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Investors' increasing allocations to unlisted infrastructure

Nicole Connolly

Record-low interest rates and the increasingly uncertain equity market outlook are prompting many investors to seek new ways to generate reliable income returns. One beneficiary of this interest is unlisted infrastructure, due to its typically stable, reliable returns and low correlation to equities.

Investors allocated US\$85 billion to unlisted infrastructure funds in 2018, up \$10 billion on 2017, according to industry researcher Preqin.

We expect 2020 to be another bumper year for infrastructure investment. Infrastructure falls between government bonds and equities in terms of risk and return, making it an excellent portfolio diversifier (see Figure 1).

Its potential for stable, reliable income and capital growth is derived from long-term, stable and predictable cash flows, typically underpinned by long-term contracts or a regulated asset base; with high visibility of income and revenues often linked to inflation.

This is one reason why unlisted infrastructure investments accounts for between 7–12% of major institutional investor portfolios, such as the Future Fund and AustralianSuper.

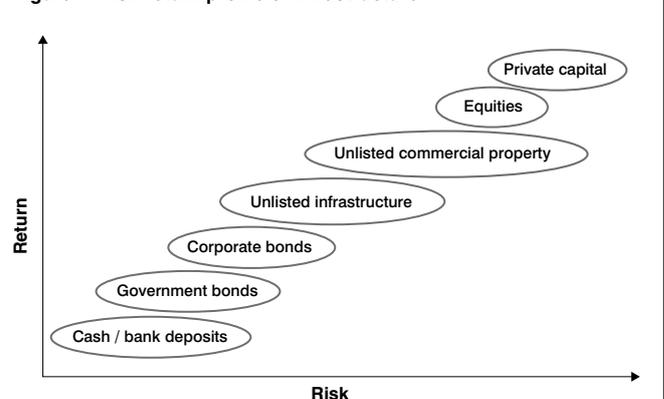
Why the increase in investor demand?

Infrastructure returns have historically been plus-9% p.a., including capital growth and yield.

The key, for both investors and managers, is to determine which assets and projects will provide the greatest, and most consistent, returns.

Unlisted infrastructure investment returns are typically generated by stable, reliable and protected income streams, which are derived from tangible, long-lived assets with monopolistic-like pricing power. Many are regulated and may feature income linked directly to inflation (although this may involve a lag).

Figure 1. Risk-return profile of infrastructure



Source: IPIF

A core infrastructure asset is defined as an asset for which the cash flows to equity owners are forecastable, with risk to these cash flows considered low. Core infrastructure aims to provide a return premium over a reference long-term bond rate, to reflect limited business risk and an illiquidity premium.

We would expect the equity risk premium for core infrastructure to be lower than the broad equity market over the long term, given the lower risk. A skill premium can also be expected, given the unique capabilities required; from originating deals through to navigating complex regulatory environments.

Defensive or growth asset?

Given the nature of unlisted infrastructure returns, investors often question whether the categorisation of the asset class should be defensive or growth.

The certainty around cash flow streams of many infrastructure assets, given their 'essential' nature, supports a defensive categorisation. However, we consider unlisted infrastructure to be a growth asset, as capital values can still be at risk during times of economic uncertainty, even though income is reliable.

In our view, although the asset class may be more defensive than equities, it still requires a growing economy to deliver on its capital growth and overall income return objectives. Increasingly however, we are seeing a number of our investors and their advisers consider unlisted infrastructure as a 'bond proxy'. This rationale is understandable in the current environment. However, in true recessionary times, an allocation to traditional fixed interest is a key ingredient in the 'balance' of a balanced portfolio.

Structure of funds

Unlisted infrastructure funds are commonly structured in two ways: open-ended and closed-ended.

Open-ended funds allow for the periodic entrance and exit of investors during the life of the fund, although

there are often entrance and exit queues, depending on the market cycle and market trends. They are the most common type of fund available in Australia and can offer an attractive opportunity to access highly sought-after, tightly held core infrastructure assets.

In theory, open-ended funds suit the long-life nature of infrastructure assets and would be positioned to avoid the situation where assets are forced into poorly timed sales due to the windup of a fund.

This leads to lower asset turnover than the typical closed-ended fund and is typically why many top-tier infrastructure assets such as the major Australian airports and a number of strategic regulated utilities are tightly held.

Closed-ended funds raise capital at the inception of the fund and then remain closed to new investors until the fund is wound up. The fund will have a specified timeframe in which it will invest the capital before returning all capital to investors at the end of the term of the fund (typically 10 years).

