AN INVESTMENT FOR ALL SIZES

Investing in infrastructure is a viable option for all pension plans

By George So and Alex Jerome

In recent years, infrastructure has emerged as an attractive asset class for Canadian pension plans and endowment funds looking for long-term, stable investments with strong risk-adjusted return characteristics. Large pension plans have developed into global leaders in infrastructure investing, as they have built teams of experienced investment professionals and committed billions to the asset class. However, infrastructure investing is also a good fit for most any size of pension plan.

What Is Infrastructure?

Infrastructure generally refers to the permanent assets that a society requires to facilitate the orderly operation of its economy. Most definitions of infrastructure include assets characterized by physical bricks-and-mortar features; high and sustainable barriers to entry (monopolistic characteristics); inelastic demand attributes; relatively stable rates of return; and strong correlation with local economic drivers, including GDP, population and employment growth. Investing in infrastructure involves purchasing a direct or indirect equity or debt interest in a company that owns or operates an infrastructure asset. These investments typically offer annuity-like cash flow streams with real return characteristics and the potential for long hold periods—sometimes as long as 30 years.

As an asset class, infrastructure can be captured in four subcategories.

1. Regulated assets include electricity transmission and distribution (T&D) networks, gas T&D networks, and water distribution, collection and treatment networks. These assets are generally natural monopolies with high barriers to entry, stable demand characteristics and revenues based on an allowed rate of return as determined by a government-affiliated body.

2. Transportation assets include toll roads, tunnels and seaports. These assets have revenues based on use or availability. For example, a usage- or patronage-based toll road collects tolls from vehicles as they enter or exit the highway, while an availability-based toll road collects

INFRASTRUCTURE PORTFOLIOS OF LARGE CANADIAN PENSION PLANS

	Total AUM (billions)	Infrastructure assets (billions)	Infrastructure assets (%)
CDPQ	$159.0	$5.8	3.6%
CPPIB	$140.1	$9.5	6.8%
OTPP	$104.7	$7.1	6.8%
bcIMC	$86.9	$4.1	4.7%
AIMCo	$70.7	$1.7	2.4%
OMERS	$54.0	$8.4	15.5%

Source: Company websites and latest annual reports pre-arranged payments from a government body if certain availability or performance targets are met.

3. Contracted assets include electricity generation, midstream gas and communications networks. With contracted assets, the underlying assets may operate in a competitive environment and are subject to fluctuating market prices and volumes. However, returns on these assets are stabilized through long-term contracted rates and volumes.

4. Social infrastructure assets include physical assets associated with providing social goods, such as schools, hospitals and prisons. Revenues are contracted through the government and are based on availability or performance standards.

What Are the Risks and Opportunities?

Infrastructure investing has become increasingly popular for a variety of reasons. According to the Pension Investment Association of Canada, the amount of capital invested in infrastructure by Canadian pension plans has doubled over the past five years to $42.1 billion (as at Dec. 31, 2010). Most notably, infrastructure assets have reliable and predictable cash flow streams based on regulated or contracted revenues and exhibit monopolistic characteristics, including a captive market and high barriers to entry, with low substitution risk (limited competition).

Consequently, infrastructure investing can provide attractive risk-adjusted returns, as well as lower volatility and risk of loss compared with other asset classes. From a portfolio construction perspective, infrastructure assets have low correlation with other asset classes, including global equities and government bonds. The long-term nature of infrastructure investments is a good fit for institutions with long-term liabilities and limited liquidity requirements, such as pension plans. And the real return nature of these investments may provide a hedge against long-term inflation.

Given the benefits of investing in the asset class and the desire to limit portfolio volatility, most institutional investors have allocated or increased their allocation to infrastructure investments (typically to 10%–15%). Consequently, there has been a flood of capital to the asset class, as more and more investors attempt to get in the game.

At the same time, there has also been a significant increase in the supply of infrastructure investment opportunities. Driving this increase are trends such as pressure on governments to trim debts and budget deficits; government attempts to create jobs and stimulate stagnating economies; existing infrastructure reaching the end of its useful life; and governments' desire to transfer risks (design, construction, operations) to investors in the private sector.

