SPONSORED ROUND TABLE

What Does the Future Hold for Infrastructure Investing?

Infrastructure investing has been in the headlines since U.S. President Donald Trump promised a big increase in infrastructure spending during the campaign last year. For institutional investors, it's not a new asset class, but new opportunities are emerging irrespective of the Trump administration's plans, which are still being developed. In this round table discussion, Darin Turner, a managing director and portfolio manager at Invesco Real Estate, Christine Todd, president and head of U.S. municipal infrastructure strategies at Standish Mellon Asset Management , and Jan Mende, senior vice president in real assets consulting at Callan Associates, define and identify opportunities in infrastructure investing, explain the nuances of investing via public and private markets, and break down due diligence best practices.

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P&I: Let's start with a quick overview of infrastructure investing. Where do we stand today in the institutional marketplace and where are we headed?

JAN MENDE: Allocations in the U.S. are typically in the low single digits but expected to grow toward 5%. Where we used to see assets flowing mostly to private infrastructure, funded from fixed income allocations, today we are seeing an increase in funding from other real assets and private equity allocations, flowing to public infrastructure securities as well as private funds.

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>
> **— DARIN TURNER,** ***Invesco Real Estate***

The investment case for infrastructure is similar to real estate in that it's a hard asset expected to offer both current yield as well as the potential for capital appreciation. But depending on how the investor is structuring their real-asset portfolio, they can adjust the comparative weight of those current yield and capital appreciation goals.

It's also important to note that the return profile for infrastructure is fairly wide. You have lower returning, safer assets that may deliver more core-like returns, as well as value-added and opportunistic assets with higher return potential. There is a wide variety of options, each with a unique risk-return profile.

DARIN TURNER: That's an important point. Investors have a lot of choices from fixed income, public equity and private markets — all depending on their goals, goals that can range from stability of cash flows to total return potential, to portfolio diversification or inflation protection.

Specifically in the area of listed equities, investors are recognizing infrastructure as a distinct asset class that can behave very differently across the business cycle compared to global equities and other real assets. For example, during the global financial crisis, infrastructure cash flows were much more stable than real estate cash flows. Thus, many investors are finding that it makes sense to maintain a static allocation to infrastructure as well.

It's similar to the trend we saw when [real estate investment trusts] were first introduced and were often originally put in the small-cap or mid-cap bucket. Eventually they were recognized to have a distinct performance profile and moved into the real assets bucket.

Today, as acceptance grows for infrastructure as its own asset class, global investors are doing the same thing: increasingly carving out infrastructure-focused investments from global equities and grouping those with real assets.

CHRISTINE TODD: On the municipals side, we are seeing a very similar trend. And that, I believe, is an extremely important development for investors. They are recognizing that different ways of accessing infrastructure can offer different outcomes, many of which are complimentary to each other.

In fact, we are seeing experienced infrastructure investors looking to diversify already meaningful allocations to this asset class. These are often European investors that have been investing in infrastructure for decades. So where U.S. institutions are commonly diversifying into infrastructure, European investors are often diversifying within infrastructure.

It's a boon to all these investors that they have so many options.

P&I: But many of these new approaches fall outside the traditional framework of infrastructure investing. Are they appropriate to include in an infrastructure or real assets bucket?

TODD: The traditional approach to infrastructure focuses on ownership of a hard asset. By contrast, we focus on exploiting inefficiencies in liquid public markets — specifically municipals — using active management. The focus on munis, and on active management, is a very different proposition compared to how investors traditionally think of infrastructure, or how they might bucket it. But it's still very much infrastructure.

Remember that 80% of the capital for U.S. infrastructure investment is coming through state and local governments. That is an enormous slice of the domestic infrastructure pie. Without it, it's hard to say that an infrastructure allocation is fully diversified.

To maintain the infrastructure focus, however, one has to narrow the investment universe by looking at the purpose of the bond issue and what the capital is being used for. If it's being applied to projects like transportation, energy, water, hospitals or schools, then it could be a viable infrastructure investment. With respect to diversification, it's also important to build a portfolio with diverse subsectors and types of financings, in an effort to mute volatility.

Within an overall real assets or infrastructure portfolio, municipals can also offer higher liquidity, lower volatility and higher credit quality, compared to owning hard assets or illiquid private funds — another important source of diversification.