These funds are more prevalent outside Australia and tend to offer the opportunity to access higher-risk strategies or more niche infrastructure opportunities. During the term of the fund, the investor does not have the ability to redeem their capital contribution. Rather, periodic distributions of cash flow and capital events (that is, sale or refinancing) proceeds are the sources of liquidity.

The 'lumpiness' of the cash-flow stream associated with higher-risk investment strategies are well matched to the closed-ended fund structure, insulating the fund manager from the distractions posed by cash management aspects of offering liquidity to investors. That is, the fund manager can focus solely on selecting and managing the investments to drive value.

One of the key drawbacks of the closed-ended fund structure is the semi-hard termination date (which typically can be extended for 1–2 years). This can leave assets vulnerable to market conditions at the time the



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Table 1. Characteristics of infrastructure investing

Characteristic	Advantages	Disadvantages
Long duration of investments	<ul style="list-style-type: none"> • Most infrastructure assets have long, stable cash flows. • Concessions for infrastructure tend to be long-term and over 25 years, often lasting 99 years. 	<ul style="list-style-type: none"> • Not all types of infrastructure are appropriate for duration matching.
The inflation relation	<ul style="list-style-type: none"> • Revenues may be either explicitly linked to inflation and/or may offer inelastic demand patterns. 	<ul style="list-style-type: none"> • Some assets may only partially adjust for inflation. • While cash flows may be linked to inflation there may be a lag.
Diversification benefits	<ul style="list-style-type: none"> • Stable return streams with low-equity beta. • Potential for high cash flow and growth component. 	<ul style="list-style-type: none"> • Illiquid. • Capital-intensive and depreciating assets. • High fees, high costs of bidding for and closing deals.
Provision of essential services result in monopolistic market structures	<ul style="list-style-type: none"> • Predictable cash flows. • Higher credit ratings resulting in favourable borrowing costs (typical gearing levels for core infrastructure 30–45%). • Limited business risks. 	<ul style="list-style-type: none"> • Regulatory uncertainty. • Political risk. • Patronage and construction risk for value add or greenfield investments.

Source: IPIF

fund is wound down. However, the incentive structure and ‘profit splits’ associated with closed-ended funds does put pressure on managers to drive value during the investment period, supporting active management to deliver target returns.

Asset valuation

The valuation of unlisted infrastructure investments will generally require assessment of their specific cash flows and investment terms by an independent valuer, with the valuation often based on comparable transaction parameters and/or a discounted cash flow (DCF) approach.

As the name suggests, a DCF value is the summation of all future cash flows generated by an asset, where cash flows are adjusted for the time value of money and risk, as well as (usually) tax. For a given set of cash flows, the lower the discount rate, the higher the valuation.

The underlying discount rate is typically derived from a capital asset pricing model and comprises the risk-free rate, plus a risk premium, plus in some cases an arbitrary adjustment factor (sometimes referred to as an ‘alpha factor’). The risk-free rate is usually based on the relevant long-term government bond rate.

Under normal circumstances, the trend to lower bond rates in key countries such as the US, UK and even Australia would be expected to reduce the discount rate for assets located in those countries and, assuming no change in the risk profile, this would in turn bolster valuations. However, evidence suggests that valuers have typically taken a conservative approach and either:

- explicitly adjusted the risk-free rate so that it did not reflect the low bond yields at the time, or
- added an alpha factor to offset the reduction in long-term bond yields. Consequently, there appears to be little evidence of valuations being systematically bolstered by the sustained reduction of long-term bonds over the last 10 years. Likewise, we do not expect significant pressure on valuations if we enter a period of increasing long-term bonds, given other factors at play.

Best practice for valuation is usually a semi-annual valuation, supplemented by quarterly or semi-annual updates.

The quarterly or semi-annual update valuations conducted by the independent valuer following an annual valuation should incorporate any updates to the valuation parameters and the annual valuation model to account for material information available since the previous valuation. This reduces the likelihood of material spikes occurring with the full annual valuation. This only applies where the benefit to an investor outweighs the additional cost of the more frequent valuations.

Performance evaluation

Unlike traditional fixed interest and equity asset classes, where performance evaluation is a fairly straightforward process, the evaluation of unlisted infrastructure performance can pose a number of challenges.

