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Asset Class Focus: Infrastructure

As Institutions Climb Infra Learning Curve Their Appetite Grows

Infrastructure investments provide institutional investors attractive diversification benefits, while keeping risk exposure low. Making a case for the asset class is **Diego Liechti**, senior investment consultant at **PPCmetrics** in Zurich. He sat down recently for a discussion with Reporter **Charlene Winkel** in which he commented on the current demand for and investment routes to the infrastructure class. He also highlighted the risks associated with infrastructure of which investors should be aware.

Diego Liechti

Assessing the current demand, Liechti noted that generally speaking European pension schemes are very interested in infrastructure. They are still a long way from actually investing, however.

"Swiss pension schemes, for instance, are more cautious when it comes to alternative investments, for example, due to the problems they had with other alternative assets, especially hedge funds, or the recent cost transparency requirements," he explained. "The experience with hedge funds, particularly, was not helpful due to their failed promises of absolute return and of high level of liquidity during the financial crisis," he continued. Potential investors might be reluctant to bet on infrastructure because they have to publish the total expense ratio in their annual financial statement due to transparency requirements introduced by the supervisory commission for occupational pensions in Switzerland, **Oberaufsichtskommission Berufliche Vorsorge** (OBV), last year.

Liechti emphasized that infrastructure is still quite new to many Swiss and other European investors, with many institutions keen to be educated about the asset class by attending seminars, seeking knowledge from asset managers, or through information exchanges with peers. "It takes time, sometimes years, until investors have informed themselves enough to take the next step and actually invest," he said.

The EUR1.15 billion Porrentruy-based **Caisse de Pensions de la Republique et Canton du Jura**, for example, first expressed an interest in infrastructure at the beginning of last year, following the dissolution of its hedge funds portfolio. Consequently, consultant **Complementa Investment-Controlling** shortlisted a manager pool, composed of three firms, from which the scheme planned to select one firm by the end of the year. Pension Fund Manager **Christian Affolter** said the process is taking longer than expected, however, especially since three new members joined the fund's investment committee last year. Those members have to become more familiar with the asset class, Affolter said (*iiSEARCHES*, 11/03).

While some investors are exploring new territory, some are more experienced. These investors allocate 1-5% to the asset class. Liechti noted though that the lack of available historical performance data on the class represents an investment hurdle to inexperienced investors. "Unlike the case for equities and bonds, there is hardly any recorded data on how well infrastructure has performed in the past. The best sources are Australian and Canadian pension schemes, which have experience in infrastructure investing and have gathered data. But this data is biased as it only covers a very small area of the market," he explained.

A Driving Force

Liechti believes that growing infrastructure offerings have done their part in attracting interest. "There has been a push from the asset management industry, which has been heavily promoting infrastructure in Europe, and particularly in Switzerland. Previously, investors had to search for infrastructure products, which back then were mainly offered by Australian and North American providers," he said, adding that increasingly European players have entered the infrastructure market, such as larger private equity firms **Partners Group**, **Ardian**, and **Deutsche Bank**.

Additionally, returns of up to 5% are luring investors. "A conservative portfolio, composed of infrastructure debt and primarily brownfield [investments], can return 2.5% in addition to the risk-free rate, while the equity of infrastructure brownfield projects can generate a 3.5% risk premium," Liechti estimated. "But if you invest in infrastructure equity and mainly greenfield projects, an assumption of a risk premium of 4-5% is reasonable," he said.

Access Routes

Whereas one to two years ago investments in the asset class where mainly made in equity, a shift towards debt has taken place of late, again driven by low interest rates. "Investors are searching for alternatives to bonds without increasing their risk exposure," Liechti said. "If investors have a mixed portfolio made up of equities, fixed income and infrastructure debt, the equity quota does not need to be dropped as much as when infrastructure equity is added to the mix in order to maintain the same risk level," he argued.

Liechti believes that because investors require a large amount of assets and specific knowledge—which a typical pension fund does not possess—to achieve "decent diversification," the easiest way to invest in infrastructure is via funds.

Be Mindful

Though infrastructure represents an attractive way to boost returns, Liechti said it does not come without risks. "A typical risk is the degree of debt financing of the projects and consequently the products. In addition, investors have to bear in mind potential leverage at the fund level as well as market efficiency—not only a large supply for infrastructure projects, but also increasing demand," he stated.

Furthermore, investors face political risk because infrastructure projects are often of value to the public. "That means that politics can intervene and change the nature of the investment," Liechti said. He noted that greenfield investors, in particular, always face construction risk because finished projects sometimes do not see commercial uptake upon completion. Other risks include regulatory risk, environmental and systematic risk.

A new, more recent, risk investors should bear in mind is fiscal risk, especially when allocating across the U.S., according to Liechti. With investors primarily investing through single funds, i.e. funds that invest directly in companies or projects, investors should clarify legally that these investments do not have any fiscal consequences for them if these companies or projects are U.S.-based, he warned. "In a worst case scenario, the investor could be subject to taxation in the U.S. because they are invested in U.S. companies," he explained. "At the moment, we regard the fiscal situation as very critical and investors should certainly inform themselves properly before making [any] infrastructure investments."

Comparing the risk of infrastructure debt versus equity, Liechti noted that it is similar to public equity and corporate bonds, i.e., debt is less risky than equity. "This is especially the case for infrastructure debt due to more covenants and collateral that historically leads to higher recovery rates and bankruptcy rates compared to typical corporate bonds," he said.

Impact On Strategy

Infrastructure could be considered a subset of private equity, according to Liechti. Hence, if an investor is already highly invested in private equity, an additional infrastructure allocation will not be a big game changer. If only a small portion is allocated to private equity, however, then additional infrastructure investments could increase yields with little impact on the risk exposure, he concluded.

—***Charlene Winkel***