The result of these confluent trends is upward pricing pressure and lower rates of investment returns. Developing a thorough understanding of the risks associated with infrastructure investing is critical in selecting the right investments or managers for your organization.

First, it's important to ensure that a particular investment opportunity matches the definition for an infrastructure asset. Certain assets—such as fibre optic cable networks and satellites—are often described as infrastructure but have volatile return characteristics and operate in competitive environments, which can be deceptive from a risk/return perspective. Furthermore, every infrastructure investment has its own unique risks that may have an adverse impact on returns. These risks include the following:

- **commodity -** uncertainty of future commodity prices due to fluctuations in market prices (natural gas);
- **pricing -** uncertainty in future electricity prices due to market fluctuations (electricity generation);
- **demand -** uncertainty of future usage (toll roads);
- **construction -** uncertainty with timing of operational launch and future use (toll roads under construction);
- **regulatory -** uncertainty regarding future pricing reviews or the risk that changes in laws or regulations will negatively affect the business;
- **technology -** uncertainty of future technological developments (communications, infrastructure); and
- **financing -** risk of default or of not being able to refinance debt at attractive rates.

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Once the investment risks are properly researched and understood, investors can more appropriately price the assets.

How Big Is the Opportunity?

Overall, the global market for infrastructure investment is enormous, with estimates as high as $20.5 trillion (including both publicly and privately held assets). The majority of infrastructure in Canada is nearing the end of its useful life and has suffered from massive underinvestment over the past 30 years. Despite their best efforts, governments at all levels lack the financial resources to pay for these upgrades. A 2007 report from the Federation of Canadian Municipalities estimates Canada's infrastructure deficit at $123 billion, which greatly exceeds the $33 billion earmarked in the 2007 federal budget for the government's *Building Canada* infrastructure plan. This presents a tremendous opportunity for private sector investment to help fill the gap.

In recent years, the public/private partnership (P3)—which originated in Australia in the early '90s—has become a popular funding model for infrastructure projects for increasingly cash-strapped governments. P3s are contracts between government and private sector entities for the provision of assets and the delivery of services that allocate responsibilities and business risks among the various partners. Typically, the private sector is responsible for the more commercial functions, including design, construction, financing and operations. The Canadian P3 market is maturing, as a number of early P3 projects have now been successfully completed and are in operation, such as Highway 407 in Ontario. Now that the model has been proven, interest in using it has spread across the country.

How Can I Access This Sector?

The appropriate strategy will depend on your organization's size, available internal resources and level of experience with the sector. The easiest way for an organization to start an infrastructure investing program is to invest with external investment managers through vehicles such as open-ended mutual funds or closed-ended infrastructure funds (public or private). This strategy will allow your organization to learn about the industry from world-class investors and limit the concentration risk (when too much capital is allocated to too few investments). Fund investing is also an attractive option for organizations that cannot dedicate the internal resources necessary to source, evaluate, structure and actively manage direct investments.

Once your organization has sufficient resources dedicated to its infrastructure investment program, a direct approach can provide more discretion over the allocation of capital and will help to lower the costs and fees associated with external investment managers. For smaller plans, direct investing opportunities come in two forms: co-investments and syndication investments. (A syndicated co-investment occurs when the lead investor sells part of an investment to smaller investors after the transaction is complete.) Direct investing will allow your organization to make more concentrated investments in individual assets and will provide the option to hold investments beyond the typical fund life, reducing the expenses associated with recycling investment capital. At the same time, a direct investment strategy is much more time-consuming and will require more internal resources to execute transactions and effectively monitor the investments.

Infrastructure investing is accessible to pension plans of all sizes. There are products in the market to fit any investment strategy or objective—whether the focus is equity or debt investing, country- or geography-specific, asset type-specific, or yield- or total return-driven. Despite the concerns and risks, infrastructure remains a compelling asset class as a means of achieving strong risk-adjusted returns.

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