impact on the communities in which they invest. Graeme Conway, head of Macquarie Infrastructure & Real Assets (MIRA), Americas, explains.

Infrastructure encompasses many types of investments. How do you define it?
There is no precise definition of investable infrastructure. Collectively, infrastructure assets provide services or facilities essential to modern economies and urban societies, and they typically have high initial capital costs, long useful lives, and high barriers to entry. They also have stable, predictable cash flows and revenues that can be linked to inflation. And as you’d expect with assets that are essential to communities, there is typically a high degree of regulatory oversight.

What is MIRA’s approach to investing in infrastructure?
We focus on a number of infrastructure sectors including energy, which encompasses regulated utilities, power, midstream, and renewables; as well as the transport, communications, and waste sectors. We look to the attributes of these portfolio companies — whether their revenue streams are regulated, contracted, based on volume, or generated via a concession agreement — to structure a portfolio that provides investors with diversified sources of return.

What are the key risks?
There are several. Infrastructure assets play a vital role in their communities, so strong stakeholder relations with elected officials, regulators, customers, and the greater public are vital to managing our portfolio companies. Environmental controls, occupational health, and safety are everyday risks, and we work closely with management teams and labor to develop and monitor appropriate mitigation programs. Regulatory risk is another, and we maintain a consistent dialogue with regulators, especially at the state and local levels, to ensure we are delivering what is expected from the portfolio company. This is critical in the regulated utilities space, but equally so when you’re operating transport and waste portfolio companies. Macroeconomic risk factors affect infrastructure investments as well, and you can manage these risks at the portfolio company level by having the proper capital structure and continually making operational improvements. From an overall portfolio construction perspective, diversifying across asset types and underlying drivers is perhaps the best way to manage macro risks. Political risk is the biggest and hardest to mitigate. We do a thorough due diligence, and if it’s too high, we’ll walk away.

How does an infrastructure investor drive value from its infrastructure assets?
An effective infrastructure investment has more to do with skillful asset management than being simply a financial transaction. MIRA’s focus on acquiring a portfolio company is to establish key objectives that include specific measures designed to improve the operational, health and safety, and financial aspects of the portfolio company. A successful infrastructure investment manager should have a great deal of specialized asset management expertise within each infrastructure sector. A long-term investment horizon is also necessary.

What does a well-balanced, diversified infrastructure allocation look like?
A diversified approach that seeks to balance the various risk factors, including regulatory, contractual, macroeconomic, and others, is likely to deliver the best results over the long haul. Investors new to the sector might look within their region to stay aligned with their current levels of macroeconomic and currency risk. As their infrastructure allocations grow, investors can diversify exposures across multiple regions, economic cycles, and regulatory regimes. Depending on risk tolerance and return requirements, they might look to emerging markets, where expected returns will be higher and the asset mix more varied, providing diversification.

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private equity,” says Conway. “We have to be careful how we characterize portfolio companies and investment opportunities, because there can be a tendency to take on risks, like commodity risk or volume risk, which are more in the realm of a private equity or opportunistic strategy, as opposed to an infrastructure strategy.”

One of the interesting features of infrastructure is its long life, and a road, bridge, or water treatment plant can have a 20- to 60-year payment profile. With people living significantly longer, there is a need to protect the financial standards of retirees, which has created longer long-term liabilities. Over the last 20 years, investors have connected the long-term stable income generated by infrastructure and the longer pension liabilities that face corporations and governments, which can also extend 60 years.

Equities, prone to volatility and with a quite different risk-return profile, aren’t necessarily up to the same task. If the market drops and a pension fund sells stocks at their lows, the capital effects can be substantial. Generally speaking, a similar scenario isn’t likely with an infrastructure project. If, for example, an airport suffers due to an economic slump, it can usually raise its landing fees, which are generally passed on to consumers. Volatility can be offset by price adjustments to continue to meet costs, capital repayments, and dividends, which is not possible with a stock.

Indeed, when comparing infrastructure to equities or real estate, returns can be attractive, but the risk-adjusted returns can be even more so. For example, the slightly higher risk in an infrastructure investment can often yield a slightly higher premium than a real estate investment. And an experienced manager of infrastructure assets can mitigate the operational risks of an airport, road, or water treatment plant.

“There are risks that are priced into an infrastructure deal, but when they’re successfully being managed, an investor can end up with an attractive risk-adjusted return,” says Cohen. If an infrastructure investor is comfortable with the additional risks that aren’t present in a real estate deal, and has confidence in the way the asset is managed, that type of return potentially can be protected, and provide a slightly higher return than similar assets.