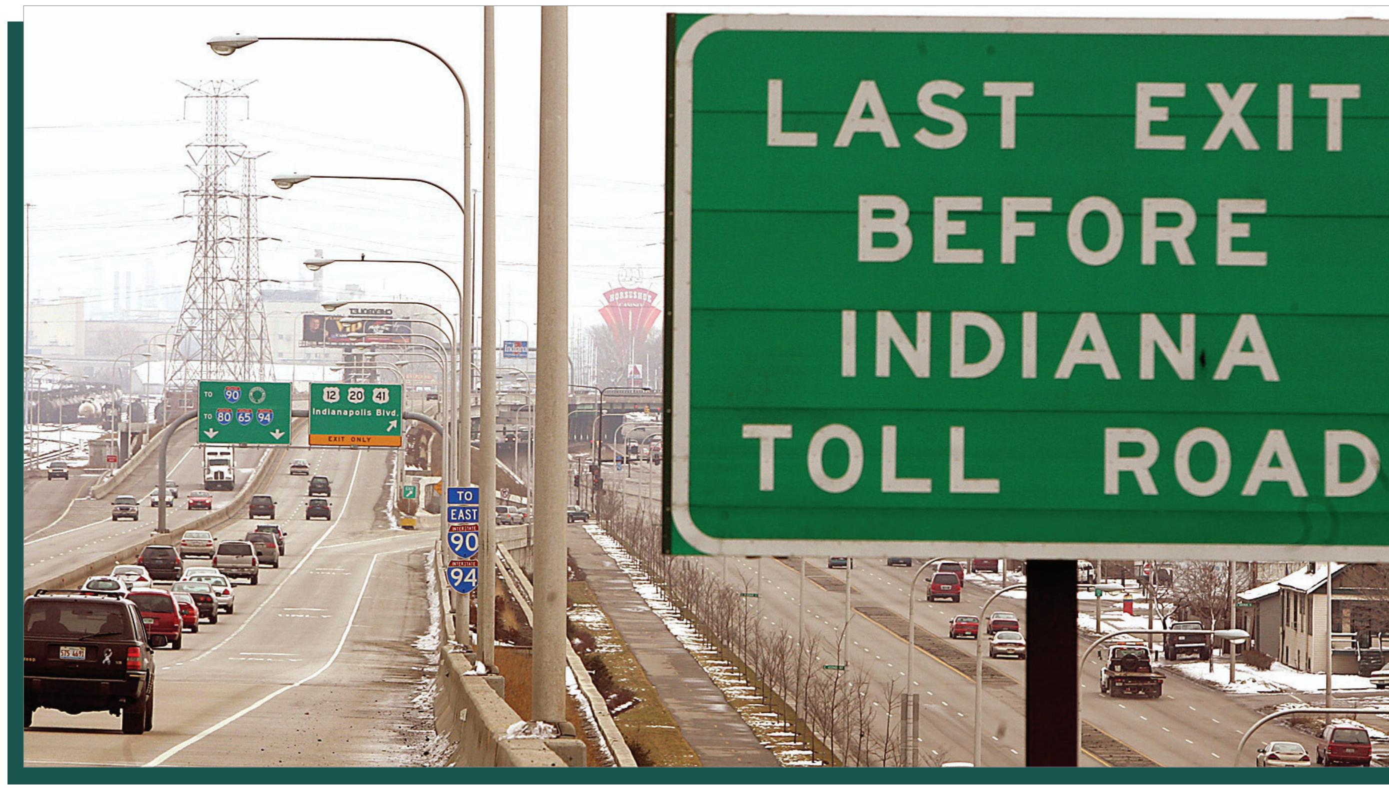
P&I: And in the equity world, do the same concepts apply?

TURNER: They do, particularly the idea of sifting through the universe of opportunities to find those that truly qualify as infrastructure. Investors are not just looking at return expectations, but also what kind of diversification benefit they may be able to achieve with infrastructure.

In our view, that means focusing on companies that earn a majority of their operating cash flow from the ownership of infrastructure assets. For example, one could ask, is a cement company infrastructure? Is a company that builds football stadiums an infrastructure company? Within our company, we take a hard line on having to own the assets and have contractual cash flows backing those assets.

Why is that? Because investors look to infrastructure for specific risk-return characteristics, such as stable cash flows, or inflation protection, or lack of correlation to other assets. A construction company or cement company is likely to have a more highly cyclical underlying business than you would find in a company that owns airports, for example. The latter type of company, with cash flows backed by assets, is much more in line with the risk-return characteristics that investors are looking to infrastructure to provide — and more appropriate for a dedicated infrastructure or real assets bucket within the overall portfolio.

MENDE: On the topic of diversification, I would add



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that investors need to take a hard look at where the risk is in the income stream.

