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Equity infrastructure: decorrelated, long-term income

Allocations to infrastructure assets are rising fast, so specialist skills are required to maintain outperformance and manage risk.

Key takeaways:

- Competition for infrastructure assets has pushed up prices. But untapped value lies in a longer-term approach, combined with a focus on mid-market projects.
- Only an asset manager with an innovative, hands-on approach can structure complex projects and realise maximum value with minimum risk.
- Demand for specialist infrastructure is strong among European institutional investors, and is gaining strength in the US and Asia for diversification purposes. It is also attractive for insurers given the low capital charge under SII.

Investors everywhere are talking about infrastructure. Amid low yields and elevated geopolitical and market uncertainty, institutional investors are increasingly drawn to the historically higher returns and relative predictability of infrastructure.

They are attracted to the historically stable, long-term income streams. They also like a risk profile which is relatively low due to the decorrelation of infrastructure assets and traditional asset classes, such as equities and fixed-income. Last, but not least, they are often enthusiastic about investing in tangible assets, which also have economic and society utility. These assets are as diverse as transport, schools, universities, hospitals, stadia, swimming pools and digital technology.

The only problem is that many investors have now recognised these attributes and infrastructure assets have become considerably more expensive. This means different ways of investing in infrastructure must be adopted to maintain the strong returns seen from the asset class in the past.

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Strong appetite bids up prices

A first step for many investors seeking increased yield has been to allocate to infrastructure debt. However, where once infrastructure debt provided significantly higher returns to low-yielding traditional bonds, high investor demand means these excess returns have shown signs of eroding.

Some investors have therefore turned to infrastructure equity to seek increased returns. Infrastructure equity still has bond-like characteristics, in

that it is considerably less volatile and returns are more predictable than publicly-traded equities. But in infrastructure equity too, rising investor appetite has meant demand has started to outstrip supply, creating intense competition for assets and pushing up pricing. In particular, institutional investors have been willing to pay sizeable premiums to deploy large amounts of capital in infrastructure projects, meaning yields are low on these types of investments.

While there is undoubtedly still value to be obtained through infrastructure investment, the critical question for investors is where to find this value and how to extract it.

We believe considerable untapped value lies in a longer-term approach than that taken by the majority of investors. We combine this long-term approach with a focus on mid-market projects, which are less favoured because of the substantial investment resources and skills that are required to structure transactions and extract value. Many fund managers and institutional investors target big ticket projects, leaving value behind in smaller, but no less attractive, assets.

Investing for the long term

Our preferred approach relies principally on investing in core infrastructure. There are essentially two approaches to investing in equity infrastructure - core and value-added.

Core infrastructure investments are largely long-term, buy-and-hold assets, with performance driven by regular cashflows. The performance of value-added infrastructure on the other hand is similar to private equity and driven by capital gains and valuation of projects. While we focus primarily on core infrastructure, we also selectively incorporate value-added in our investments.

Why do we allocate principally to core? We see a long-term approach as a key differentiating factor in an increasingly crowded infrastructure market. Our philosophy is to operate public assets, which are essential to local communities, over the very long term. Most infrastructure funds have a 10-15 year time horizon with an exit strategy oriented to capital gains, while we have a buy-and- hold approach over 25 years, which matches the maturity of the underlying assets in which we invest . The strategy is designed to maximise yield and, at the same time, provide long-term support to communities.

A long-term buy-and-hold strategy may also reduce infrastructure investment risk. First, buying and selling assets regularly can expose investors to price and interest rate volatility. Second, long-term core assets offer investors security, because they are sourced from financially-stable governments and local authorities through public-private partnerships (PPP), and provide long-term yields.

Examples of the investments we make include essential community services such as universities, where rent is paid over very long-term periods by the state or a region. Other assets include transportation, including high speed railway lines, light-rail, highways, car parks and telecoms projects such as broadband networks and fibre to the home. Other PPP projects include social infrastructure such as, administrative buildings, defence projects such as prisons, and leisure facilities, such as zoos and sports stadia.

A multi-strategy approach

Our core infrastructure approach is applied to both greenfield and brownfield investments in Europe.

Greenfield investment means structuring projects from inception, monitoring them from commissioning through to building. Brownfield investments, on the other hand, are assets that have already been built and used, but which are then generally sold by their original owners, who wish to recycle the proceeds for further projects. In contrast, we retain the assets until the end of their life-cycle.

From an investment viewpoint, the essential difference is that greenfield infrastructure takes time to produce returns, although returns will be higher over the longer term. Brownfield infrastructure, on the other hand, usually produces returns from Day 1, making it a good fit for core infrastructure funds primarily seeking income.

Mirova's approach is unique in that it has the skills to manage both greenfield and brownfield infrastructure investments, thus achieving a mixture of possible return streams.

TRAMWAY PROJECT: THE MALAGA METRO

The Malaga Metro is a typical Mirova mid-market, long-term investment. Supported by the European Investment Bank, the asset comprises a light-metro network with two lines and 17 stations. It began operating in 2014.

The revenue stream for Mirova is hybrid: half of the payments come from the Malaga public authority and the other half from commuter demand. It scores highly in terms of ESG[2] performance, given its strong public utility and low carbon emissions.

Mirova has a 24.7% share of the asset, providing it with a target net yield of 12.7%[1].

However, not all investors possess the skills to manage assets over the longer term. As an asset manager dedicated to responsible investing, Mirova always focuses on the long term and on sustainable factors that can have a significant impact on returns from investments.