A diversified portfolio best protects against the maximum number of downsides, and infrastructure can help. Like anything, it’s a balance of risk and a portfolio’s objectives. A portfolio seeking to achieve a match of assets to liabilities might endeavor to produce a 7 percent return, and may have a large allocation to infrastructure. Others looking for a different type of return might expect a lower percentage to dampen some volatility with a stream of more stable long-term returns.

“Asset markets are generally pretty rationally priced, and the spectrum of returns from infrastructure available to investors today ranges from around 8 percent for a core, long-term contracted cash-flow asset to around the low to mid-teens for an asset that has some degree of operational complexity,” says Conway. Those investments with high-teens returns typically come with a set of risks that may be beyond those which the market considers typical infrastructure risk.

Another reason the infrastructure asset class has grown is the investment environment of lower-for-longer, and many asset owners that have spent the past several years catching up are now finally in the market. For example, conservative asset owners with classic allocations to fixed income, equity, real estate, and cash, who are historically used to 7 or 8 percent returns, now find themselves scrambling to deliver 3 or 4 percent. In response, they have had to learn new investment categories and sectors, particularly those that demand a greater understanding of the fundamentals, like infrastructure, and this requires significant time and resources.

“There are a lot of institutions that have missed out because it’s taken them so long to analyze the sector and get comfortable making allocations,” says Cohen. “We now see, particularly in North America, a lot of interest from family trusts, endowments, and public retirement plans – all of which are generally low on internal resources – that have spent a lot of time to understand infrastructure’s intricacies and are now making allocations.”

Some funds that made modest investments ten years ago are increasing allocations, generally because the track record has been successful. Other new sources of capital include local and regional pension funds, mainly in the U.S., U.K., and Australia, many of which have substantial assets. Bureaucratic in behavior, they have also been slow to invest, but are now just entering the market after several years of researching and becoming familiar with the asset class. Similarly, wealth management firms, on behalf of high-net-worth clients, have embraced infrastructure as they seek higher-yielding investments.

— Howard Moore
Time horizons are some of the most important considerations for investors when they structure their portfolios. In the case of infrastructure, investors are looking at some of the longest investment time horizons available, with projects that can last not only years but generations. And this can run directly counter to many of the short-term objectives prioritized by politicians looking to be re-elected.

Therefore, we must look for a way to bridge this gap between what governments are asking people to pay for in the present and the future benefits of the project that occur in the decades to come. In order for infrastructure investments to succeed over the long term, transparency and accountability are necessary. But even more importantly, political stability is paramount when investing in infrastructure, as this can be a key determinant in the success or failure of a project. Without a degree of consensus on major infrastructure developments that supersedes changes in political power, progress will be challenging.

In our view, a favorable political environment for large infrastructure investments has a few key characteristics. First, the economy should be in stable condition, with corruption kept at a minimum. Second, legal frameworks should be in place to uphold the legality of contracts. Third, the central administration should be able to bring ideas together on long-term needs for its citizens, from energy to transportation. But even with all of these key considerations in place, infrastructure opportunities will vary among regions and markets.

In developed markets, the biggest obstacles to meaningful infrastructure investment are sluggish growth and a lack of political will to push ahead with these projects. And, of course, there is the matter of who will pay for these improvements. Many governments in developed markets are strapped for cash at this point, and their constituents aren’t enthusiastic for paying for these long-term projects. Public-private partnerships can help lever in private capital, but public resources still need to be committed alongside private funds. These challenges, along with the bureaucracy that accompanies public-sector decision-making, have a tendency to extend timeframes on infrastructure projects.

In emerging markets, conditions are quite different. There are often better opportunities for economic growth relative to developed markets, but governments don’t always possess the stability needed to drive infrastructure projects forward. In-depth research and local knowledge can help uncover attractive infrastructure opportunities such as those in the Andean region of Latin America, where political structures are more stable and politicians are able to plan for the long term.

While the economic and social benefits of infrastructure investments can be significant, it is challenging to balance short-term and long-term decision making. One way to create long-term accountability is to report within each political term which projects will receive funding, and to issue an annual report showing how funds are being invested in projects that will deliver the greatest benefits. Clear communication and transparency can go a long way in helping build public confidence.

For more information on Aberdeen’s infrastructure capabilities, contact our U.S. Institutional Business Development team by calling 215-405-5700.

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