Not only are unlisted infrastructure returns publicly unavailable, but the performance data of some of these assets can be relatively short. Further, the emergence of new subsectors of infrastructure such as land titles registry offices (as a result of various state government privatisation programs) adds to the lack of publicly available performance data.

The risk-return trade-off varies significantly by type of investment at different stages, hence no single return metric can adequately capture the whole infrastructure asset class or strategy. There is also no single broadly accepted index for use in performance evaluation.

Infrastructure portfolios are typically measured against a fixed absolute rate of return or a fixed margin above an economic indicator that reflects the performance characteristics of infrastructure investments. The most common evaluation tools currently in use are:

- **absolute rate of return**—a nominal flat rate of return typically expressed as either a holding period return p.a. or an internal rate of return (IRR) over a specified period
- **inflation plus margin**—effectively a real rate of return
- **bond yield plus margin**—the ‘opportunity cost’ of not investing at the risk-free rate
- **(inflation-linked) bond index return plus margin**—capturing the effects that changes in interest rates have on the capital values of infrastructure businesses
- **equity return plus margin**—the ‘opportunity cost’ of not investing in the listed market plus a premium for asset and portfolio specific risks.

These elements are unambiguous, measurable and can be specified in advance. With regard to the appropriateness of evaluation tools, it is important that this decision is made with reference to the specific performance objectives of the investor and the overall style of the fund. For instance, an inflation plus margin suits entities with the investment objective of achieving real or ‘inflation protected’ returns such as superannuation funds that are seeking to match assets with liabilities.

Bond yield plus margin is more suited to mature-stage infrastructure portfolios where income dominates total return rather than growth portfolios. This is because mature-style portfolios are less volatile than growth portfolios, supported by a more stable yield.

Inflation-linked bond index return plus margin is likely to suit growth-style portfolios rather than mature-style portfolios because the effects of interest rate changes will be more pronounced for growth-style assets, where the capital return component dominates total return.

Equity return plus margin is intuitively more appropriate for growth-style infrastructure portfolios, which are dominated by early-stage infrastructure businesses. These growth-style portfolios with medium-term investment horizons have risk levels comparable with the equity market and the majority of their total returns typically come from capital return as opposed to income return.

For investors adopting an after-tax investment focus, choosing between evaluation tools also means favouring the ones which reflect the impact of tax on investment returns. Some approaches more readily accommodate after-tax considerations than others.

In addition to these common approaches, investors have the following alternative approaches at their disposal.

Infrastructure shares common traits with bonds, private equity and real estate. As a result, depending on the risk-return profile of the infrastructure investments, performance can be evaluated against a combination of these traditional and alternative asset classes.

Peer group of unlisted infrastructure funds involves identifying and comparing against a range of peer portfolios with similar management style, investment horizon and approach to sector and geographic diversification as the selected portfolio.

Investment example: the Australian airport sector

Airports have been a strong driver of returns for unlisted infrastructure portfolios. The sector in Australia has a strong track record of long-term growth, with only one year of negative passenger growth over the past 25 years. This compares to four years of negative growth for Australian equities over the same period.

The airport sector performed relatively well through the global financial crisis, with airlines managing the downcycle through a range of initiatives including discounted ticket prices and reduced services.

The resilience of the Australian airport sector is due to a number of other factors, including the diversity in revenue streams which includes aeronautical, car park services, trading (retail), property and security; and is also reflective of the economic environment in Australia.

Although performance of airports may slow with a further downturn in the Australian economy, resulting in a slowdown in passenger growth, they have sound and sustainable capital structures.

Those with near-term debt maturities are well advanced and well positioned to roll over and/or extend out debt maturities.

Regulation is an important factor when considering the future attractiveness and risk of the sector. The Australian airport sector is lightly regulated.

The current system promotes commercial pricing negotiations between the airlines and airports. However, it includes a provision for arbitration in relation to access charges, should commercial negotiations falter. (The Australian Competition & Consumer Commission (ACCC) has a price monitoring role in relation to aeronautical services and facilities, including car parking services.

The ACCC in the past has raised concerns over the level of airport parking charges.)

Conclusion

Australian unlisted infrastructure managers have produced compelling returns for investors over the past two decades, generally making a positive contribution to the diversification of portfolios and delivering relatively stable and predictable income yields.

Looking forward, demand for local infrastructure development, including those projects being funded under the latest Federal Budget, presents significant opportunities for all investors. A key is to determine which projects and assets will provide the greatest and most consistent returns. **FS**