For example, some infrastructure investments are regulated utilities that provide monopolistic services at a regulated rate, which may seem like a safe revenue stream. However, the regulator-authorized return on equity is not guaranteed, as the utility is still subject to business risk. The political and regulatory environment for each investment can have a big impact on future rates. Other infrastructure assets, such as toll roads, may have more GDP-linked revenue streams. This may allow the owner more price flexibility to pass through changes in costs, but on the flip side offers less future revenue certainty.

So as private infrastructure managers are constructing portfolios, it's important to have diversification — putting in some assets with GDP-linked revenue and some with more regulated revenue. That may provide smoothing in overall returns over the longer term.

P&I: We'll return to the topic of risk in a minute, but first let's talk about opportunity. Where are institutions investing, and where are managers finding opportunity?

TURNER: In the U.S., we continue to think energy is going to be the prevalent infrastructure sector that most investors have an opportunity to invest in. But we also think that the goalposts will move, allowing some additional investment opportunity within some of the more traditional infrastructure sectors like toll roads.

TODD: The value that we see is in some of the less essential-type issuances, such as hospitals, schools, waste energy, renewable energy, gas transmission. Those would be some of the more attractive areas at this point.

Geographically where we are finding value is of course in U.S. municipals but also [the Commonwealth of Independent States, an alliance of Russia and 10 other former member of the USSR], the Middle East, Latin America, Asia. These are all countries that are less mature in their infrastructure development and are offering more attractive yields as a result.

Now you could argue that the U.S. is a mature market, which it is, but our infrastructure is past its expected life, so the way we view the U.S. is that it is immature and it is at the beginnings of a major investment period to the tune of $4.6 trillion over the next seven or eight years.

MENDE: The main sectors are of course electric and natural gas utilities, water distribution and transportation assets like airports, seaports, rail, roads and bridges. Then there are energy assets, which could be generation or transmission or pipelines. There are also communication assets, as well as social infrastructure such as government buildings, schools, hospitals and courthouses.

Europe, Australia and Canada have a broad, established track record with infrastructure investments, and there have been many examples of deregulation and public-private partnerships in these markets, which have created investment opportunities. The U.S. has some examples of public-private partnerships, and investors are hopeful that there are more opportunities in the U.S., but to date, most private fund infrastructure investments have been outside the U.S.

For investors in core funds, we are seeing a preference for listed assets, so that allocations can be increased or decreased as the portfolio evolves. But each institution will have its own preferences. Some prefer unlisted funds because the typical performance profile is less volatile than public securities. Overall, investors like the stability and durability of infrastructure assets. Each organization has to determine how it views infrastructure and what kind of assets and vehicles make sense for its portfolio.

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P&I: There has been a lot of talk from U.S. policymakers and legislators about infrastructure. How strong is the U.S. opportunity compared to the rest of the world?

TODD: We think a great deal of U.S. infrastructure financing will come from the muni market, as it always has. And those opportunities will continue to grow. Issuance in the muni market is about $450 billion a year, with a third of that going to retire existing debt and two-thirds available for new infrastructure projects.

The infrastructure proposal from the current administration — at $100 billion a year for 10 years — is de minimis in terms of what the muni market is already providing. And the administration has already acknowledged that its plan should be considered supplemental to existing muni funding streams. So how realistic is it that we are going to hit $4.6 trillion in infrastructure investment by 2025? Not very.

However, we do believe that local infrastructure investment will accelerate, with additional investor interest coming from outside the U.S. Infrastructure spending in the U.S., as a percent of GDP, has been declining since World War II. But we are now seeing a positive grassroots movement toward accepting that infrastructure investment is a necessity. State and local ballot initiatives are increasingly common, and increasingly successful — a clear indication of momentum toward raising more capital.

Now, U.S. munis do not deliver the highest available yields in the infrastructure space. So those investors pursuing higher yields — and willing to take on more risk — can combine U.S. munis with non-U.S. sovereign, quasi-sovereign and corporate opportunities. That might mean CIS, the Middle East, Latin America or Asia, for example.

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TURNER: Our conversations with clients focus first on regions where they are looking to invest, and second on the types of underlying infrastructure they find attractive.

Investors are taking a hard look at Europe. For example, European airports have delivered the greatest absolute performance over the past nine months or so, driven by increased expectations for overall traffic, helped in large part by Chinese consumers. There is also a great deal of activity in the telecom sector with construction of cellphone towers, driven by demand from the global telecom giants.

The opportunity set in the U.S. is quite different. Whether you are talking about the private equity model or listed securities, mostly what's been available in the U.S. is energy infrastructure. That's one of the main reasons why U.S. institutions are under-allocated to infrastructure — just the overall lack of opportunity across infrastructure sectors.