Avoiding the crush in the midmarket

The other key plank of Mirova's strategy, which is complementary to the buy-and-hold approach, is a focus on mid-market infrastructure assets. A portfolio of smaller assets requires more investment resources, so this segment is less attractive to the broader market. As a result, there is less demand for smaller assets and the segment has not suffered from the strong increase in pricing, as seen in larger infrastructure assets.

The resources required in the mid-market are substantial - Mirova's infrastructure team is comprised of 17 investment and asset management specialists, and 30 in total, including infrastructure support functions.
To find and access mid-market projects, it is essential to be pro-active, forming and maintaining relationships with industrials, financial organisations, advisers and, particularly, public entities. In addition, the assets themselves frequently require complex structuring and negotiations can be complicated too.

And the story does not end when a deal is struck. Mid-market success also depends on taking responsibility for what has been negotiated, including taking seats on the boards of the project companies. Monitoring and active management is essential for extracting long term value, obtaining and deploying ESG data, and having a beneficial impact on investor portfolios and local communities alike.

The skills required typically fall into three camps: financial, legal and industrial. Industrial skills and experience are a clear advantage when negotiating with industrial firms, while financial advisers are adept at finding and implementing solutions. Legal experience is key to negotiating contracts, since the bulk of our transactions are predicated on contractual negotiations.

The combination of the three sets of skills allows for innovative and robust structures and, thereby, access to the possibility of better returns.

Aiming to maximise yield and minimise risk

The expected yields on infrastructure investments are considerably higher than for traditional bonds, primarily because returns are based on an illiquidity and project premium.
In Europe, for pure brownfield investments, yields for investors are around 7%-8%[1-3], while for greenfield investments the yield is 10%-12%[1-3]. However, greenfield investments are impacted by the "J-Curve", whereby initial costs reduce returns in the early years of the investment.

Overall, target yields from Mirova funds are in the region of 8%-9% over 25 years for long-term core investments[4].
This compares to current yields of around 1% for core European sovereign bonds and 2.5%-3.5% on senior secured debt.

Of course, like all investment strategies, infrastructure is not without risk. Given the long-term nature of the investments, It is critical to monitor regulatory risk and only invest in countries with a proven legal framework, to which all investors have recourse.

Contracts are a key pressure point too. The health of the industrial company operating the asset is critical to ongoing returns. Industrial contracts should allow for a remedy if the existing company is performing poorly or mismanaging the asset.

Depending on the type of project, there may also be volume risk. For instance, the income generated by an asset such as a train line or motorway, is partly dependent on usage. It is relatively easy to model usage for brownfield sites using historical data and simple macro-economic correlations. For a greenfield project, however, long-term forecasts of future traffic are less reliable.

How infrastructure may boost your portfolio

Equity infrastructure can help long-term investors, such as insurers and pension funds, to match their liabilities. Expected higher yields on debt and equity infrastructure may replace or complement the bond portfolio, where yields may be too low to match liabilities, and in which risks are rising. Infrastructure can also form part of the alternatives portion of the portfolio, given its low correlation to traditional assets and illiquid nature.

It is particularly attractive for insurance companies for whom the capital charge, under the Solvency II Directive, is lower - the Solvency Capital Requirement (SCR) is just 30% compared with 49% for most private equity investments.

This means there is particularly strong appetite from European institutional investors, but demand for specialist infrastructure strategies is also gaining strength in the US and Asia, where investors are increasingly seeking to diversify their portfolios. Investors in Australia and Canada, home to large and sophisticated pension schemes, have made allocations to the strategy for a considerable time.

Is this the right time for infrastructure?

There is clearly plenty of appetite for infrastructure given the historically long-term yields and diversification benefits, but is the supply of assets as buoyant? Mirova's long-term, mid-market strategy relies on brownfield assets continually coming on stream, offering a diverse range of assets with different diversification and return potential.

Indeed, a substantial brownfield opportunity is emerging. A large number of greenfield projects were launched around a decade ago, many supported by the European Union and the European Investment Bank. Many of these are now being recycled as brownfield investments, as their owners look to reinvest in new projects. In some cases, given the deterioration of the continental European economy since the mid-2000s, the owners have become distressed sellers or require liquidity to develop their businesses, and are willing to sell assets.

The pool of continental European PPP is large, numbering 587 projects with a total value of €183bn completed since 2005. Dealflow was sizeable in 2016 and is likely to be as buoyant for at least the next three to four years.

The potential for dealflow also reflects the relative immaturity of infrastructure markets. Early fund vintages are only now starting to recycle their assets. With interest rates low and prices high, many of these funds see an opportunity to sell existing assets and realise gains for their investors.

As for the long-term future, the signs are equally promising: 134 new greenfield projects have been launched, with a value of €45.9bn, since 2014. These projects may, in time, become attractive brownfield opportunities.

And let's not forget that the new US administration has signalled a willingness to invest heavily in infrastructure, even if the timing and extent of the proposed program is as yet unknown.

Conclusion – be hands-on, be innovative

In the current low interest rate environment, funds investing in infrastructure equity may access stable and healthy yields compared to traditional equity and fixed-income asset classes.

Value can best be extracted through accessing smaller assets with great long-term potential. Investors need sizeable skills for this: Mirova, which created the first brownfield continuation infrastructure fund dedicated to continental Europe, has the proven expertise and human resources to succeed in this space. Many of our deals are bespoke and our innovative, hands-on approach is essential for structuring complex projects and realising maximum value with minimum risk.

[1] The figures provided relate to previous years and past performance is no indicator of future performance.
[2] Environment, Social and Governance
[3] Source: Mirova, InfraDeals 2016
[4] Targets yields do not provide a guarantee of future performance.

Written on 28 February 2017

Past performance is no guarantee of future results.

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