How Private Investors Can Narrow the Global Infrastructure Gap

Governments have been unable to address infrastructure shortfalls. Private investors can help fill the gap.

Chronic underinvestment in global infrastructure has been a consistent headache for policymakers for decades. A 2016 McKinsey **study** placed the gap in infrastructure spending at $800 billion annually through 2030. One solution suggested by the study? Tap the $120 trillion of assets managed by banks and institutional investors.

With purported stable, long-term cash flows, infrastructure projects align well with the typical demands of large financial investors. Industry giants such as Brookfield have been in this space for a long time and make the case. Blackstone's recently unveiled $40 billion infrastructure fund along with Brookfield and Global Infrastructure Partners funds that closed in excess of $15 billion suggest there is strong demand, and the funds' ability to leverage those amounts with debt financing underscores their real impact.

Core characteristics of the asset class

The growing demands placed on the world's infrastructure have been exacerbated by population growth, increased urbanisation, a transition to low-carbon economies and national budget constraints. These structural shifts and the consistent return profile of mature infrastructure projects have helped propel infrastructure to a viable, long-term asset class with a unique role in an institutional investor's portfolio.

The stable return profile and low correlation to traditional asset classes offered by infrastructure are driven by the following core characteristics:

- **Provision of essential services resilient to the economic cycle:** Infrastructure assets generally serve as the backbone for basic, irreplaceable public services such as road networks, airports and power lines. As such, essential infrastructure assets benefit from relatively inelastic demand, relative to debt and equity capital markets.
- **High barriers to entry:** Assets usually enjoy some form of monopolistic market positioning through regulations, concessions or capital constraints, or through other characteristics that would make a similar investment unreasonable or uneconomical.
- **Predictable and resilient long-term cash flows:** Infrastructure assets are long-life assets. The regulatory framework, concessions or contracts under which services are provided typically run for 15 to 20 years, sometimes for more than 40 years, with pricing provisions that provide a predictable return over time.
- **Inflation-linked revenues:** Cash flows produced by infrastructure assets are

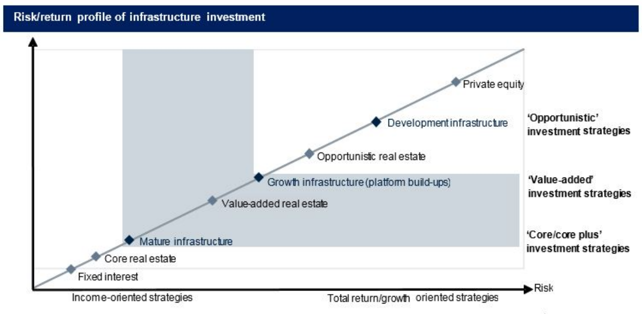
commonly linked to measures of economic growth such as gross domestic product or inflation. In some cases, revenue increases due to inflation are embedded in concession agreements, licenses and contracts.

- **Predictable operations and maintenance capital requirements:** The nature of infrastructure assets is such that they are generally highly capital-intensive with relatively predictable operating and maintenance expenses.

These general characteristics of infrastructure hold true across its wide array of underlying industries, be it energy infrastructure, transport infrastructure, telecom infrastructure or social infrastructure.

Risk/return – Infrastructure in an investor's portfolio

As an asset class, infrastructure investments provide a risk/return profile that spans between core real estate and private equity investments. While infrastructure assets share the characteristics listed above, there is significant variability in the risk/return profiles of assets at different stages of development. Add the specific attributes of the target country, market segment and asset dynamics, and the risk/return permutations are endless.



For illustrative purposes only: There can be no assurance that the above targets will be achieved.

Equity investment into infrastructure projects can fall into three main investment strategies: core/core plus, value-added and opportunistic. Different investment strategies within the infrastructure space have different risk/return profiles and are suitable for investors with different risk appetites and return expectations.

Core/core plus strategies, such as public-private partnerships (PPPs) have the potential to provide stable long-term returns, while growth and development infrastructure typically offer significant capital appreciation potential. For example, an investment in a **brownfield**, regulated infrastructure asset – such as a regulated electricity transmission network focused on yield – is supported by a detailed regulatory or contractual framework with explicit revenue-inflation linkage. The high predictability of returns from this type of asset typically comes part and parcel with limited capital appreciation potential.

Investing in a **value-added** strategy such as a greenfield PPP project can involve additional risks, but also offers additional capital appreciation potential. As an example of growth infrastructure opportunity, we have seen many independent power producers (IPPs) successfully built-out in recent years. These IPPs tend to have seed assets with contracted cash flows that support the expansion into new geographies and, potentially, new technologies.

The telecom tower business is another underlying segment that has been successfully replicated over different geographies. The quality and volume of underlying contracted assets in telecom tower businesses make it an attractive sector for a platform play. Similar to an IPP model, the risk and considerations are naturally country- and location-specific, yet the economic models and key value drivers are similar.

Opportunistic investments and **value-added** infrastructure strategies have similar risk profiles but have at least one risk factor that makes a project's return profile more uncertain.

Returns for all lifecycle investments can be de-risked and/or enhanced by the specialist skills of professional infrastructure investment managers, particularly those supported by asset management teams. Infrastructure provides managers with an active and strategic opportunity to add value directly to an investment and increase returns. Applied effectively, active asset management can, amongst other things, help boost user volumes and revenues, cut costs and optimise capital structures and cash flow, enhancing returns over and above the cost of active management.

The key risks, return drivers and return expectations of these three investment strategies – along with the characteristics of fixed interest/junior debt – are summarised in the table below.

	Junior debt	Core equity	Core + equity	Value-added equity	Opportunistic equity
Key risks	Market risk, operating assumptions, strategy implementation	Operating assumptions, leverage levels, regulatory risk	Operating assumptions, leverage levels, regulatory risk, construction	Political, ,market, operating contracts, strategy implementation, construction, currency and/or hedging risks, other	Political, market, operating contracts, strategy implementation, construction, currency and/or hedging risks, other
Contracted revenues	No	Yes	Yes	In some cases	In some cases
Operating asset (w/ cash flows)	N/A	Yes	In some cases	In some cases	In some cases
Main return driver	Mostly income	Mostly income	Income and appreciation	Income and appreciation	Mostly capital appreciation
Returns assumptions	5.5-9%	5-8%	8-12%	11-14%	>14%

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An investor's risk appetite, knowledge of different segments, investment horizon and deployable funds are key considerations that dictate either a broad allocation policy (typical for large institutional clients) or focus on specific deals in a single segment (value-add fund manager or family office).

The way forward

The demand for infrastructure is not expected to soften any time soon. The short to medium-term outlook for infrastructure investing is positive due to a wall of capital chasing investible assets and the pursuit of yields in the current low-interest-rate environment. The high multiples seen for infrastructure assets and companies in 2016 are likely to persist in 2017, supported by a huge amount of bank liquidity.

While the ability of policymakers to plug the global infrastructure gap remains an open question, the attractiveness of the infrastructure asset class for institutional investors seems less controversial. Big-ticket investors, including infrastructure funds and major institutional investors now going direct, are looking to deploy large amounts of capital in brownfield assets in developed markets. Opportunities in greenfield assets presented by the infrastructure gap, particularly in emerging markets, may attract investors seeking more attractive yield and capital appreciation, yet global political uncertainty will enable only the best projects to reach a close.

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