That could be changing. Our belief is that, compared to other funding sources, listed companies will play a larger role than they have played historically, and that larger role will persist for 20 to 30 years as the U.S. tries to close its infrastructure funding gap.

Listed companies are having great success in toll roads, where new projects are coming in on time and under budget. Experienced European toll road operators have won new contracts in the U.S. I'm based out of Dallas, where our most recent toll road project was built by a Spanish company. Additionally, there have been auctions in North Carolina and Washington, D.C. The new Denver rail project is another example, in which a British developer owns a 45% stake.

P&I: That's a great overview of the opportunities, but no asset class is without risk. What are you watching?

TODD: In addition to political and currency risk, investors in public bond markets have to be wary of quality risk — the risk of not being repaid. It's easy to make the case that in the U.S. municipals market, that's a low risk. With the newer emerging markets, that becomes a bigger question and one that has to be addressed through fundamental credit analysis.

But when accessing infrastructure through the municipals market, the biggest risk factor is liquidity, which can sneak up on you in the form of retail investor behavior. After the Taper Tantrum there were severe dislocations in emerging markets and U.S. municipals markets because retail investors exited their fixed-income positions for fear of higher interest rates. Those two sectors were hit hard because they are less able to absorb secondary supply.

The flip side of that is capacity. Large institutions — insurance companies, for example — often need to fund large mandates. Part of the appeal of this asset class is the Solvency II treatment of municipals by European regulators. And the infrastructure element gives further favorable calculations from a regulatory perspective. Clients are often concerned about sufficient capacity to fund their mandates, or that it will have an effect on the first risk, which is liquidity.

TURNER: In listed equities, two of our top three risks are regulatory and political risk, which at times can be very different. The third one is perhaps the most under-appreciated — obsolescence. Infrastructure investing is generally very concentrated on certain assets. The typical private equity fund can be comprised of a few very large, hard assets that can make up the bulk of the portfolio.

And when you think about rapid changes happening in the world, particularly from a technology standpoint, no one really knows how those are going affect transportation, for example, or energy transmission. We have a lot of conversations with clients about midstream energy as it relates to oil pipelines vs. solar or wind turbines.

Obsolescence can be a very large risk, and investors need to do their due diligence to understand the barriers to entry for new competitors, how these hard assets fit into an ever-evolving landscape, and what the implications are for long-term, terminal asset values.

MENDE: Issues related to currency definitely deserve greater attention when U.S. institutions go abroad with their infrastructure investments. An additional risk for infrastructure investments is leverage, as many investments carry significant leverage. Questions such as, will an investment will be able to service the debt should the economy slow down, and is there any potential refinancing risk are on people's minds.

I also remind investors that while Europe is seen as fairly stable, it is not immune to political risk. There's a well-known case in the private infrastructure world where the Spanish government retroactively changed a tariff regime, which was detrimental to owners of solar assets in Spain, and several fund managers are suing the Kingdom of Spain as a result. So even though Europe is a developed market, you still have political risk that when things get tough for governments, they could roll back existing agreements.

There can also be a question of reinvestment risk, depending on whether one is investing in closed-end or open-end fund structures. Closed-end funds generally have a higher return target than open-end funds and may focus less on current income. So first, investors need to determine their return target and then select the right fund structure for their time horizon. And second, they may need to prepare themselves for a decision about where to put that capital back to work at the end of a fund's lifespan if they elect to invest in a closed-end fund structure.

P&I: What about due diligence?

MENDE: Success is a two-edged sword. Yes, there are more opportunities, and good ones, in infrastructure. But there has been a lot of demand for those assets, particularly in regions like northern Europe that are seen as relatively safer places to put one's money. So the costs to own infrastructure there have gone up significantly.

Also, the market for infrastructure has performed well overall, so in their due diligence, investors should take special care to separate out the managers that are truly outperforming vs. the ones that have benefitted from the overall rise of the asset class.

TODD: I would encourage investors to think broadly about the myriad opportunities available. Infrastructure is evolving as an asset class, and we need to get past the idea that the U.S. municipals market is only for individual taxable investors in the U.S. In fact, it's a long-enduring, relevant, deep market that may help institutional investors address issues around quality, volatility, diversification and yield.

TURNER: The reach for yield story is still driving a lot of investor behavior, including in infrastructure investing. But generally speaking, in the equity space, companies with higher payout ratios that run higher leverage generally have weaker assets. Our view is that the spread between valuations of low- vs. high-quality companies has compressed as demand for infrastructure investments has increased.

That is an added risk to the sector long term, if we were to eventually see some type of economic correction or steadily rising rates. It's something top of mind for us — understanding valuation in the context of investors just looking to buy yield in isolation. ■

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